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Pre-Budget 2017: Accelerating Growth, Ensuring Fiscal Prudence, Enhancing Well-being of the Rakyat

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In a nutshell

- Budget 2017 will, once again, be tabled at a time of global economic uncertainty and when Malaysia is confronting challenges in consolidating its fiscal position following lower-than-expected revenue as a result of low crude oil prices. Globally, while the United States (US) economy is enjoying a steady improvement in its labour market, anxiety over the likelihood of an interest rate hike is building up. In addition, a continued moderation in China's economy poses a significant risk to Asian export-dependent countries while the diminishing capacity of central banks to speed up economic growth, particularly in Europe and Japan, is hampering investor sentiment, causing increased volatility in global equity and bond markets. In the commodity market, crude oil prices, which remain less than half of their peaks in 2014, are expected to have limited upsides due to a strong US dollar (USD) and the higher level of inventories, despite the recent agreement among members of the Organisation of the Petroleum Exporting Countries (OPEC) to cut production in the near term.
- The focus of Budget 2017 will continue to be on addressing the declining revenue, sustaining the fiscal position, supporting economic growth and assisting the *rakyat* in dealing with the rising cost of living. The Budget will also deal with economic development inclusiveness issues to maximise the benefits of economic expansion to the *rakyat.* Supporting economic growth is critical as Malaysia confronts global headwinds amid decelerating growth in China and mediocre recovery in Europe and Japan. On this, MARC expects weaker domestic demand arising from softer consumer spending and moderating investment activities to limit Malaysia's real economic growth in 2016 and 2017. This will pose some challenges in achieving the budget deficit target of 3.1% of gross domestic product (GDP) in 2016.
- For Budget 2017, MARC anticipates that the government will highlight revenue-generating measures that will add to the government coffers and help support its balance sheet amid declining income from oil-related resources. A decline in revenue by nearly 10% year-on-year (y-o-y) and rising overall expenditures by 5.4% y-o-y in 1H2016 had led to higher-than-expected budget deficits during the period, thus limiting the government's ability to take aggressive steps to consolidate its fiscal position this year. That said, however, the fiscal position in 2H2016 may improve slightly as the government takes additional efforts to enhance revenue collection through the proceeds from Petronas, levy from foreign workers and etc. In addition, revenue from petroleum income tax (PITA) will likely be higher-than-expected as average crude oil prices remain above USD40 per barrel this year, against government's projection of between USD30-35 per barrel. Similarly, total expenditure will likely shrink in 2H2016 as the government doubles its efforts to achieve its targeted RM9 billion reduction as outlined in the recalibrated Budget 2016.
- Against a backdrop of lower-than-expected revenue, Budget 2017 is likely to focus on sustaining fiscal deficits going forward. Due to persistent annual fiscal deficits, the government will likely maintain the deficit target at circa 3% of GDP in 2016 and 2017. If this proves to be the case, then cost-cutting measures will remain a prominent feature in Budget 2017. Such a scenario could mean below-trend economic growth in 2017 as expenditures will be cautiously planned in order to achieve the budget deficit target. On this, MARC takes a slightly differing view as it feels that a slight deterioration in the government's balance sheet will not create an overly negative perception among credit rating agencies (CRA) and investors in general. In fact, during an economic down cycle, a short-term deviation from the government budgetary target will not be seen by CRAs as a derailment from its overall long-term fiscal consolidation path. As such, a slower pace of fiscal consolidation is acceptable temporarily, provided that government spending is focused on areas which will boost growth considerably and leakages are effectively contained.
- In order to sustain the growth of the economy, private investments need to be further supported. In this regard, MARC views that it is worth considering extending the period for the Special Re-Investment Allowance (RA) to at least six years. According to Malaysian accounting firms, the Special RA was a highly utilised tax incentive. Extending the Special RA to six years from the current three years would further encourage reinvestments by companies which have exhausted their eligibility for the incentive. While the repercussions of the extension would be slightly negative on the government budgetary position, the measure will ensure that private investments will continue to grow at a decent pace in the years to come.
- The 2017 Budget will continue to focus on alleviating the financial burden on the middle- and lower-income group which has been a hot topic among the *rakyat* in recent times. This will be done by addressing the rising cost of living which continues to accelerate despite the meager increases in Malaysia's headline inflation and

