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MALAYSIAN RATING CORPORATION BERHAD
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Pre-Budget 2013: Aiming for More Balanced and Quality Growth

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In a nutshell

- Budget 2013 will be tabled at a time when the Malaysian economy is challenged by a weak external sector emanating from multiple headwinds ranging from the ongoing debt problem in Europe to the wobbly labour market conditions in the United States (US) and slowing growth in Asia's major economies such as China and India. On the domestic front, the economy seems to have cruised along relatively well, judging by the strong growth performance in 1H2012. Notwithstanding this, the impact of global economic weaknesses on the domestic economy has yet to be seen in 2H2012. Overall, we think that the growth of Malaysia's gross domestic product (GDP) for 2012 will tilt towards the upper range of our forecast of between 4.8%-5.2%. At the same time, we feel that the prospects for 2013 are more encouraging as the US economy continues to expand steadily despite the hiccups in the labour market. The bottoming of Asian economic giants such as India and China will also mean that we are close to the cyclical trough, if not past it. As such, Malaysian GDP growth will likely rebound to the 5.0% - 5.5% range in 2013.
- Some of the pertinent issues that the government will seek to address in Budget 2013 will include: (1) low disposable income due to low wages and narrow personal income tax band; (2) rising cost of living due to persistent increases in housing and consumer prices; (3) unfavourable government financial position due to the narrow tax base and growing operating expenditures; (4) lack of long-term savings and financial safety nets for the *rakyat.* While some of these concerns are currently being addressed by the government, we are of the view that more measures should be undertaken to ensure that the *rakyat* can cope with the rising cost of living and at the same time remove some imbalances that can affect the economy's long-term capacity. Issues on raising the economy to a higher plane to effectively compete in the global arena through greater innovation will likely be addressed.
- On the issue of preventing the erosion of disposable incomes, we still hold the view that we voiced out in our Pre-Budget 2010 published in 2009 that a more favourable personal income tax structure is needed to ensure that Malaysian workers will not be pushed into higher income tax brackets until they see substantial increases in their incomes. The narrowness of Malaysia's income tax band is clearly visible when a comparison with the personal income tax structure in other countries like Singapore is made. We wish to re-iterate our view that a revamp in the structure will not only make a difference in terms of the disposable incomes of the *rakyat* but also serve as an incentive for Malaysian workers not to seek job opportunities in other countries. As such, the problem of brain drain can be partially alleviated.
- At the same time, we think that certain forms of tax relief are due for upward revision as the cost of living has increased significantly since the last time they were reviewed. These include, amongst others, the relief for children which is currently at RM1,000 per child, and for those with children pursuing higher education which is presently at RM4,000 per child for the diploma level and above. This is in view of the 13% increase in education costs (based on its component in the Consumer Price Index, or CPI) since the last time the government reviewed it. We also wish to re-iterate our view that we voiced out in our Pre-Budget 2010 that a separate relief for the contributions to the Employees Provident Fund (EPF) and life insurance should be provided in view of the two-fold benefits of increasing disposable incomes and encouraging the purchases of life insurance.
- In terms of providing safety nets to the *rakyat*, we have also voiced out our view that the government should consider allowing withdrawals from the EPF to purchase medical insurance as this will help reduce the *rakyat's* burden of high medical costs during their golden years. Logically speaking, if the government allows EPF withdrawals for investment in unit trusts, we do not see any compelling reason why withdrawals should not be allowed for the purpose of purchasing medical insurance which will undoubtedly benefit the *rakyat* in their future years. In addition, many medical coverage plans have investment elements attached to them (investment-linked insurance) which will provide returns to policyholders. Encouraging the *rakyat* to have some form of medical coverage will also lessen the government's burden on medical expenditures going forward.
- On the property sector, while we do not think that a property bubble exists in Malaysia, we are concerned about the sharp increases in property prices, especially in certain regions such as the Klang Valley, Penang and Negeri Sembilan. We are also of the opinion that the persistent rise in house prices has to be dealt with through more meaningful measures in order to enable a typical Malaysian to own a home. The current tax measures are too mild in our view and judging by the trend in house prices, we think that more measures

are needed to curb investors from speculative activities in the property market. Measures such as higher Real Property Gains Tax (RPGT) and limiting sales to group buyers may not be popular but will help temper speculative activities and slow the upward momentum in house prices. In addition, disallowing foreign buyers to purchase landed properties or raising the price limit of landed properties that can be sold to foreigners should be considered, especially in view of the fact that Malaysia is one of the few countries in the region that allow landed properties to be sold to foreign buyers. Countries such as Singapore, Thailand and the Philippines generally do not allow foreign purchases of landed properties. We applaud the government for implementing various programmes such as My First Home Scheme (SRP), 1Malaysia People-Friendly Home (RMR1M) and 1Malaysia Housing Programme (PR1MA) that will help increase home ownership among the *rakyat*. However, we think that there is a need to speed up such programmes as this will help lessen the burden on the *rakyat* and alleviate future imbalances in the property market.

