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Pre-Budget 2019:
Getting Finances Back on Track

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In a nutshell

- Budget 2019 will focus on strengthening the economy's medium- and long-term fundamentals by alleviating imbalances that had accumulated over the past few years. The main beneficiaries will be those who need assistance the most (i.e. the Bottom 40% of households (B40), the Middle 40% of households (M40), Small- and Medium-Sized Enterprises (SMEs)). Financial aid could be made conditional while blanket subsidies will be replaced with targeted aids.
- The government's focus on improving fiscal health and reducing debt would mean total expenditure will be further rationalised. Excluding a one-off commitment for Goods and Services Tax (GST) refund, allocations for operating expenditures (OPEX) will likely be trimmed for 2019 as hinted in the mid-term review of the 11th Malaysia Plan. For OPEX, three main areas of focus could be (i) emoluments; (ii) pension and gratuities; and (iii) debt service charges, which grew faster than the nominal gross domestic product (GDP) in the past 10 years (7.3%, 9.6% and 9.0% p.a. on a compound annual growth rate or CAGR basis).
- The proposed allocation for development expenditure (DE) in Budget 2019 could be lower than the average of past Budgets (2010-2017: RM50 billion per annum). While this may be so, MARC expects the government to push for higher utilisation of the budgeted allocation in 2019 (2010-2017: 89% utilisation of the budgeted allocations).
- The urgent need to raise additional revenue in the medium- and long-term arises from the loss in revenue from the abolishment of the GST. Several options have been discussed including taxes on foreign providers in the digital economy, higher stamp duties for property transactions by foreigners, sin taxes, etc. Current tax incentives given to different industries could be made conditional (i.e. based on productivity improvements). Inheritance and capital gains taxes may not be considered in the near term, as more studies are required to assess the effectiveness and repercussions of their implementation on the capital market and the economy.
- The debt problem will be addressed through the firming up of future economic growth plans, rather than through overzealous expenditure cuts. Budget deficit targets could be revised upwards to between 3.5%-3.8% of GDP for 2018 but will be reduced to 3.4% of GDP in 2019. MARC sees this spike in budget deficit as a one-off event as the government implements measures to repair its balance sheet. Further increases in the government's contingent liabilities will be avoided (2010: 11.8% of GDP; 2017: 17.6% of GDP).
- Other macro assumptions that MARC has penciled in for 2019 include: (i) a real GDP growth of 4.6%; (ii) an inflation rate of 2.0%-2.5%; (iii) a government budget deficit of 3.4% of GDP; (iv) a current account surplus of 2.0%-2.5% of the gross national income (GNI); and (v) an overnight policy rate (OPR) of 3.0%.
- A slight adjustment in the OPR is possible if the headline growth starts to skid towards the bottom range of 4%. This is in view of the fact that (i) inflation is expected to be well contained in 2019; and (ii) fiscal policy is constrained by budget deficits. The statutory reserve requirement (SRR) could also be adjusted downward in an effort to enhance liquidity support.
- Anxiety over a possible adjustment in Malaysia's sovereign rating outlook by international credit rating agencies (CRAs) could resurface going forward. Key to Malaysia's future rating and rating outlook are CRAs' medium-term assessments of its budgetary landscape and debt position. A convincing and detailed narrative of how the new fiscal trajectory will pan out in the near term is critical to give comfort to the CRAs. In any case, MARC sees the following factors remaining supportive of Malaysia's rating outlook at this juncture: decent headline GDP growth, benign inflation, relatively favourable external position and better perception of improving transparency and governance.
- The main focus of the investment fraternity will likely be on the ringgit's future trajectory as attention will be on the market's reaction towards a medium-term budget deficit trajectory, the government's new revenue-generating measures and new growth forecasts as well as initial assessments by international CRAs.

The focus of Budget 2019

To target only the needy

Budget 2019 to focus on economy's medium- and long-term fundamentals.