softer home prices. Measures to curb excessive increases in prices of necessity goods (such as food) could be looked into further. Food security will likely be another major issue to be discussed in Budget 2017. Measures to address high home prices will continue and a more aggressive effort to match the supply and demand of affordable homes under various government programmes is on the cards. In addition, the slow pace of the completion of these programmes will likely be addressed in Budget 2017.

- With regard to high property prices, we feel that Bank Negara Malaysia (BNM) has done a respectable job in ensuring that property lending is channeled to those who will not face difficulty in servicing their loans. The macroprudential measures introduced since 2010 has had a positive effect in neutralising speculative activity in the property market and has somewhat curbed the pace of household debt. By ensuring that loans are given based on borrowers' payment ability, the BNM has helped prevent excessive financial burdens being imposed on borrowers who would not be able to service their loans. We believe that imposing higher interest rates on loans given to less affordable buyers would only add to their financial burden. Incentive schemes, while helping home buyers with their down payments, will cause home prices to rise at a more rapid pace. Notwithstanding this, allowing first time buyers to withdraw more than the current 30% from the Employees Provident Fund (EPF) to purchase their homes is worth considering as it would somewhat lessen their financial burden, especially at a time when prices are still at or close to their peak.

- MARC views that more comprehensive financial safety nets are needed as a long-term measure to cushion the impact of economic shocks on the *rakyat*. Among other measures, the unemployment insurance scheme which was a proposed initiative in Budget 2015 would be worth looking at in more detail. While in the US, unemployment insurance has benefitted workers who have lost their jobs due to retrenchment, such a comprehensive scheme has yet to be developed in Malaysia. MARC is of the view that such an insurance scheme would not burden the government as it would only involve a very small contribution that can be absorbed by both employers and employees.

- Special attention should be paid to the impact of the ageing population on the economy, particularly in the area of healthcare as medical expenses now constitute a large part of individuals' expenses, especially in old age. Rapid increases in medical costs not only burden the *rakyat* but will also increase the government's healthcare expenditure in the long run. Raising the penetration rate of medical insurance will benefit both parties. This could be done by, among others, allowing members to withdraw from their EPF to purchase a critical illness medical plan which is important when they are no longer covered by employee medical benefits. This would enable Malaysians to save on medical costs during their golden years and help ease the government's increasing medical expenditure in the future. Currently, EPF withdrawals for paying medical costs after they are incurred are allowed, and we view that withdrawals for purchasing medical protection plans would be less costly in the long term.

- With regard to the financial market, MARC feels that a new guarantee fund is needed for the purpose of credit enhancement for infrastructure projects. As funding for infrastructure projects remains a key issue, a government-led initiative akin to the European Investment Bank's (EIB) project bond credit enhancement or the Asian Development Bank's (ADB) backstop partial credit guarantee facility to provide partial credit enhancement to project bonds could help mobilise more capital market investment in infrastructure projects.

- MARC is also of the view that efficiency in domestic capital markets can be enhanced further through selected measures such as making Initial Public Offering (IPO) Ratings mandatory. Such a measure will ensure potential investors have the benefit of an independent, reliable assessment of the fundamentals of new public issues. This has been done in other countries such as India, where an IPO rating, which is a one-time exercise based on equity fundamentals, is required. MARC believes that such a measure would also be positive for Malaysia's capital market.

