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MALAYSIAN RATING CORPORATION BERHAD
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Budget 2015: A Revision

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In a nutshell

- Overall, the review of Budget 2015 shows that the government is realistic about the expected impact of current economic conditions on both government revenue and expenditure. Its tweaking of Budget 2015 is aimed at ensuring that the budget deficit level does not rise significantly above its initial target of 3% of gross domestic product (GDP). The cut in operating expenditure (OPEX), as opposed to development expenditure (DE) as widely expected, is to avoid a sharp landing of the economy. As such, it has revised downwards its real GDP growth target for 2015 by only 50 basis points, from 5.0-6.0% to 4.5-5.5%. From a rating agency's point of view, these actions are credit positive.

- The government projects total OPEX to shrink by almost 5% from its original estimate of RM223.4 billion. However, it remains to be seen as to how much the government can reduce OPEX because it is normally "sticky" compared to DE. There is also the concern that the RM5.5 billion reduction in OPEX planned by the government - through cutbacks in transfers and grants to statutory bodies and government-linked companies (GLCs), deferment of the National Service Training Programme, as well as deferment of purchases of non-critical assets - may be insufficient to achieve the budget deficit target of 3.2% if nominal GDP shrinks more than projected.

- We were intrigued by the government's move to keep the DE at RM48.5 billion and not reduce it. Major infrastructure projects such as the LRT3, MRT Line 2, KL-Singapore High-Speed Rail (HSR) and Pan-Borneo Highway remain in place, and so do projects related to flood mitigation and public housing. Although we had expected the DE to be trimmed, we think the government's rationale to leave it untouched was so as not to cause a sharp decline in headline GDP growth, which would have caused government revenue to fall. Notwithstanding this, we envisage total DE to be lower than the projected RM48.5 billion because over the past seven years, actual DE had, on average, been lower than originally budgeted by approximately RM2.3 billion per annum.

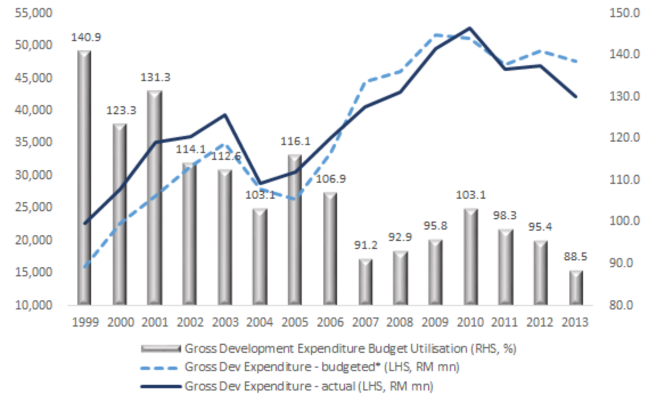
- We think the new budget deficit target (3.2% of GDP) is now more realistic, especially if the entire RM5.5 billion reduction in OPEX planned by the government can materialise and nominal GDP growth remains robust in 2015. However, if nominal GDP shrinks more than expected (-1.7% from the original estimate as expected by the Ministry of Finance), it is likely that the new budget deficit target of 3.2% of GDP will have to be revised again. Notwithstanding this, the lower-than-budgeted DE may cushion some of the impact on the deficit.

- At an average oil price of USD55 per barrel in 2015, the government envisages the current account (CA) balance in the balance of payments to moderate to 2-3% of GNI from an estimated 5.1% in 2014. We concur with the government's estimate as expected lower trade surpluses in 2015 will generate lower CA surpluses. As we do not expect Bank Negara Malaysia (BNM) to raise interest rates, we expect lower CA surpluses to continue putting pressure on the ringgit (MYR).

- There are speculations that the CA balance will turn negative, especially if commodity prices remain depressed throughout 2015. With no likelihood of BNM raising the Overnight Policy Rate (OPR), it is likely that capital outflows will persist, and this will exert additional pressure on the MYR. However, we believe that BNM has adequate international reserves to serve as a buffer against capital outflows and provide against market volatility. As at 31 December 2014, the international reserves of BNM amounted to USD116.0 billion, sufficient to finance 8.4 months of retained imports and is 1.1 times the short-term external debt.