- To help alleviate pressure on the fiscal position, we think that the government should consider speeding up the implementation of the Goods and Services Tax (GST) no matter how unpopular it may be. We understand the difficulty in implementing such an unpopular measure. And due to the possible adverse repercussions of GST on consumer prices, we think that proper measures need to be put in place to prevent excessive manipulation by traders. As we mentioned in our previous reports, the enforcement of the Price Control and Anti-Profiteering Act 2011 can somewhat deter such practices. Similarly, another unpopular measure – subsidy rationalisation – should continue to be pursued. Again, in view of its unpopularity, such efforts should be introduced through proper channels to ensure minimum dissatisfaction among the *rakyat.* Transparency in terms of the exact use of the proceeds from subsidy reductions will be key to the success of such efforts.
- We also voiced our opinion in the Second Half 2012 Outlook report that the government may wish to consider utilising a portion of the additional revenue gained above the budgeted level to help ease the pressure on the government coffers. Malaysia has persistently received more revenue than projected in the past years except for the years when the economy was in recession. For instance, in the past ten years (save for the recessionary years), Malaysia collected RM82.6 billion more revenue than projected. This is an important source of income that can be utilised to partly reduce the country's budget deficits. We are also concerned that the persistent underestimation of revenue may lead to over-spending, especially when the actual receipts overshoot the projections by a large amount. One other option to boost revenue that the government can pursue is to reduce transfer pricing abuses that may be practiced by some corporations to limit their tax liabilities in Malaysia. By creative pricing of export and import invoices, companies can effectively choose the tax jurisdiction of their choice, thus reducing the tax and duties that the government can collect. The problem can be significant given the large disparities in trade values reported by Malaysia and our trade partners.
- To encourage the *rakyat* to increase their long-term investments and acquire financial safety nets, the government may wish to consider imposing a small amount of capital gains tax on investments in financial instruments that are held for less than a certain period of time (e.g. one year). Currently, most short-term investors are not subjected to any taxes while long-term investors are taxed on their dividends. While the sentiment in the financial market may be temporarily affected by such measures, in the long term we believe that financial market players will base their investment decisions on the fundamentals and prospects of the market and the economy rather quibble over the minimum amount taxes they need to pay. In the West, capital gains tax are normally imposed on gains in financial instruments irrespective with the holding period, while for Japan and India, capital gains tax are assessed on gains from securities that are held for less than a certain period.
- To reduce the possibility of significant capital outflows from Malaysian shores, we are of the view that the government should consider imposing a small withholding tax on the sales of government bonds that are held for less than a certain period of time (e.g. one year). Such withholding taxes are imposed by countries such as Indonesia, Thailand and South Korea to prevent rapid build-ups in foreign purchases of sovereign bonds that may destabilise the financial market if they exit in a big way. While there are fears that this may harm market sentiment and liquidity, this measure should only deter “hot” money flows without penalising legitimate long-term investors. An example can be seen from the continued inflows of capital into the Indonesian sovereign bond market despite the withholding tax imposed by the authority.

Economic climate surrounding Budget 2013

Budget 2013 will be tabled at a time when the global economy is facing multiple headwinds ranging from the ongoing debt problem in Europe to the wobbly labour market conditions in the US and slowing growth in Asia's major economies such as China and India. The anxiety over this confluence of factors is evidenced in the recent outlook from the International Monetary Fund (IMF) which recently downgraded its global economic growth forecast in 2013 to 3.9% from 4.1% previously. There were notable downgrades of many European countries which are reeling from deep austerity measures imposed with the intention of trimming their budget deficits and debt levels.

For the Malaysian economy, challenges come mainly from the weak external sector as a result of waning demand from advanced economies and China's slowing appetite for the country's exports. The declining strength in the external sector is evidenced by the anemic 2.1% expansion in real exports in the recent quarter (2Q2012), compared to the 21.2% expansion during the cyclical peak in 2010, despite the surprising strength in the overall economy as reflected in the stronger GDP growth of 5.4% year-on-year (y-o-y) in 2Q2012. The more worrying factor is the possible repercussions of slowing export performance on the domestic economy which may, in the worst case scenario, weaken the labour market and ultimately affect private consumption, the primary growth engine for the Malaysian economy.