Economic conditions surrounding Budget 2017

Budget 2017 will, once again, be tabled at a time of global economic uncertainty and when Malaysia is confronting challenges in consolidating its fiscal position following lower-than-expected revenue as a result of low crude oil prices. Globally, while the US economy is enjoying a steady improvement in its labour market, anxiety over the likelihood of an interest rate hike is building up. A rate hike, if perceived to be less gradual, will take a toll on global financial market. In addition, a continued moderation in China's economy poses significant risk to Asian export-dependent countries while the diminishing capacity of central banks to speed up economic growth, particularly in Europe and Japan, is hampering investor sentiment, causing increased volatility in global equity and bond markets. In the commodity market, crude oil prices which remain less than half of their peaks in 2014, are expected to have limited upsides due to a strong USD and the higher level of inventories, despite the recent agreement among members of the OPEC to cut production in the near term.

Being an open economy, Malaysia's performance will likely be tied to the health of global economy. Mediocre growth in international trade coupled with decelerating domestic demand will likely cap the growth trajectory below its long-term trend in 2016 and 2017. In addition, declining government revenue will likely induce further caution in spending trends, again exerting downward pressure on headline growth.

Critical issues facing the government and *rakyat*

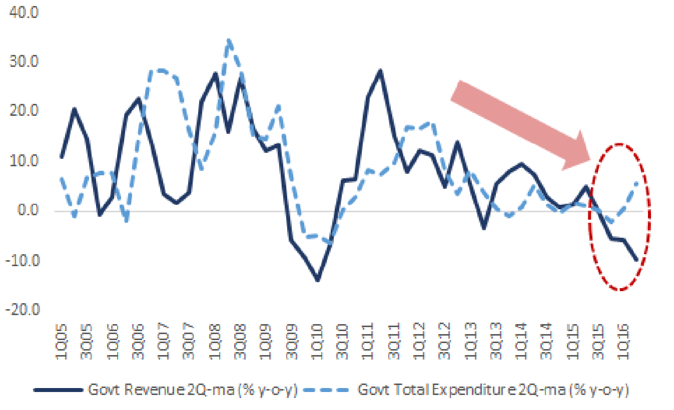
Several critical issues confronting the government in the near and long term include addressing the impact of lower government revenue on its fiscal consolidation plan, supporting economic growth amid global and domestic headwinds, consolidating its fiscal position and ensuring inclusive economic growth with a focus on reducing the impact of the rising cost of living.

- ***To deal with the impact of lower government revenue***

  As mentioned in our last year's pre-Budget report, government revenue will likely be lower in 2016 and may record another year of negative growth (2015: -0.7%) as the full impact of the 60% plunge in oil prices will be reflected in the government's full-year financial position. A decline in revenue by nearly 10% y-o-y and rising overall expenditures by 5.4% y-o-y in 1H2016 had led to higher-than-expected budget deficits during the period, thus limiting the government's ability to take aggressive steps to consolidate its fiscal position this year. That said, however, the fiscal position in 2H2016 may improve slightly as the government takes additional effort to enhance revenue collection through the proceeds from Petronas, levy from foreign workers and etc. In addition, revenue from PITA will likely be higher-than-expected as average crude oil prices remain above USD40 per barrel this year, against government's projection of between USD30-35 per barrel. Similarly, total expenditures will likely shrink in 2H2016 as the government double its effort to achieve its targeted RM9 billion reduction as outlined in the recalibrated Budget 2016. This will likely help cushion the negative impact on the operating balance which had turned negative in 1H2016 (negative RM13.2 billion) and the overall budget deficit which climbed to 5.6% of GDP.

