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Post-GST Removal: Risk Prospects Ahead

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Macro assessment and sovereign rating

- Overall, MARC is of the view that based on its national rating scale, the government transition post-General Election 14 has no sovereign credit rating impact. Under its national scale, the government of Malaysia is rated AAA as it has the lowest relative credit risk in the country.

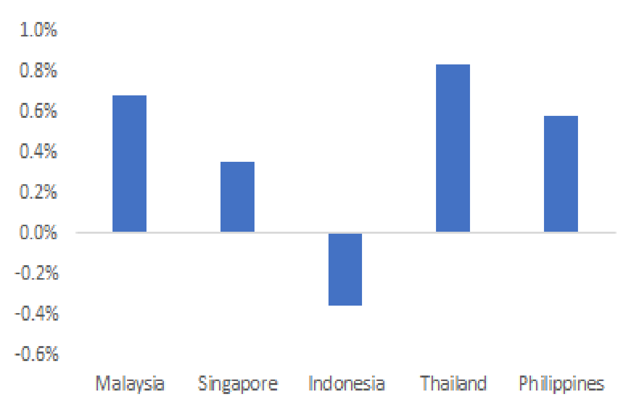
- MARC does not expect any significant shift in the country's long-term macro policy direction at this juncture. Economic growth will remain resilient on the back of economic policies that are generally proactive and practical, supported by strong macroeconomic and prudential policy frameworks. Bank Negara Malaysia's effective monetary policy, for example, is one of the key factors contributing towards Malaysia's economic success. There are, however, concerns over Malaysia's future fiscal landscape especially with the absence of the Goods and Services Tax (GST) revenue which accounted for roughly 20% of total federal government revenue in 2017.

Growth prospects remain unchanged

- At a macro level, we maintain our real gross domestic product (GDP) growth forecast for 2018 at 5.3%. Growth will generally be supported by a favourable external environment. Robust global trade, although could be affected by negative sentiment following an inward-looking US trade policy, is key to a decent export performance by Malaysia this year. A commendable export sector performance would in turn act to support domestic demand. MARC foresees real export growth to be 6.0% in 2018.

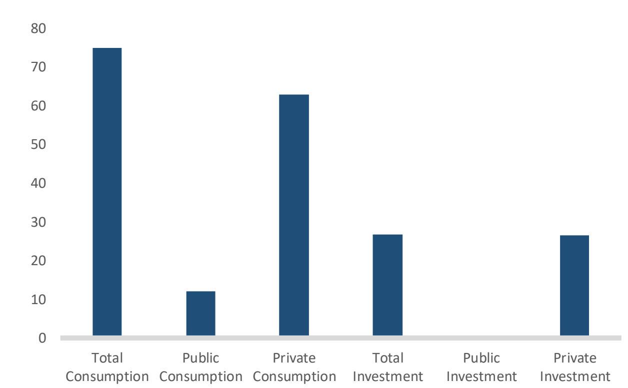
- On the domestic side of the equation, MARC foresees total investment's contribution to headline growth to decline in 2018 in view of the possible moderation in the pace of mega projects due to the new government's reprioritising of projects. In 2017, total investments had contributed circa 26.6% to headline growth (2016: 16.3%). Meanwhile, private consumption growth could sustain circa 7.0% level, and its contribution to headline growth will likely improve slightly to 65%-70% (2017: 63%).

Chart 1: GDP growth in 2017 versus average 2010-2016



Source: DoSM, IMF, MARC Economic Research

Chart 2: Malaysia - contribution to headline GDP in 2017

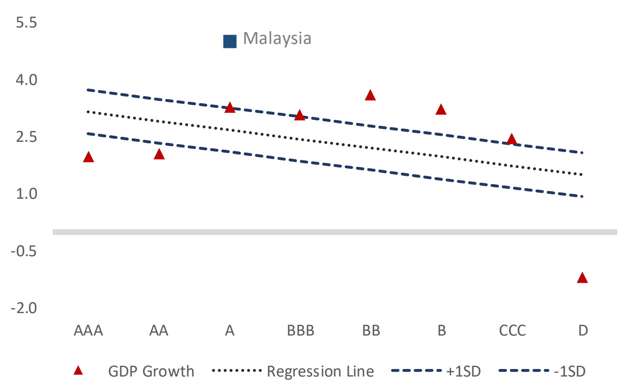


Source: DoSM, CEIC, MARC Economic Research

- We expect the impact of GST removal to be neutral on private consumption in 2018. While it will uplift consumer sentiment in the short term, the actual consumer spending trend would depend on the impact of GST removal on general prices. We foresee "price stickiness" to be a major challenge for policy makers as businesses may, for example, be reluctant to reduce prices due to (1) profiteering (2) a general belief that most businesses will not reduce prices. As such, alternative mechanisms may be needed to handle the issue of "price stickiness" post-GST removal, if a decrease in prices is the objective of the authorities.