From the point of view of the *rakyat*, low disposable incomes and rising costs of living are still their main concerns, which if left unaddressed will breed unfavourable economic and social hazards such as rising crime rates and declining quality of life. This is compounded by the fact that rising food prices as a result of unfavourable weather conditions in the US and other countries are expected to trigger another round of food inflation and prevent the government from speeding up its subsidy rationalisation programmes in order to minimise the burden on the *rakyat.*

Addressing other macroeconomic imbalances such as the overstretched household sector, rising government operating expenditure and insufficient innovative capacity and competitiveness will also be challenging at a time when the global economy remains fragile. The need to prevent another round of economic downturn will mean that the government will not push for fiscal consolidation too aggressively in the near term, something that we feel is the right policy choice at this juncture. Notwithstanding this, we are of the view that the government is on track to achieve the targeted deficit level of 3.0% of GDP by 2015 following stronger-than-expected growth in revenue.

Critical issues facing the *rakyat* and government

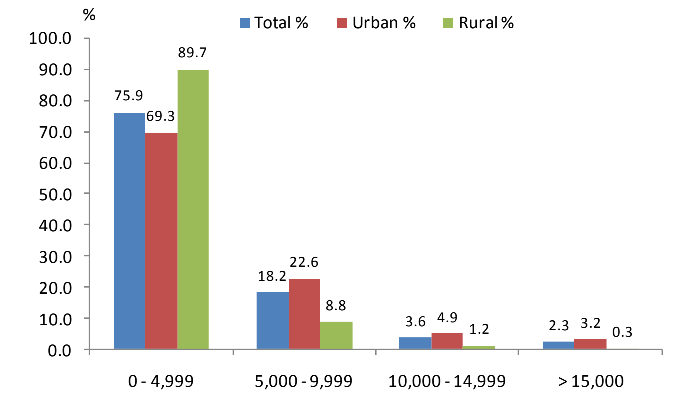
- ***Limited disposable income***

The limited amount of disposable income for certain groups of the population has become one of the major concerns among Malaysian workers. The situation is compounded by the country's narrow income tax structure which we believe tends to quickly push workers into higher income tax brackets when their incomes start to rise.

It is also worth mentioning that Malaysian workers start to pay income taxes when their annual chargeable incomes are above RM2,500 per annum, which is low by most standards. However, we do note that this is somewhat being offset by higher tax reliefs compared with other countries. For comparison, in Singapore, only those with chargeable income above SGD20,000 per annum will be taxed.

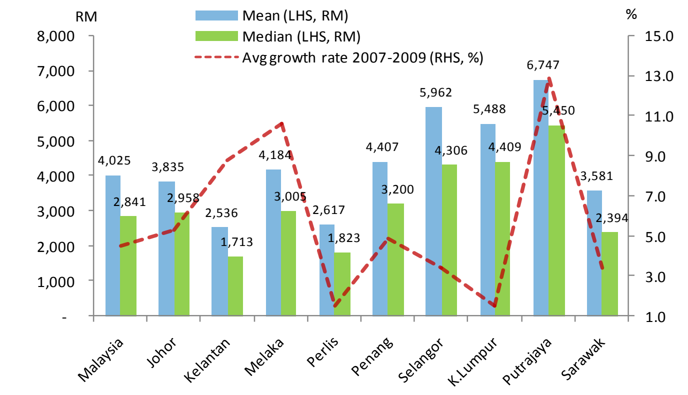
In Malaysia, about 76% of households earned below RM5,000 per month (less than RM60,000 per annum), according to the Household Income and Basic Amenities Survey Report 2009. However, income tax rates for Malaysians whose chargeable income of circa RM60,000 per annum are as high 19%, relatively hefty for those with this amount of income. This is in contrast Singapore which imposes a maximum income tax rate of 7% for those with chargeable incomes of less than SGD80,000. The highest tax rate (which is currently at 26%) is imposed on those whose chargeable income is above RM100,000 per annum. In Singapore, only those whose chargeable incomes are above SGD320,000 per annum fall in the top tax bracket.

Chart 1: Share of distribution of income quartile by location



Source: DOS, MARC Economic Research.

Chart 2: Monthly household income – mean, median and growth



Source: DOS, MARC Economic Research.

Table 1: Malaysia & Singapore's personal income tax bands

Malaysia		Singapore	
Chargeable Income (RM)	Rate (%)	Chargeable Income (SGD)	Rate (%)
0-2500	0.0	0-20,000	0.0
2,501-5,000	1.0	20,001-30,000	2.0
5,001-10,000	3.0	30,001-40,000	3.5
10,001-20,000	3.0	40,001-80,000	7.0
20,001-35,000	7.0	80,001-120,000	11.5
35,001-50,000	12.0	120,001-160,000	15.0
50,001-70,000	19.0	160,001-200,000	17.0
70,001-100,000	24.0	200,001-320,000	18.0
> 100,000	26.0	> 320,000	20.0

Source: IRB, IRAS.