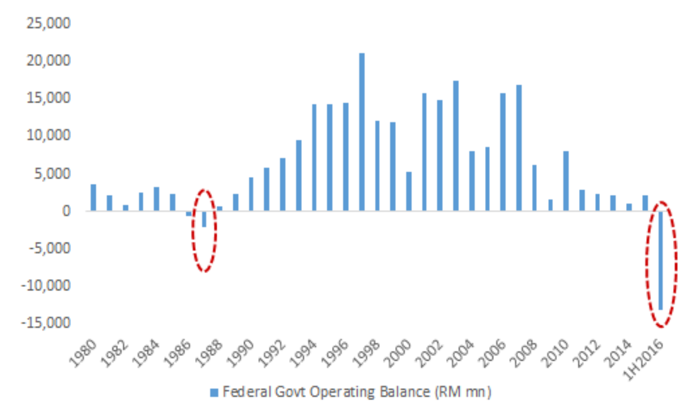
  Against a backdrop of lower-than-expected revenue, Budget 2017 is likely to focus on sustaining fiscal deficits going forward. Due to persistent annual fiscal deficits, the government will likely maintain the deficit target at circa 3% of GDP in 2016 and 2017. If this proves to be the case, then cost-cutting measures will remain a prominent feature in Budget 2017. Such a scenario could mean below-trend economic growth in 2017 as expenditures will be cautiously planned in order to achieve the budget deficit target. On this, MARC takes a slightly differing view as it feels that a slight deterioration in the government's balance sheet will not create an overly negative perception among CRAs and investors in general. In fact, during an economic down cycle, a short-term deviation from the government budgetary target will not be seen by CRAs as a derailment from its overall long-term fiscal consolidation path. As such, a slower pace of fiscal consolidation is acceptable temporarily, provided that government spending is focused on areas which will boost growth considerably and leakages are effectively contained.

Chart 1: Government revenue and total expenditure growth (2Q-moving average)



Source: CEIC, MARC Economic Research.

Chart 2: Government operating balance



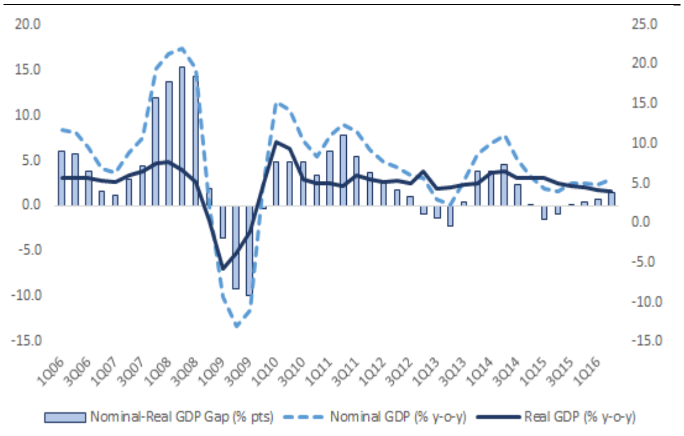
Source: CEIC, MARC Economic Research.

- ***To sustain decent economic growth***

  Malaysia's nominal GDP growth had decelerated below its real growth in 2015. In 1H2016, nominal growth expanded at a 5.1% pace on a y-o-y basis, compared with the government's implied full-year forecast of circa 6% in January 2016. A weaker nominal growth will affect deficit and debt ratios, making it challenging for the government to achieve their full-year targets.

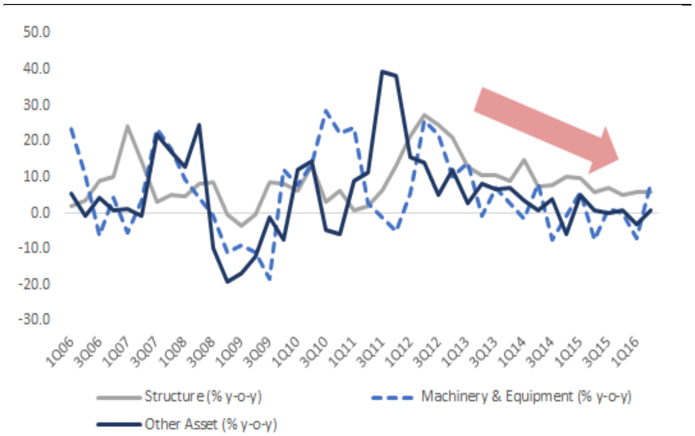
  Going forward, in order to sustain real economic growth, private investments need to be further supported. In this regard, MARC views that it is worth considering extending the period for the Special RA to at least six years. According to Malaysian accounting firms, the Special RA was a highly utilised tax incentive. Extending the Special RA to six years from the current three years would further encourage reinvestments by companies which have exhausted their eligibility for the incentive. While the repercussions of the extension would be slightly negative on the government budgetary position, the measure will ensure that private investments will continue to grow at a decent pace in the years to come.