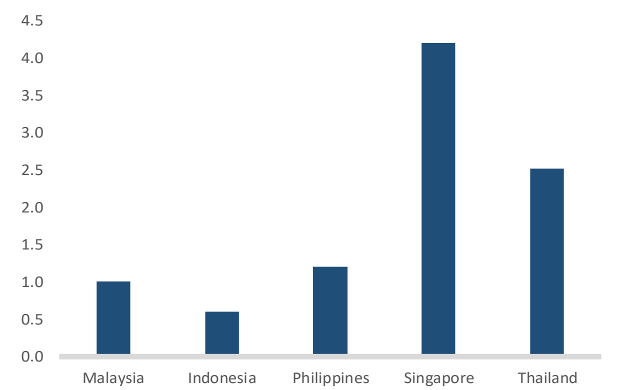
- In comparison with A-rated countries (at international scale by S&P, Fitch and Moody's), Malaysia's GDP growth performance has been commendable in the past few years. Real GDP growth came in at 5.9% in 2017, and its three-year median stood at 5.0% compared with 3.3% for A-rated countries*.

Chart 3: Three-year median GDP growth by rating band



Source: IMF, MARC Economic Research
**Referred to all A-rated countries by the Big 3-Moody's, Fitch and S&P*

Chart 4: GDP growth volatility of selected ASEAN countries



Source: IMF, MARC Economic Research

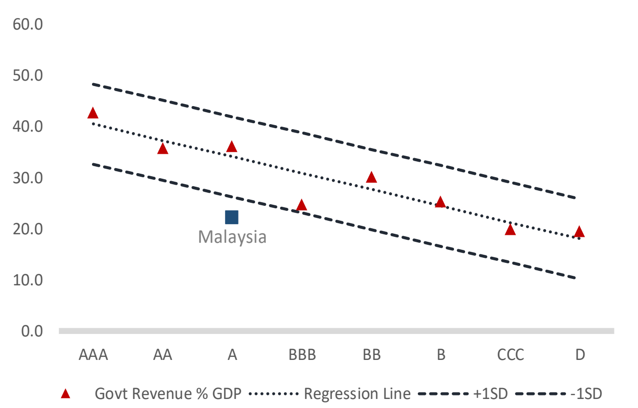
Main concern is future fiscal landscape

- The main concern from a sovereign rating perspective is none other than the shortfall in federal government revenue after the abolition of the GST. The government has, on 16 May, announced that all goods and services subject to the GST will been zero-rated. It is notable that the revenue from the GST averaged circa RM43 billion per annum between 2016-2017, about RM26 billion more than the average amount collected under the sales and service tax (SST) between 2013-2014. MARC is of the opinion that the gap between the amount of SST to be collected in the near future and the abolished GST would not be as large as generally expected due to the larger number of taxpayers after the latter was introduced in 2015.

- Short-term measures that the government will likely introduce to fill the revenue gap include reducing leakages and reprioritising projects when utilising its operating expenditure (OPEX). Higher commodity prices (particularly from oil and oil-related products) would also provide extra revenue to government coffers. This is in view of the average year-to-date (YTD) Brent crude oil prices which are 30% more than the prices assumed in Budget 2018. For 2018, we foresee crude oil prices to remain circa USD70 per barrel or one-standard deviation below its long-term mean. This is premised on stronger global economic growth, supported by a resilient US and China as well as a steady recovery of the European economy.

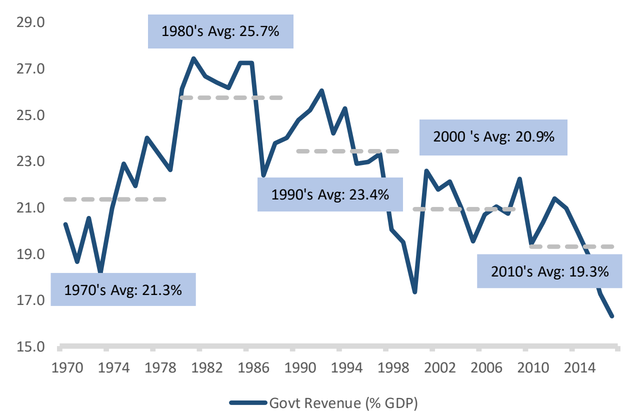
- Our estimate shows that Malaysia's budget deficit for 2018 would remain unchanged from last year's level of 3.0% of GDP. This is based on the assumption that nominal GDP growth will be circa 7%-8% and the gap between the earlier projected GST revenue and the potential revenue in 2018 (GST in the first 5 months of 2018 and SST in second half of the year) would be around RM17 billion. Furthermore, we assume a 3%-4% reduction in OPEX. After taking into account the RM7-RM8 billion additional revenue from higher crude oil prices and additional cost of fuel and electricity subsidy this year, we foresee budget deficits to be roughly RM44 billion or 3.0% of nominal GDP.

