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Pre-Budget 2015: Accelerating Growth, Ensuring Fiscal Sustainability and Prospering the Rakyat

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In a nutshell

- Budget 2015 will be tabled at a time when the Tenth Malaysia Plan (10th MP) is drawing to a close, after a challenging journey in the past five years following the Global Financial Crisis (GFC) in 2009. Challenges arising from waning global economic momentum and slowing domestic demand will continue to pose headwinds to the Malaysian economy despite the faster-than-expected recovery of its external sector which helped the economy to post a stronger-than-expected gross domestic product (GDP) growth in 1H2014. While the headline growth will be relatively robust in 2014, slowing domestic economic momentum will likely exert pressure on the economy which will be impacted by rising prices and cost of living following the impending implementation of Goods and Service Tax (GST) in 2015 and subsidy rationalisation efforts by the government.
- The focus of Budget 2015 is expected to be on the key issues of fiscal consolidation, economic growth and addressing the rising cost of living. Further fiscal consolidation efforts will be needed to ease concerns of a possible downgrade in Malaysia's sovereign rating, which had been maintained on a negative outlook by an international rating agency since July 2013 despite better outlook provided by other major international rating agencies. At the same time, a respectable GDP growth momentum will be needed to offset other pressing macro issues such as mediocre revenue growth, the high government debt level and moderating momentum in private consumption. The government will also focus on alleviating the rising cost of living stemming from not just increased consumer prices but also asset prices which have remained stubbornly high.
- Besides focusing on the above issues, MARC is of the view that, going forward, the government has to consider long-term plans to strengthen the resilience of the economy to withstand economic shocks. These would include appropriate strategies to unwind the current cash handout programmes, measures to address contingent liabilities (debt guaranteed by the federal government) that have been rising in recent years, elevated government operating expenditure (OPEX) levels which have continuously exerted pressure on its coffers and high government debt, and deal with the impact of a more liberalised capital market.
- MARC is of the view that Budget 2015 is likely to include measures to mitigate the effects of GST on the cost of living. The initial impact of GST on inflation cannot be underestimated, with a spike in demand expected ahead of its implementation as well as a possible rise in profiteering activities. Businesses will likely try to pass on the rise in costs to minimise the impact of GST on their profit margins, especially in less competitive sectors. Even the prices of zero-rated items, which are in theory supposed to stay unchanged, may experience some upward pressure as businesses try to offset losses in other segments of goods and services. Strong enforcement of the Price Control and Anti-Profiteering Act 2011 will be crucial in preventing indiscriminate increases in consumer goods prices.
- We are of the view that the government will increase direct cash handouts (1Malaysia People's Aid or BR1M) temporarily for one to two years to help the *rakyat* deal with the expected inflationary effects of GST. In addition, a one-off handout is also likely to be given to ensure the low-income population will not be burdened. The number of goods classified as zero-rated will also likely be increased. These include essential items which are considered necessities which include fruits and medical drugs. There is also a possibility that residential properties priced below RM400K which are currently on the GST-exempt list will be classified as zero-rated. Such a measure is also meant to curb further escalation in house prices as developers may pass on the additional costs to consumers if these residential properties are maintained on the GST-exempt list in order to protect their profit margins.
- MARC expects details on deficit targets and measures to achieve them to be clearly outlined in the budget as well as a review of previous measures taken as the budget deficit is one of the key factors in determining sovereign ratings. Another related issue that often cloud the assessment of Malaysia's debt position is the amount of contingent liabilities which has increased rapidly since 2008. In this respect, greater disclosure on the breakdown of contingent liabilities would improve transparency, which would be positive from the perspective of credit rating agencies.
- MARC feels that more incentives should be provided to encourage greater participation in Private Retirement Scheme (PRS) to ensure that Malaysians have sufficient savings for their golden years. Recent statistics from the Employees Provident Fund (EPF) on the average amount of savings by Malaysians seem to indicate that a large portion of the population does not have sufficient savings to meet expenses after retirement. This is critical considering that private consumption is the main pillar of the Malaysian economy.

- On the bond market, MARC continues to feel that a more liquid secondary market is needed to reduce liquidity risk premiums which would in turn encourage issuers of bonds rated A and below to enter the primary market. This would help address the lackluster bond origination activities in this segment. We are also of the view that the government should allocate funds to invest in investment-grade bonds that are rated A and below. A fund management unit can also be set up to manage the fund and be monitored by government institutions with a proven track record such as Khazanah Nasional Berhad.