Chart 3: Real GDP growth and nominal GDP growth



Source: CEIC, MARC Economic Research.

Chart 4: Investment growth by asset class



Source: CEIC, MARC Economic Research.

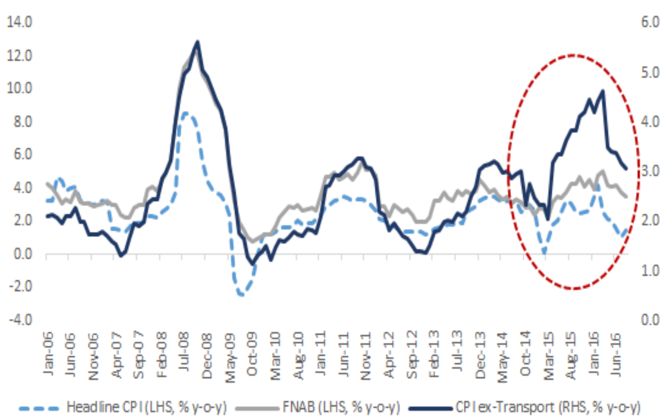
- ***To continue addressing the issue of rising cost of living***

The 2017 Budget will continue to focus on alleviating the financial burden on the middle- and lower-income group which has been a hot topic among the *rakyat* in recent times. This will be done by addressing the rising cost of living which continues to accelerate despite the meager increases in Malaysia's headline inflation and home prices. While Malaysia's Consumer Price Index (CPI) climbed by only 2.3% in the first eight months of 2016, the benign statistics are largely due to low energy prices. Excluding the transport component, the CPI actually rose by an average of 3.7% during the period. Food prices which climbed at a higher pace of 4.3% are also a primary concern with regard to the high cost of living. As such, MARC is of the view that Budget 2017 is likely to include measures to curb excessive increases in prices of necessity goods, for example, measures to enhance food security while adjusting the structure of the food industry to make it more competitive.

Budget 2017 is also expected to address the issue of affordable housing. Although prices have generally increased at a slower pace in recent times (Malaysian House Price Index or MHPI 2015: 7.4%, 2014: 9.4%), overall prices have remained elevated and beyond the reach of a typical Malaysian. There have been recent debates over a proposal to allow property developers to provide financing to end buyers. On this issue, MARC believes that BNM has done a respectable job in ensuring that property lending is channeled to those who will not face difficulty in servicing their loans. The macroprudential measures introduced since 2010 has had a positive effect in neutralising speculative activity in the property market and has somewhat curbed the pace of household debt. By ensuring that loans are given based on borrowers' payment ability, the BNM has helped prevent excessive financial burdens being imposed on borrowers who would not be able to service their loans. We believe that imposing higher interest rates on loans given to less affordable buyers would only add to their financial burden. Incentive schemes, while helping home buyers with their down payments, will cause home prices to rise at a more rapid pace. As such, a more aggressive effort to match the supply and demand of affordable homes under various government programmes is on the cards while the slow pace of the completion of these programmes will likely be addressed during the Budget.

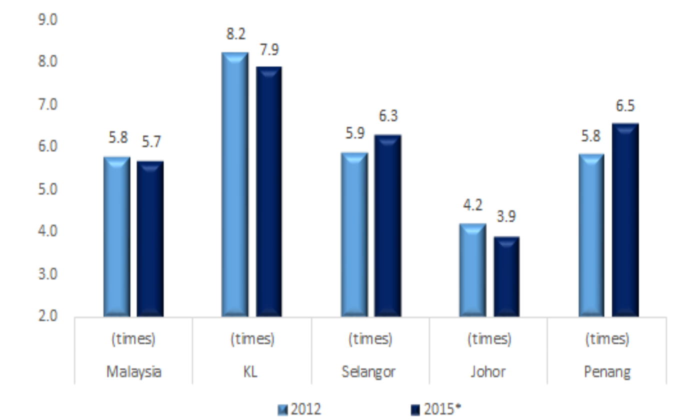
With difficulties faced by home buyers at a time of economic uncertainty, MARC feels that recent news flow on the possibility of allowing first time buyers to withdraw more than the current 30% from EPF to purchase their homes is worth considering as it would somewhat lessen their financial burden, especially at a time when prices are still at or close to their peak.