Chart 5: Three-year median of government revenue as % of GDP by rating band



Source: IMF, MARC Economic Research

Chart 6: Malaysia's revenue as % of GDP & its averages over the decades



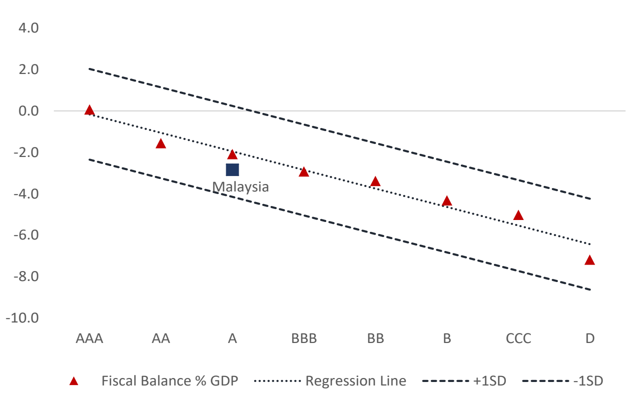
Source: MoF, MARC Economic Research

- Over the medium-to-long term, however, it remains to be seen the types of new revenue sources that are available to replace the fiscal shortfall due to the removal of the GST. Longer term initiatives will be needed to keep medium-term fiscal consolidation efforts on track. This would mean new initiatives to generate alternative revenue sources in the years ahead. It is worth noting that Malaysia's average revenue-to-GDP has declined to 19.3% between 2010-2017, compared to 20.9% in the 2000s and 23.4% in the 1990s. This is in contrast to an average of more than 35% of GDP among A-rated countries.

- At the same time, it is also worth noting that Malaysia's OPEX as a percentage of GDP had increased to 19% between 2010 and 2017 from 18.1% in the 1990s and 18.6% in the 2000s. This increase, if it is not contained, could exert more pressure on Malaysia's fiscal position if revenue further declines in the absence of the GST.

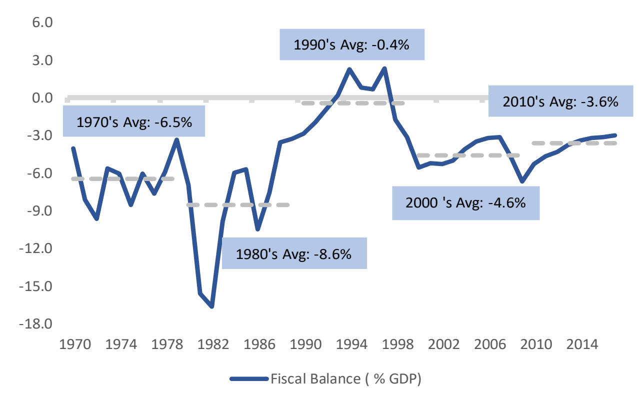
- We are of the view that greater clarity with regard to policy measures that affect both revenue and expenditure is needed to fully assess the impact of GST removal on Malaysia's fiscal performance in the next few years. From a sovereign rating perspective, the government's fiscal vision in the medium term is critical in determining its prospects going forward. On a three-year median basis, Malaysia's fiscal balance stood at circa -3% of GDP, compared with -2.1% of GDP for A-rated countries. Notwithstanding this, we need to stress the fact that Malaysia has never defaulted on any of its sovereign debt despite running fiscal deficits in most of the years since 1970.