- MARC also is of the view that the government should continue promote retail participation in the bond market given that bonds are a relatively safer investment than equity. The government can facilitate greater retail participation by lowering the bond market entry requirements, e.g. net assets required and minimum lot size. The government can also expand the number of Fixed Income Exchange Traded Funds (ETF) and Exchange Traded Bonds (ETB) which require lower investment outlays compared to over-the-counter bonds. In addition, increased efforts to educate the public about bond investment will help retail investors in the market.

- The government's efforts to further enhance retail participation in the financial market is also positive in our view as this would increase individuals' financial safety net in the future. In this regard, the recent discussions between Bank Negara Malaysia (BNM) and the Securities Commission (SC) and the Association of Financial Advisers (AFA) on implementing a single licensing framework for the local financial advisory services is a step in the right direction as this will promote the vibrancy of the financial advisory and planning industry, which is crucial in creating greater awareness among the general public of different financial instruments available in the market.

- As we argued in our last pre-budget write-up, we think the government should assist the *rakyat* to be more prepared for the increase in medical costs during their golden years by allowing withdrawals from EPF to purchase medical protection after they are no longer covered by their employers' medical benefits. This would enable Malaysians to save on medical costs during their golden years and at the same time help ease the government's increasing burden of high medical expenditure in the future. If the government allows EPF withdrawals for investment in unit trusts (under the current ruling), we do not see any compelling reason why withdrawals are not allowed for the purpose of purchasing medical insurance which would undoubtedly benefit the *rakyat* and the government in the future. In addition, many medical coverage plans have investment elements attached to them (unit-linked insurance) which provide some returns to policyholders.

Economic Conditions Surrounding Budget 2015

Budget 2015 will be tabled at a time when the 10th MP is drawing to a close, after a challenging journey in the past five years following the GFC in 2009. It is widely expected that the upcoming budget will continue to focus on the issues of fiscal consolidation, sustaining economic growth momentum and the higher cost of living arising from subsidy rationalisation measures as well as the impending implementation of GST.

A more challenging global economic environment

The Malaysian economy will continue to face headwinds from waning global economic momentum despite a faster-than-expected recovery of its external sector which helped the economy to post a stronger-than-expected GDP growth in the 1H2014 (GDP growth 1H2014: 6.3%). Rising risks of a deflationary spell in the Euro region (CPI Aug: +0.3%) coupled with a setback in the Japanese economy (GDP growth 2Q2014: -7.1% seasonally adjusted annualized rate) following the first round of a hike in sales tax last April will drag the overall performance of advanced economies despite a respectable recovery of the United States (US) economy. China's recent economic weakness following a sharp correction in the property market will be a wildcard for the Asian region in general. All these will have an important bearing on a trade-dependent economy like Malaysia.

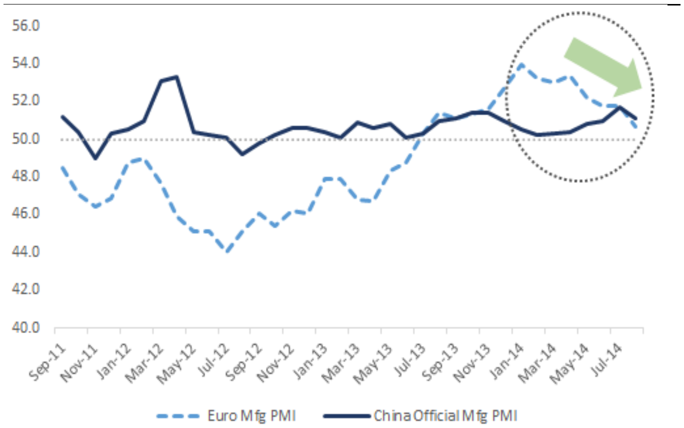
Slowing domestic economy

Moderating domestic demand evidenced from the slower pace of private consumption growth in the 1H2014 will likely exert some downward pressure on Malaysia's headline GDP in the next one year as the lag effects from a series of macroprudential measures by the BNM and higher borrowing costs ripple through the economy. Continuing efforts to achieve fiscal sustainability entailing a more cautious spending trend in the public sector will act as a drag to public investment and consumption, exerting additional pressure on the domestic economy. Adding to this is the risk of further monetary policy responses to higher inflation arising from subsidy rationalisation measures and implementation of GST which could further dampen private consumption growth, which has slipped by 2.9 percentage points since its peak in 2Q2012.