- In the medium term (three to five years), we still foresee the economy registering an average real GDP growth rate of 5%. This is on account of the continued investment momentum, thanks to the ongoing implementation of mega projects, even though a moderation is expected in 2015. Our view is also based on the assumption of continued deleveraging in the household sector that would help minimise the risk of a collapse in private consumption, a major driver of the economy.

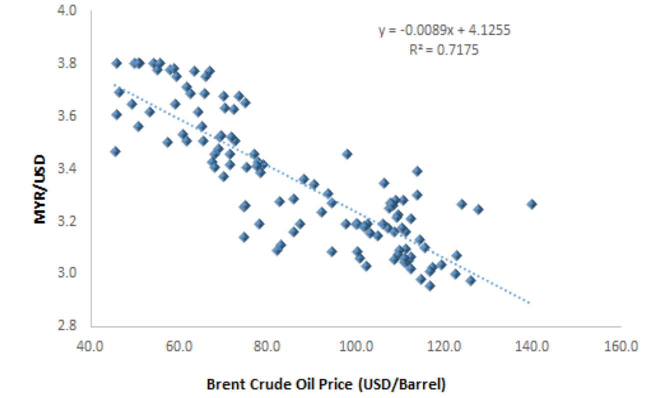
Chart 1: Gross development expenditure – budgeted and actual



Source: MoF, MARC Economic Research
*Note: * = excluding RM2 billion for contingencies*

Malaysia's actual DEs have been lower than their allocations in the past several years. If the trend continues, the amount of total reduction in expenditures may be more than what has been projected in the latest Budget review. This may help the government achieve its deficit target.

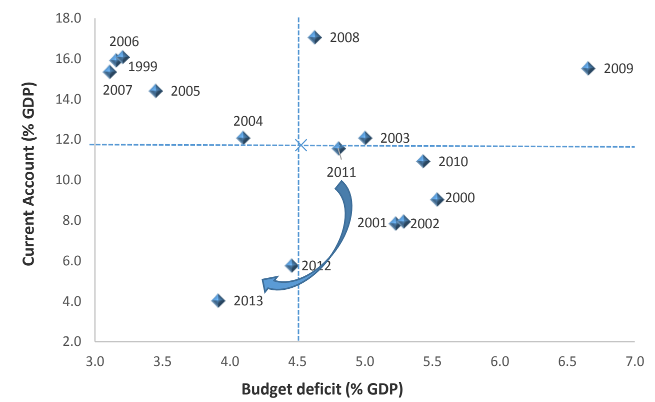
Chart 2: Ringgit and Brent oil price – scatter diagram



Source: Bloomberg, MARC Economic Research

The MYR may continue to be under pressure in the short term if oil prices remain low, judging by their past relationship. In the long term, however, the prospects on growth, government fiscal balance, and the CA balance will determine the trajectory of the MYR.

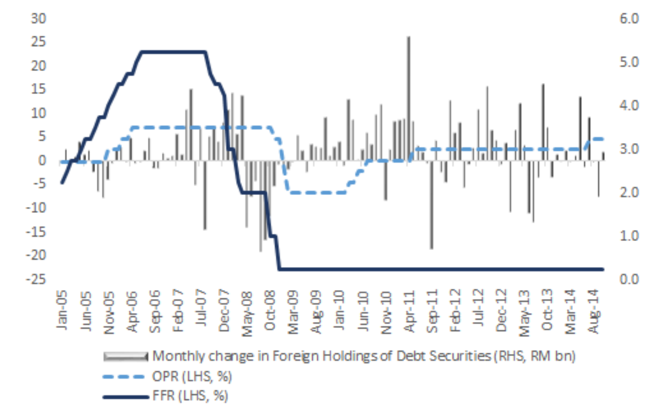
Chart 3: Budget deficit and current account balance as % GDP



Source: CEIC, MARC Economic Research

Although the CA balance will likely remain positive in 2015, its declining trend may cause speculations of a possible negative balance in the future, exerting pressures on the MYR. The CA balance as a percentage of GDP has declined consecutively since 2011.

Chart 4: OPR, FFR and monthly change in foreign holdings of debt securities



Source: CEIC, MARC Economic Research

Increasing MYR volatility may also be attributed to the gyrations in foreign holdings of Malaysian debt securities especially if the US Federal Reserve (Fed) starts to raise interest rates due to a narrower differential with the OPR.

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