- ***Rising cost of living***

The rising cost of housing has been one of the primary concerns commonly discussed in the past few years. Based on Malaysia's house price index, home prices have escalated by 31.2% since 2006. In Kuala Lumpur for instance, (save for the recessionary year) prices have increased by an average of 8.4% per annum in the past five years while for Selangor, the average price has surged by 5.7% per annum within the same period. In the 4Q2011 alone, prices have jumped by 10.0% y-o-y before tapering off in the subsequent periods. These are the average increases. It is common to see house prices escalated by more than this.

To be fair, the government has responded positively by introducing a few programmes to help increase access to affordable homes for the *rakyat*. For instance, the SRP was introduced in Budget 2011 to assist young adults earning RM3,000 per month or less to own their first home through a 100% financing scheme. Similarly, in Budget 2012, the RMR1M programme was introduced with the intention of assisting those with household income of RM3,000 per month and below to purchase affordable homes. Another programme, the PR1MA was introduced to assist the middle-income group whose household income is RM6,000 per month and below to purchase affordable homes in cities nationwide.

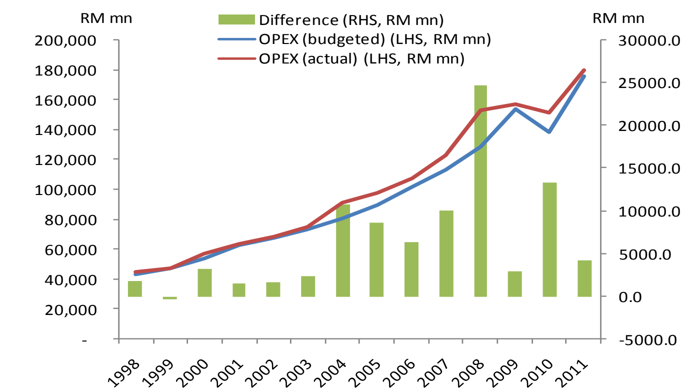
Rising medical costs, although seldom highlighted, is another factor that pinches the *rakyat*'s pockets. According to the Credit Counselling and Debt Management Agency, or Agensi Kaunseling dan Pengurusan Kredit (AKPK), one of the primary reasons for rising credit card usage among Malaysians that led to defaults is excessive medical charges. It was revealed that of the cases handled by the AKPK, about 24% was due to the inability to cope with high medical expenses. This is not surprising as the cost of private medical services, which people tend to seek in the event of emergency, has been rising rapidly over the years.

▪ ***Unfavourable federal government budgetary position***

The budget deficit has been a thorny issue for Malaysia in the past one decade or so. Since the Asian Financial Crisis, the federal government's budgetary position has been in the red and has become a common topic discussed among international rating agencies. The deficit had actually declined to 3.1% of GDP in 2007 from as high as 5.5% of GDP in 2000. However, the Great Recession in 2009 once again pushed the deficit up to 6.7% of GDP in 2009 before it slipped to 4.8% of GDP in 2011.

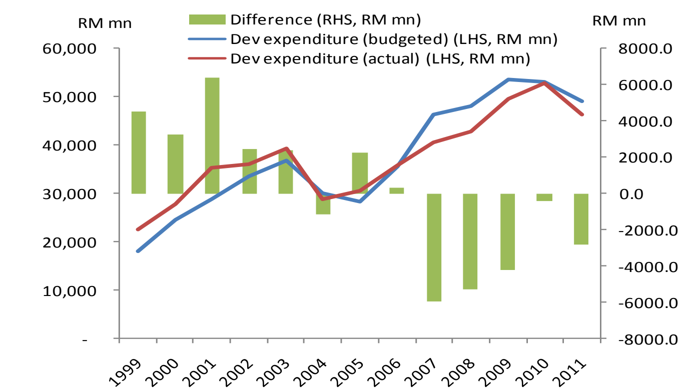
From a pure statistical point of view, Malaysia's fiscal space looks rather limited. Consider this: the federal government's revenue is in the region of RM185 billion per annum while the operating expenditure is roughly RM180 billion. On top of that, development expenditure is about RM45 billion per annum. As operating expenditure is more or less fixed, there is not much room left to maneuver. Lo and behold, Malaysia experienced consecutive years of budget deficits.

Chart 3: Operating expenditures (OPEX) – budgeted and actual



Source: BNM, MOF, MARC Economic Research.

Chart 4: Development expenditures – budgeted and actual



Source: BNM, MOF, MARC Economic Research.

▪ ***Lack of long-term savings and safety net***

The awareness among Malaysians of the crucial need for long-term savings and financial safety net should be further cultivated as many Malaysians tend to exhaust their savings within ten years after retirement. As such, long-term investment plans in the form of savings and insurance should be further encouraged.