Stronger inflationary pressure

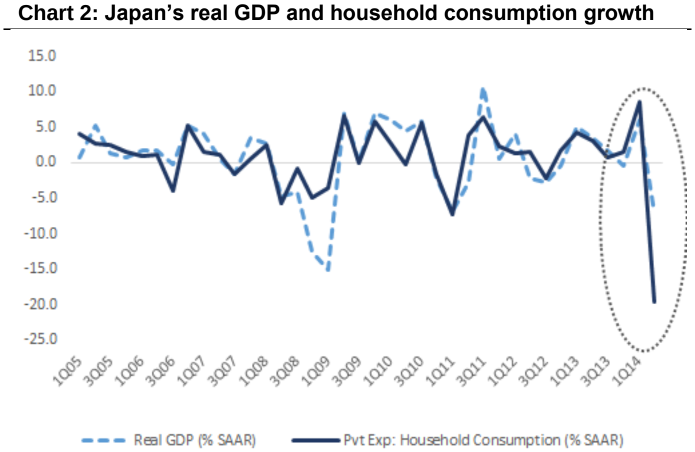
Rising inflationary pressure since the beginning of 2014 has been a pressing issue among consumers who have to deal with not only higher costs of consumer goods but also higher asset prices. Elevated levels of home prices (MHPI 1Q2014: +8.0%) continue to pinch consumers' pockets while subsidy rationalisation measures undertaken by the government continue to push up electricity and transport costs, causing knock-on effects on other goods and services. In addition, the impending implementation of GST has to some extent induced businesses to pass on their costs to end consumers to maintain their profit margins.

Chart 1: Euro and China's PMIs



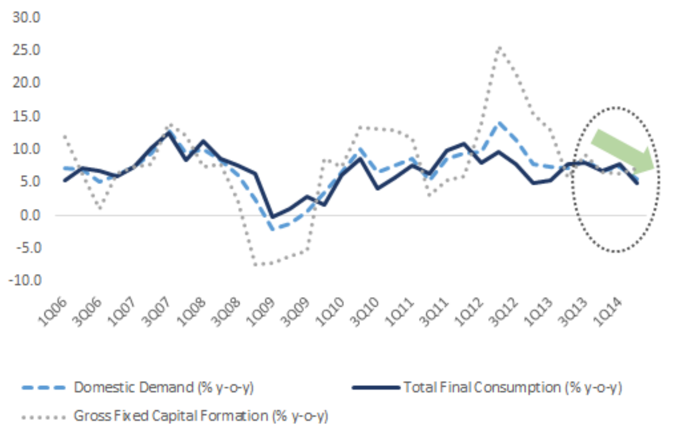
Source: Bloomberg, MARC Economic Research.

Chart 2: Japan's real GDP and household consumption growth



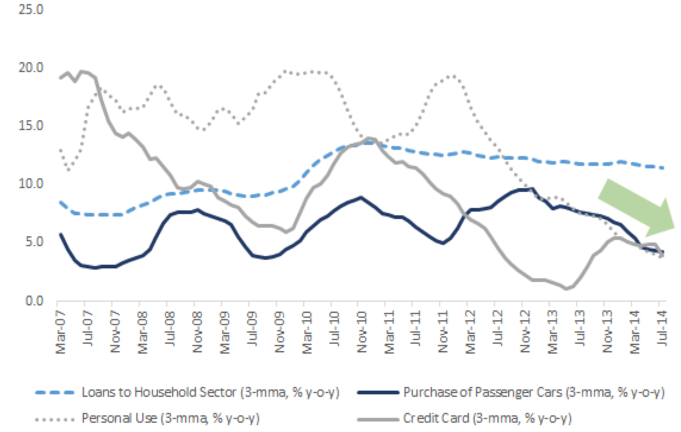
Source: CEIC, MARC Economic Research.

Chart 3: Malaysia domestic demand



Source: CEIC, MARC Economic Research.

Chart 4: Consumer loans are moderating



Source: CEIC, MARC Economic Research.

Critical issues facing the government and *rakyat*

The government has identified the issues of fiscal consolidation, GDP growth and alleviating the burden of rising cost of living as their top priorities.