Chart 7: Three-year median of fiscal balance as % of GDP by rating band



Source: IMF, MARC Economic Research

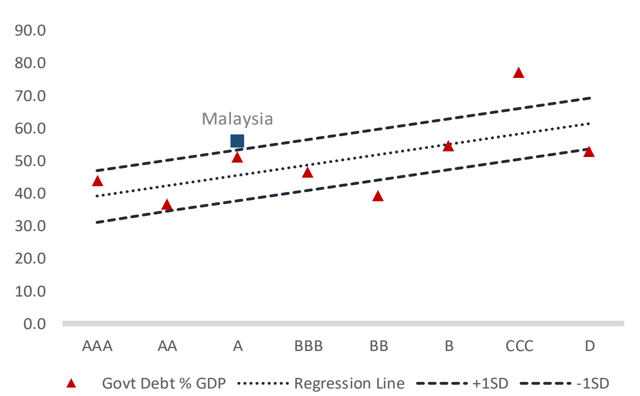
Chart 8: Malaysia's fiscal balance since 1970



Source: MoF, MARC Economic Research

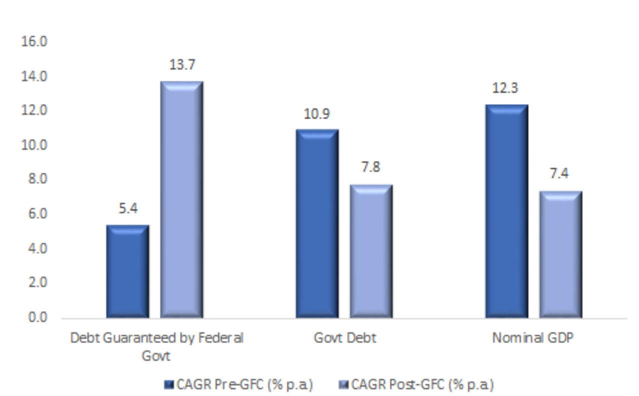
- Malaysia's debt level is another sovereign credit rating constraint. While the federal government debt-to-GDP ratio has moderated recently, debt in absolute terms has risen over the years. Post-Global Financial Crisis (GFC), government debt had risen by 7.8% on a compound annual growth rate (CAGR) basis over the 2010-2017 period while debt directly guaranteed by it has climbed by 13.7% over the same period. Overall, as a percentage of GDP, Malaysia's general government debt level lies approximately at one standard deviation above the mean for A-rated countries.

Chart 9: Three-year median of general government debt as % of GDP by rating band



Source: IMF, MARC Economic Research

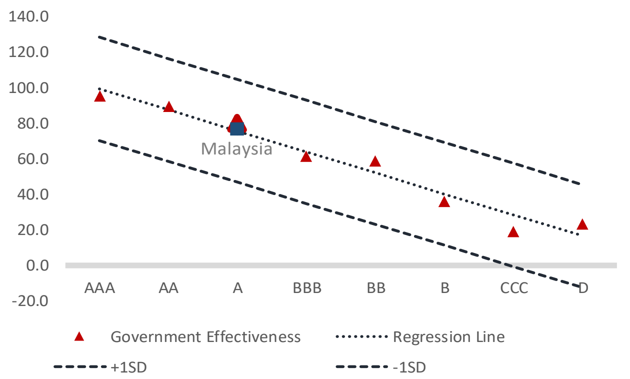
Chart 10: Growth of government debt, debt guaranteed and nominal GDP on CAGR basis 2002-2008 and 2010-2017



Source: CEIC, MARC Economic Research

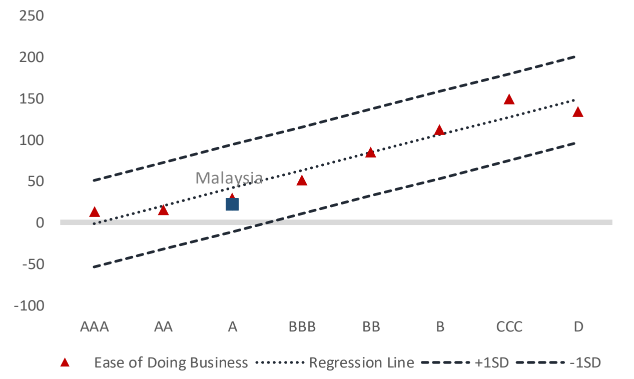
- Part of the pledge by the new government is to improve governance and keep the business environment friendly. An improvement in governance would be positive from a sovereign rating perspective going forward. On a three-year median basis, Malaysia's percentile ranking in terms of 'government effectiveness', a sub-component in the World Bank's Worldwide Governance Indicators project report, stands at circa 77, down from its peak of 85 in 2007. This is in comparison with a median percentile ranking of 80 among A-rated countries. As for ease of doing business, Malaysia is ranked quite favourably in the World Bank's "Ease of Doing Business" ranking report at number 23 on a three-year median basis, compared with number 30 for A-rated countries.

Chart 11: Three-year median of World Bank's government effective ranking by rating band



Source: World Bank, MARC Economic Research

Chart 12: Three-year median of Ease of Doing Business by rating band



Source: World Bank, MARC Economic Research

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