In Malaysia, while long-term investments are taxed (through their dividends), capital gains derived from shorter-term investments are not. As such, the low-income group who normally invest in long-term financial instruments such as unit trusts are being 'penalised' as opposed to those who do short-term trading and speculate in the financial market.

Similarly, while withdrawals from the EPF can used for investment in approved unit trusts, they are not allowed to be withdrawn for the purpose of purchasing medical insurance which can benefit policyholders during their golden years when they normally require more medical attention and are no longer employed.

Measures that can be considered

To ease the burden of limited disposable income and to help *rakyat* cope with rising costs of living, the following measures can be considered by the government:

- ***Widen Malaysia's personal income tax band***

As mentioned, the lower- and middle-income tax payers are entitled to higher tax relief compared to workers in Singapore. However, as income increases, Malaysian workers tend to pay more as the effective tax rate for Malaysia is higher than that of Singapore.

The narrow income tax base in Malaysia has led to many workers falling into the higher tax brackets even if the increase in their pay is not significant. The narrow tax bracket is one of the reasons for the relatively small disposable income of Malaysian workers. It is also part of the reasons Malaysian workers tend to look for jobs in other countries.

The ideal solution for the problem would be to widen the personal income tax band so that workers do not fall into higher tax brackets as a result of small salary increments. The disadvantage is the foregone revenue for the federal government, which is a critical issue at a time when the government is burdened by consecutive years of budget deficits. However, we opine that the impending implementation of the GST and other possible taxes that the government can introduce (e.g. capital gains tax, inheritance tax) would partially offset the reduction in the government's revenue as a result of wider income tax bands.

- ***Increase relief for children and those with children pursuing higher education***

The RM1,000 per annum (RM83 per month) provided as a relief for each child is no longer sufficient in today's economic environment in Malaysia given the higher education and medical costs as well as the overall cost of living, particularly in urban areas. The government last increased child relief from RM800 to RM1,000 in Budget 2004. We think that this is another area where adjustments need to be made in order to commensurate with the present cost of living in Malaysia.

Similarly, additional relief can be provided to families whose children are pursuing higher education which is presently at RM 4,000 per child for the diploma level and above. This in view of the cost of education has risen by 13.0% (based on its component in the CPI) since the last time the government reviewed it.

- ***Separate relief for EPF contributions and insurance premiums***

Under the current ruling, a combined relief of RM6,000 is given for life insurance premium payments and EPF contributions. We are of the view that a separation of, say, RM 5,000 for EPF contributions and RM3,000 for insurance premium payments should be considered. The two-fold benefits of having a separate tax relief for EPF contributions and insurance premiums are: (1) increase individuals' disposable incomes through reduction in their taxable incomes; (2) encourage purchases of insurance policies which will serve as a safety net in the future years.

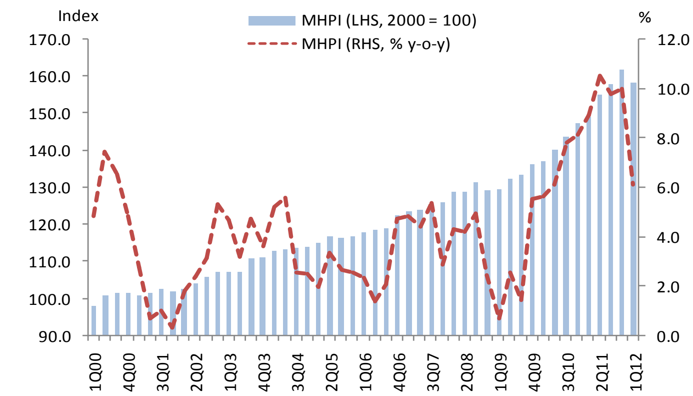
To alleviate upward pressure on home prices, the government may consider the following measures:

- ***Increase real property gains tax***

We are of the view that the recent increase in property gains tax to 10% for properties held and disposed of within two years is still too mild to curb speculative activities. Rising property prices in recent years (31.2% since 2006) has continued to lure investors to continue flipping their properties, resulting in further price increases. Such practices will have to be curtailed in order to avoid a build-up in the property bubble in

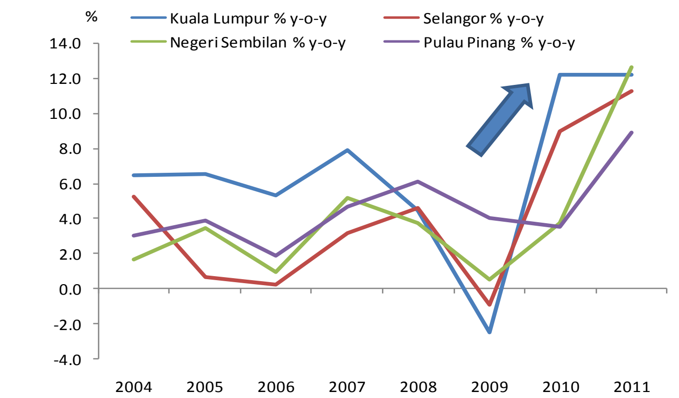
Malaysia. We think that the previous tax structure of a sliding scale in the RPGT (from 30% to 0%, depending on the number of years held) is preferable to the present scale to deter speculation in the property market.