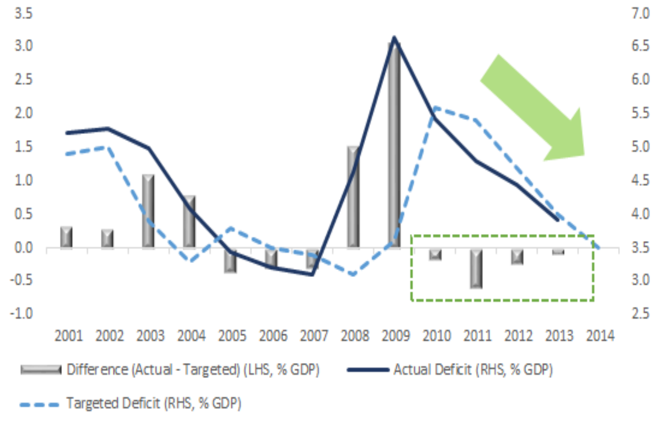
- ***To address three main issues – fiscal consolidation, economic growth and higher cost of living***

  (1) Further fiscal consolidation efforts will be needed to avert a possible downgrade in Malaysia's sovereign rating. Malaysia's rating had been maintained on a negative outlook by an international rating agency since July 2013. Although two other major international rating agencies had maintained their "Stable" and "Positive" outlooks, the government will continue to make serious efforts to prevent deterioration in its sovereign rating.

  (2) Sustaining a respectable GDP growth momentum will be needed to offset other pressing macro issues such as mediocre revenue growth, the high government debt level and moderating momentum in private consumption. The government's fiscal health is largely dependent on tax revenue which hinges on GDP growth, while its ability to improve its debt position will depend on its budgetary position. Similarly, labour market and investment momentum are strongly correlated with headline growth. The fact that Malaysia's nominal GDP has not been as robust as previous recovery cycles despite a strong headline real GDP growth is an issue that the government will need to address.

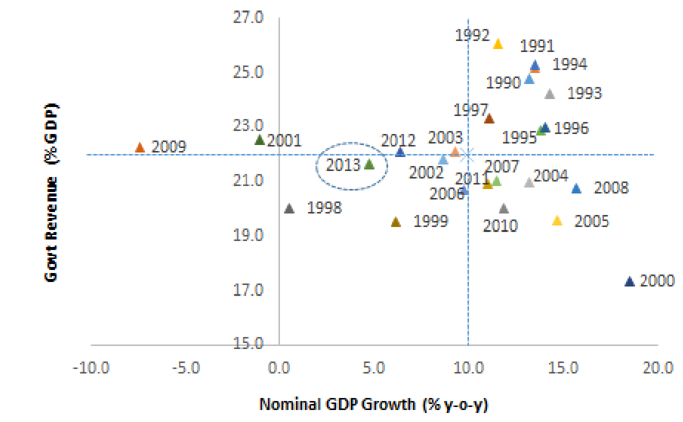
  (3) The government will also focus on alleviating the rising cost of living stemming from not just increased consumer prices but also asset prices which have remained stubbornly high. The cost of living is also expected to come under further upward pressure from the implementation of the GST in April 2015 and continued subsidy rationalisation efforts by the government.

Chart 5: Budget deficit – actual and targeted as % GDP



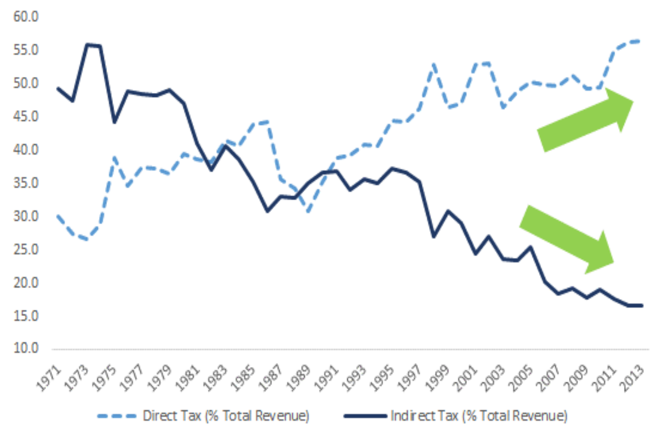
Source: CEIC, MoF, MARC Economic Research.