Chart 5: Headline CPI, CPI ex-transport and food prices



Source: CEIC, MARC Economic Research.

Chart 6: Median house price-to-income ratio by major states

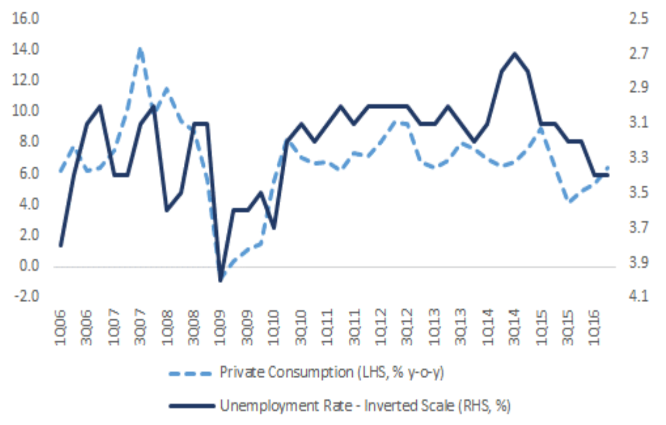


Source: CEIC, NAPIC, MARC Economic Research.
*Note: * = Median house price as of end 2015, annual median household income as of 2014*

- ***To craft a long-term financial safety net plan for rakyat***

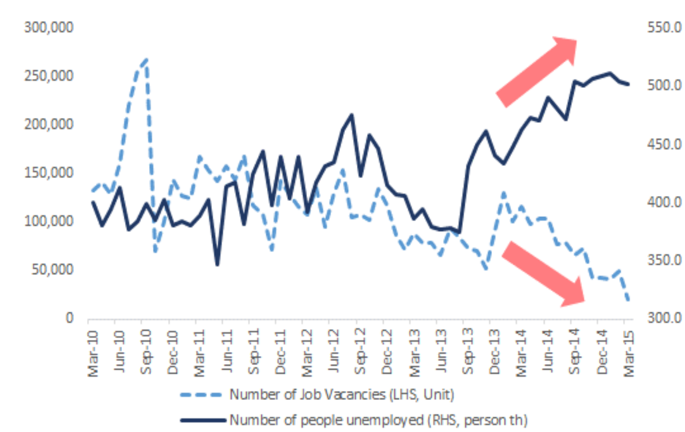
According to the Khazanah Research Institute (KRI), the average ratio of Malaysian household savings to adjusted disposable income stood at only 1.4%, suggesting that many households are vulnerable to economic shocks. MARC views that more comprehensive financial safety nets are needed as a long-term measure to cushion the impact of economic shocks on the *rakyat*. Among other measures, the unemployment insurance scheme which was a proposed initiative in Budget 2015 would be worth looking at in more detail. While in the US, unemployment insurance has benefitted workers who have lost their jobs due to retrenchment, such a comprehensive scheme has yet to be developed in Malaysia. MARC is of the view that such an insurance scheme would not burden the government as it would only involve a very small contribution that can be absorbed by both employers and employees. As such, a comprehensive framework should be developed for such an insurance scheme.

Chart 7: Private consumption and unemployment rate



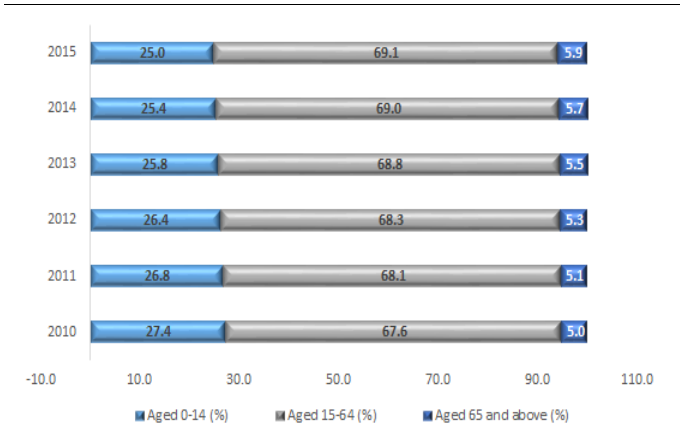
Source: CEIC, MARC Economic Research.