Chart 5: House price index for Malaysia



Source: CEIC, BNM, MARC Economic Research.

Chart 6: House price indices in major states



Source: CEIC, BNM, MARC Economic Research.

- ***Limit sales of properties to group buyers and landed properties to foreigners***

It has been reported that new properties launched by developers are usually taken by groups of buyers who purchase multiple units with the intention of investing for higher profit. Consequently, individual buyers tend to end up having limited choices of units that are more expensive and less attractive. We are of the view that such practices, if they continue to persist, will accelerate price increases of homes, especially in urban centers. As such, we think that the government should identify ways to ensure individual buyer interests can be protected.

Similarly, to prevent prices from escalating due to increasing demand from foreign buyers, the government can limit purchases of landed properties by foreigners in the country. Such a measure is not too radical considering that Malaysia is one of the few countries in the region that allows foreign buyers to purchase landed properties. Countries such as Singapore, Thailand and the Philippines generally do not allow foreign purchases of landed properties.

- ***Speed up construction of homes under various government programmes***

Several programmes to assist the *rakyat* in buying affordable homes have been initiated by the government. These include the PR1MA, RMR1M and SRP, which focus on different income groups. The greater emphasis on providing assistance to the middle-income group has recently emerged as recent studies reveal that save for Kuala Lumpur, the median affordable house price for Malaysia is between RM120,000 and RM150,000.

However, as in other programmes, the speed of implementation is critical. More locations should be identified to ensure the *rakyat* can benefit from programmes like PR1MA.

To ease the burden on the federal government coffers, the following measures can be considered:

- ***Speed up the implementation of GST***

The implementation of GST will broaden Malaysia's tax base. It is also viewed as a more equitable tax system as it generates revenue only when people spend, and of course, big spenders are normally those in the high-income groups. The difficulty in implementing the GST has been widely discussed - possible inflationary implications, political backlash, consumers' lack of understanding and administrative issues. Most of them, however, could be overcome if there is proper communication and enforcement issues are addressed. The Price Control and Anti-Profiteering Act 2011 can be further enforced to prevent unscrupulous traders from raising prices unnecessarily, while programmes to increase awareness of the benefits of GST can be implemented.

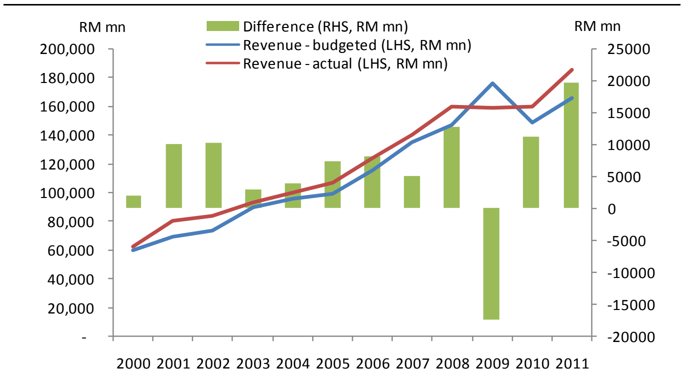
- ***Further rationalise subsidies***

The rationalisation of subsidies is another politically sensitive issue as it is an unpopular move among Malaysians. Given this situation, we think that the term 'rationalise' should continuously be emphasised (as opposed to the term 'subsidy reduction') as the real intention is to take from the rich and give to the needy. To minimise public resistance to subsidy rationalisation measures, information on the use of the savings from the reduction in subsidies should be made available. For instance, the government can inform the public that the savings will be used to assist the needy groups with income below certain levels. The public should also be informed once those benefits have been channeled to the targeted groups. The greater transparency would help reduce the anxiety among the *rakyat.*