Chart 6: Nominal GDP growth versus government revenue as % GDP



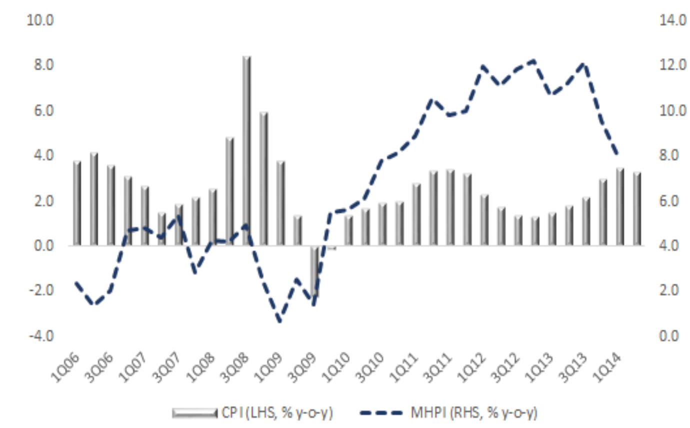
Source: CEIC, MARC Economic Research.

Chart 7: Direct tax and indirect tax revenue as % total revenue



Source: CEIC, MARC Economic Research.

Chart 8: CPI growth versus MHPI growth



Source: CEIC, MARC Economic Research.

On top of these issues, MARC feels that longer term challenges will have to be closely monitored and addressed as they will influence the macro landscape in the future years.

- ***To deal with the long-term impact of cash handouts***

  While it is a necessity to provide cash handouts to the public at times of the need (during rising cost of living and so forth), there is a need to articulate a plan the means to unwind such measures when the need arises. In general, MARC believes the government will give a one-off cash handout in addition to increasing its BR1M cash payments to help low-income households cope with the impact of GST. This will support private consumption which will be critical in sustaining headline growth. However, going forward, MARC opines that a plan to unwind cash handout programmes is needed to avoid creating another subsidy component in the government's OPEX which would be politically difficult to remove and prevent the development of a dependent mentality among the *rakyat* in the long term.

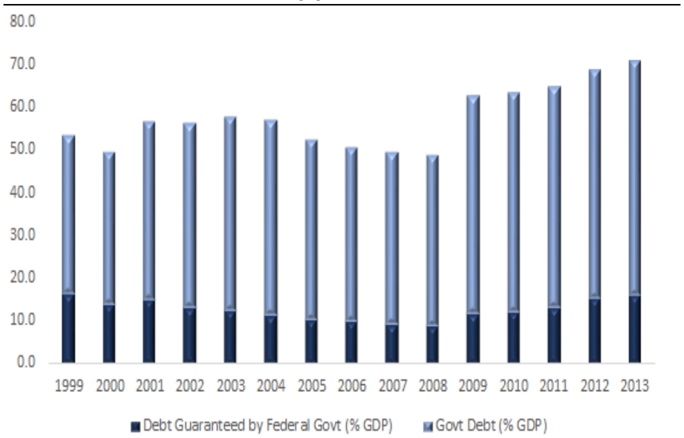
- ***To deal with contingent liabilities***

  While the government has continued to focus on lowering the budget deficit and expanding its revenue base, the issue of its contingent liabilities, estimated by the amount of government guarantees, stand at approximately 16% of GDP will need to be looked at more closely. Greater transparency on the government's contingent liabilities could help improve credit rating agencies' perception on Malaysia's fiscal and debt management capability. A detailed breakdown of Malaysia's contingent liabilities could be disclosed and make known to the public.