Chart 8: Number of people unemployed and number of vacancies



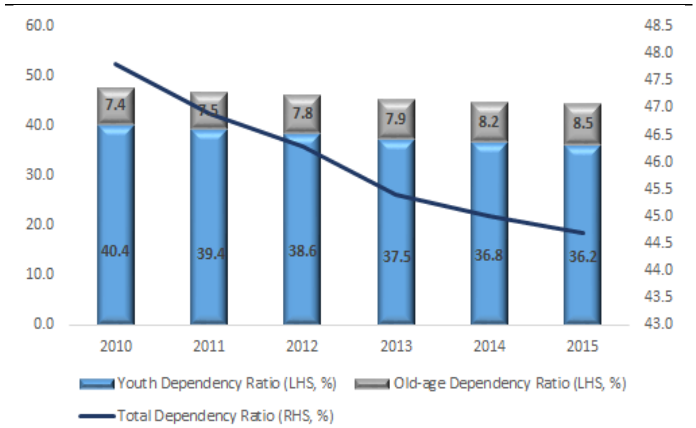
Source: CEIC, MARC Economic Research.

Chart 9: Malaysia's age structure as % total population



Source: DOS, MARC Economic Research.

Chart 10: Dependency ratio as % working age population



Source: DOS, MARC Economic Research.

- ***To deal with long-term issue of ageing population***

While Malaysia's median age population is rather young at 28 years, the impact of an ageing population in the economy is slowly emerging. For instance, statistics show that while government expenditures for emoluments as a percentage of total operating expenditure (OPEX) remained unchanged at about 32% in 2015 compared with 30 years ago, the percentage of expenditures on pensions and gratuities had doubled to more than 8% compared with 4.1% in the mid-1980s. This evidences the need for long-term measures to mitigate the impact of an ageing population on the economy.

In this regard, MARC feels that one of the areas to focus on is healthcare as medical expenses now constitute a large part of individuals' expenses, especially in old age. Rapid increases in medical costs not only burden the *rakyat* but will also increase the government's healthcare expenditure in the long run. Raising the penetration rate of medical insurance will benefit both parties. This could be done by, among others, allowing members to withdraw from their EPF to purchase a critical illness medical plan which is important when they are no longer covered by employee medical benefits. This would enable Malaysians to save on medical costs during their golden years and help ease the government's increasing medical expenditure in the future. Currently, EPF withdrawals for paying medical costs after they are incurred are allowed, and we view that withdrawals for purchasing medical protection plans would be less costly in the long term.

- ***To deal with increasing complexities of the financial market***

With regard to the financial market, MARC feels that a new guarantee fund is needed for the purpose of credit enhancement for infrastructure projects. As funding for infrastructure projects remains a key issue, a government-led initiative akin to the EIB's project bond credit enhancement or the ADB's backstop partial credit guarantee facility to provide partial credit enhancement to project bonds could help mobilise more capital market investment in infrastructure projects. The partial credit enhancements can be used to enhance project bonds with standalone "A" ratings to the "AA" level, which will meet the minimum required credit rating requirements of domestic institutional investors.

MARC is also of the view that efficiency in domestic capital markets can be enhanced further through selected measures such as making IPO Ratings mandatory. Such a measure will ensure potential investors have the benefit of an independent, reliable assessment of the fundamentals of new public issues. This has been done in other countries such as India, where an IPO rating, which is a one-time exercise based on equity fundamentals, is required. MARC believes that such a measure would also be positive for Malaysia's capital market.

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