- ***Utilise additional revenue above the projected level***

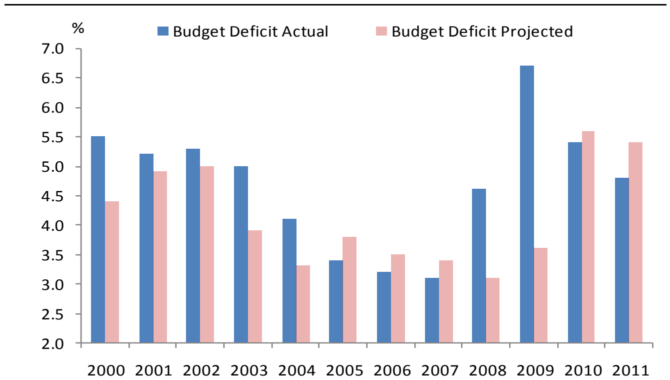
Past trends suggest that the government tends to underestimate its revenue in their annual projections. For instance, in the past ten years (excluding the recessionary years of 2001 and 2009) the government had projected a total revenue of RM1.13 trillion but actually received a total of RM1.21 trillion. The RM82.6 billion in additional revenue is an important source of income that we think can be utilised to reduce the country's budget deficits. To ensure the additional revenue is channeled towards reducing budget deficits, a specific percentage of this additional revenue can be clearly determined for this purpose. This will lessen the tendency to spend the additional revenue unless the situation clearly warrants it, for example, during periods of extremely weak economic growth or recession.

Chart 7: Federal government revenue – budgeted and actual



Source: BNM, MOF, MARC Economic Research.

Chart 8: Budget deficit as percentage of GDP – projected and actual



Source: BNM, MOF, MARC Economic Research.

- ***Generate revenue through measures that minimise transfer pricing***

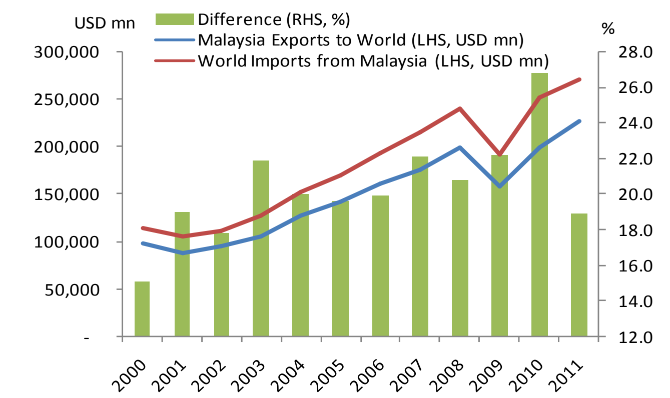
The concern over capital outflows emerged after Malaysia was reported to be in the top ten list of the largest 'illicit' financial outflows between 2000 and 2008. We disagree with the term 'illicit', although we do not doubt that capital has 'left' the country in some form or another. We are of the view that capital outflows that are related to reverse investments are not particularly worrying as they represent opportunities seized by Malaysian investors abroad. In addition, profits that are repatriated back to Malaysia will benefit the Malaysian economy.

However, another aspect of the outflows is worth noting. We think that a part of the problem of the alleged capital outflow was due to what is termed as ‘transfer pricing’ - where the value of imports from a particular country, say China, is substantially different than the value of exports to Malaysia reported in China. The same goes for exports to another country where their values are normally reported lower than the value of those importers reported in China.

We think that these gaps are due to corporations trying to minimise their tax payments. For instance, declaring higher value of imports will mean higher input costs that will be subject to lower taxes. This will naturally boost their profits. Similarly, declaring lower value of exports means less tax charges.

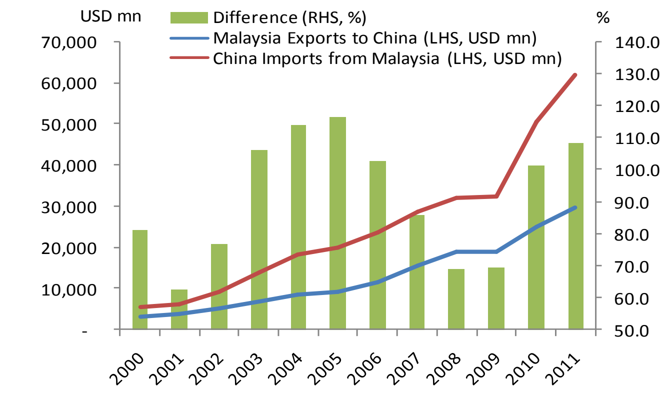
If this is really happening, then appropriate measures that can be taken to minimise such abuses as it will result in more revenue for the government.

Chart 9: Value of Malaysian trade with the world



Source: UNCOMTRADE, MARC Economic Research.

Chart 10: Value of Malaysian trade with China



Source: UNCOMTRADE, MARC Economic Research.