- ***To deal with high OPEX***

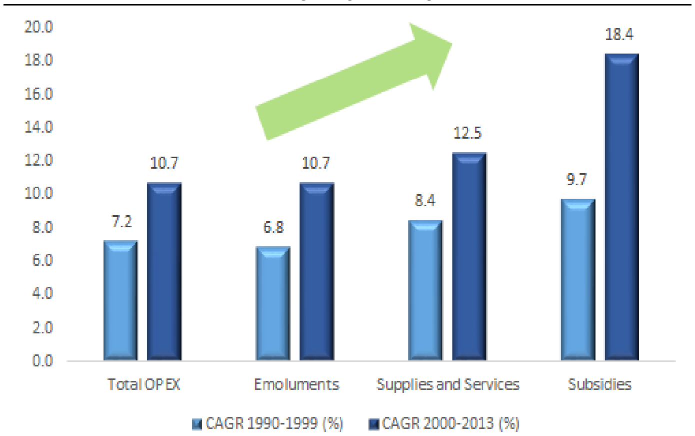
The high compound annual growth rate (CAGR) of government OPEX of 10.9% in the past 11 years against the slower expansion in revenue (8.7% CAGR) has put a strain on the government's fiscal health. MARC views that the government should continue and step up its efforts to tighten its OPEX through (1) a steady reduction in the amount of subsidies; and (2) upgrade the efficiency of expenditures of 'supplies and services' component. In addition, while it is argued by some quarters that Malaysia's size of civil servants is not as large as it looks (as it is not comparable with those of other countries due to different definition in the calculation methodology), a reduction in the size of the civil service could also alleviate the strain on OPEX. While this would arguably be a difficult task, intensified efforts in, for example, building entrepreneurial programmes could provide employment opportunities and reduce dependency on government employment in the long run, leading to a leaner public sector as well as higher productivity levels.

Chart 9: Government liability position as % GDP



Source: CEIC, MARC Economic Research.

Chart 10: Growth in OPEX by major components



Source: CEIC, MARC Economic Research.

- ***To deal with rising government debt***

Rising government debt is a thorny issue that has drawn criticism from international credit rating agencies. Although the 55% cap to GDP is a self-imposed limit, a rapid increase would not augur well for Malaysia's sovereign rating. A positive point is that under the new definition, a sizeable 70% of the government debt is domestic debt and the declining budget deficit will slowly ease the strain on its ratio to GDP in the near future. Notwithstanding this, the relatively high amount of foreign holdings of government papers (approximately 48% of total outstanding MGS) makes the ringgit vulnerable to a sudden and massive outflows of capital.

- ***To deal with the impact of a more liberalised capital market***

Financial market liberalisation is taking place everywhere in the region. Increasing financial market sophistication and interconnectedness – while a positive factor for the economy in some aspects – pose greater challenges as policy responses in one country affect other countries and regions. To cope with financial market volatility, greater macroeconomic stability is needed (the amount and access to foreign exchange reserves, strong domestic economy, adequate regulatory framework etc.) while risk taking activities should be minimised. The pace of liberalisation should also be properly planned to avoid major disruptions to the present economic landscape. Tighter regulation of information dissemination is also needed to increase the transparency in the financial market in order to prevent systemic risk.

Measures That May Be Considered and Our Wish List

- ***One-off increase in BR1M and special handout to help deal with GST***

  The government will likely increase the BR1M temporarily for one to two years to help *rakyat* deal with the expected inflationary effect arising from the introduction of GST. An amount of RM150 is widely expected on top of the existing amount of RM650. A one-off handout will also be given (RM300 as announced in the 2014 Budget) to ensure the low-income population will not be burdened by the adverse impact of GST. This is critical considering that 39% of households had incomes of RM3,000 or less according to the Household Income Survey in 2012.

- ***Increase in the number of items in zero-rated segment***

  The number of goods classified as zero-rated will likely be increased. These include essential items such as different types of food which are considered necessities for the *rakyat*. Fruits and medical drugs for instance, may be added to list of zero-rated items. This is to ensure that GST will not be regressive as in other countries.

- ***Additional packages to help businesses cope with GST***

  More incentives will be given to businesses to utilise the existing government allocation of RM150 million for small and middle enterprises (SME) to purchase GST-compliant accounting software and RM100 million grant for businesses to increase GST training. As of mid-September, only 12% of the 300,000 businesses which are eligible for GST had registered for the new tax system, of which 80% are SMEs. In addition, efforts by the Royal Malaysian Customs Department to closely work with firms which registered for GST will be intensified.

- ***Homes priced below RM400K classified as zero-rated***

  To further relieve the burden of the low- and middle-income group, residential properties priced below RM400K which are currently on the GST-exempt list will likely be classified as zero-rated. Such a measure is also meant to curb further escalation in house prices as developers may pass on the additional costs to consumers if these residential properties are maintained on the GST-exempt list in order to protect their profit margins.

- ***Multi-tier subsidy rationalisation package***

  As the government is working towards shifting its strategy away from providing indiscriminate subsidies to the *rakyat*, Budget 2015 may include a multi-tier petrol subsidy plan. This could be in the form of rebates for those with income below certain levels. The concern, however, is that the multi-tier system may mean that petrol subsidies may be removed, although there is now a possibility that GST will not be imposed on petrol to avoid a double impact on consumers following the recent 20 sen increase in prices of RON95 and diesel.

- ***Update on PR1MA***

  Several programmes to increase access to affordable housing have been initiated by the government. The most popular is 1Malaysia People's Housing (PR1MA), which focuses on the household income group of between RM2,500 and RM7,500 per month. However, as in other programmes, there is a need to update and speed up the implementation of these affordable housing projects, especially the ones planned by PR1MA. Since its introduction in Budget 2012, only one out of 38 projects proposed has been realised.

- ***Further commitment and clearer measures on the plan to reduce budget deficits***

  The government's continual commitment is an important aspect that a credit rating agency focuses on. In this regard, MARC expects Budget 2015 to outline details on deficit targets and measures to achieve them as well as a review of previous measures taken as the budget deficit is a key factor in determining sovereign ratings.

- ***Greater disclosure on contingent liabilities***

  Clouding the assessment of Malaysia's debt position is the amount of contingent liabilities. While the government provides statistics on the overall amount through an item categorised as 'government guarantees', greater disclosure on the breakdown of contingent liabilities, such as what would be included or excluded from this item category, would improve transparency, which would be positive from the perspective of international credit rating agencies.

- ***More incentives for private pension scheme***

  Currently, the government is giving a one-off incentive amounting to RM500 for youth aged 20-30 years who participate in the PRS with a minimum cumulative investment of RM1,000 within a year. On top of that, the government is giving a tax relief up to RM3,000 for PRS contributors. Despite these incentives, total private savings have remained below the government's target. According to the EPF's 2013 annual report, the average savings for its active members aged between 51-55 stood at RM147,057 per person, below its minimum savings target of RM196,800 upon retirement age of 55. We feel that more incentives should be provided to encourage more participation among private individuals, especially the youth (median age of 28 years), as the majority of the population have relatively low levels of retirement savings.

- ***Plans to increase liquidity for bonds rated single A and below***

  In view of the current lackluster bond origination activities for papers rated single A and below (due to wide yield spread against the higher rated bonds), a liquid secondary market would reduce the liquidity risk premiums which would in turn encourage issuers rated A and below to enter the primary market. MARC is of the view that the government should propose a fund be allocated and a fund management unit be set up to invest in investment-grade bonds that are rated A and below. Such a fund management unit can be monitored by government institutions with proven track record such as Khazanah Nasional Berhad.

- ***Measures to promote retail participation in the local bond market***

  As major investors in the local bond market are primarily big pension funds, insurance companies and financial institutions, the government should continue to promote retail participation given that (1) bonds are relatively safer investments than equity; (2) there will be higher liquidity risk premiums due to Basel III's liquidity coverage ratio requirement which would reduce market liquidity. The government can facilitate greater retail participation by lowering the entry requirements into the bond market, e.g. net assets required and minimum lot size. The government can also expand the number of Fixed Income ETF and ETB which require lower investment outlays compared to over-the-counter bonds. There should also be more initiatives to educate retail investors about the risks and advantages of investing in bonds. At the same time, the bond covenants should be regulated to ensure a certain degree of standardization to make the products easy to understand.

- ***Incentives for private education (rebates on fees)***

  The increasing number of students enrolled in private education institutions will in the long term reduce the government's education expenditures. While it is sometimes argued that this trend could increase the gap between the quality of graduates, we feel that the solution for this would be to improve the quality of public education centres rather than discouraging the establishment of private institutions. In addition, this will help reduce the pressure of limited places in local higher education centers. As such, there is a case for providing incentives to parents who send their children to private institutions through some kind of tax relief.

- ***EPF withdrawal for medical insurance***

  The cost of healthcare is increasing every year and this is expected to burden the *rakyat* especially after they retire and are no longer covered by their employers' medical insurance. Although the government heavily subsidised medical costs for the *rakyat*, we opine that the government should assist the *rakyat* to be more prepared for the increase in medical costs during their golden years by allowing withdrawals from EPF to purchase some kind of medical protection after they are no longer covered by the employers' medical benefits. In the longer term, this will enable Malaysians to save on medical costs during their golden years and at the same time help ease the government's increasing burden of high medical expenses in the future years.

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