To encourage the *rakyat* to increase long-term investments and acquire financial safety nets, the following measures can be considered:

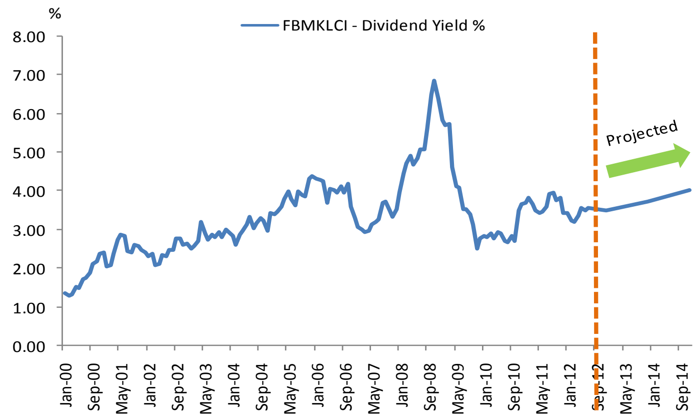
- ***Impose capital gains tax on financial transactions***

To encourage long-term and non-speculative investments, a minimal amount of capital gains tax can be imposed for investments in financial instruments that are liquidated within certain periods (e.g. one year). The tax can be imposed at source when transactions (sale of securities) are completed. If required, some exemptions can be made, e.g. certain strategic institutional investors.

It is worth noting that in the West, capital gains tax are normally imposed on gains in financial instruments irrespective with the holding period, while for Japan and India, capital gains tax are assessed on gains from securities that are held for less than a certain period.

Understandably, the proposal of the imposition of capital gains tax will raise concerns about Malaysia's capital market competitiveness, especially vis-a-vis its neighbouring country Singapore. However, we think that from the investors’ point of view, a small amount of tax will not deter them from investing in Malaysia if other favourable factors exist in the financial market such as the relatively high level of free-float, sufficient liquidity, fundamentally strong companies and respectable and consistent rates of dividends.

Chart 11: Dividend yield for KLCI stocks



Source: Bloomberg.

- ***Allow withdrawals from EPF to purchase medical insurance***

The fact that the government is working on national health insurance such as 1Care for 1Malaysia (1C1M) signifies the importance of medical coverage for Malaysians as healthcare becomes more costly by the day. More importantly, Malaysians will be burdened with even greater cost of healthcare in their golden years, especially after they are retired and no longer covered by their employers' medical insurance.

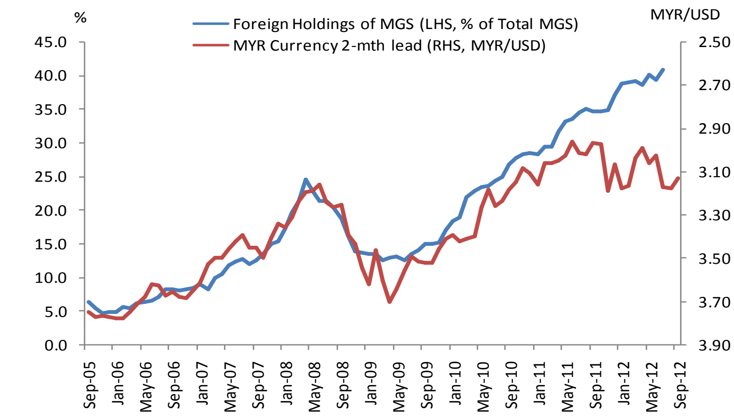
Therefore, it would be advantageous to get them to be prepared for their golden years by allowing withdrawals from EPF to purchase some kind of medical protection after they are no longer covered by their employers' medical benefits. This will not only allow them to save on medical costs during their golden years but also help to somewhat ease the government's burden of higher medical expenditures for the *rakyat* in the future years. Logically speaking, if the government allows EPF withdrawals for investment in unit trusts, we do not see any compelling reason why withdrawals are not allowed for the purpose of purchasing medical insurance which will undoubtedly benefit them in their future years. In addition, many medical coverage plans have investment elements attached to them (investment-linked insurance) which will provide returns to policyholders.

To reduce the possibility of significant capital outflows from the Malaysian shores, certain measures can be considered:

- ***Impose withholding tax to prevent volatility in capital market***

The government can also consider imposing a small withholding tax on the sales of government bonds that are held for less than a certain period of time (e.g. one year). In some countries such as Indonesia, South Korea and Thailand, investments in government bonds are subject to certain holding periods. This is to prevent a sudden exit by foreign investors which, if it happens in massive amounts, can destabilise the financial market. In Malaysia, such a measure may help to temper the accumulation of Malaysian Government Securities (MGS) by foreign investors which has caused their holdings to escalate in recent times. While there are fears that this may harm market sentiment and liquidity, this measure should only deter "hot" money flows without penalising legitimate long-term investors. An example can be seen from the continued inflows of capital into the Indonesian sovereign bond market despite the withholding tax imposed by the authority.

Chart 12: MYR/USD and foreign holdings of MGS



Source: CEIC, Bloomberg, MARC Economic Research.

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