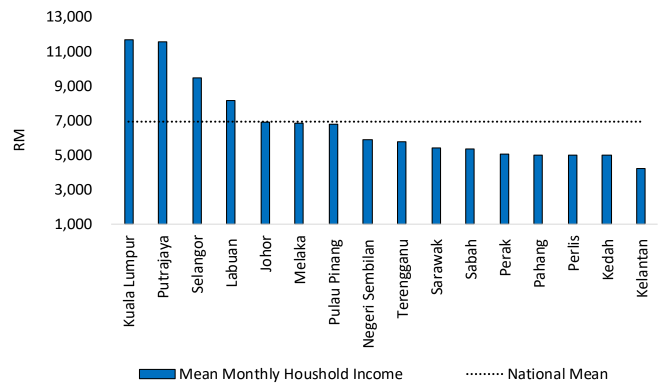
- Budget 2019, which is scheduled to be tabled on November 2, 2018, is expected to focus on strengthening the economy's medium- and long-term fundamentals by alleviating the imbalances that have accumulated over the past few years. The government's determination to address the problem of rising federal government debt in recent years, which is now estimated to be RM1.09 trillion, would mean unnecessary expenditure would be contained in the upcoming Budget.

Special attention will be given to those who need assistance the most.

Conditional financial aid and targeted subsidies could be implemented.

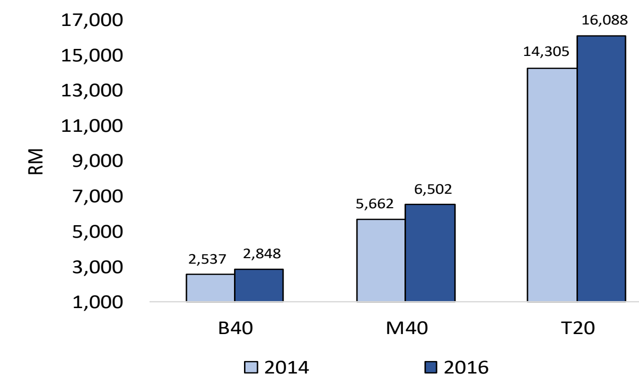
- Only those who need assistance the most (i.e. the B40 and M40 households, SMEs) would likely receive special attention. The recent findings by Khazanah Research Institute on the gap between the income of the top 20% households, and medium and bottom 40% households having widened post-Global Financial Crisis (GFC) underscores the need to further assist low-income groups. However, financial aid for such groups could be made conditional to help mitigate the rising costs of living. Similarly, blanket subsidies (i.e. fuel subsidy) will be replaced by aids targeted only for low-income groups.

Chart 1: Mean monthly household income by state, 2016



Source: CEIC, MARC Economic Research

Chart 2: Mean monthly income by household group, 2014 and 2016



Source: CEIC, MARC Economic Research

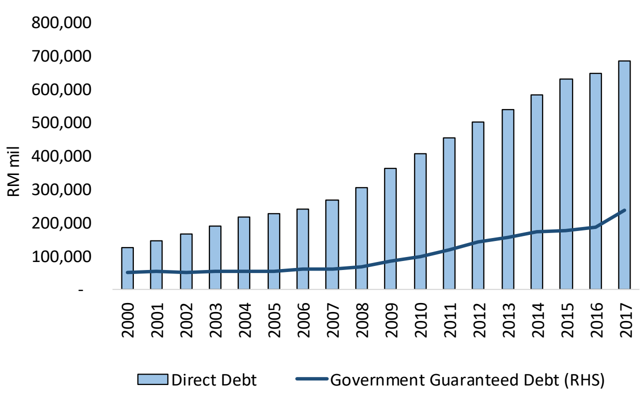
To continue addressing the debt problem

Gap between growth of government debt and nominal GDP raised concerns among policy makers.

- According to the new estimate, the federal government debt is RM1.09 trillion* (compared with the previous estimate of RM686 billion by the former administration at end-2017). Even by using the previous estimate, the Malaysian government debt had risen by 9.4% p.a. on a CAGR basis since 2008. Malaysia's nominal GDP, on the other hand, grew at a slower pace of 6.5% during the period. The gap between the growth of government debt and nominal GDP has raised concerns among policy makers.

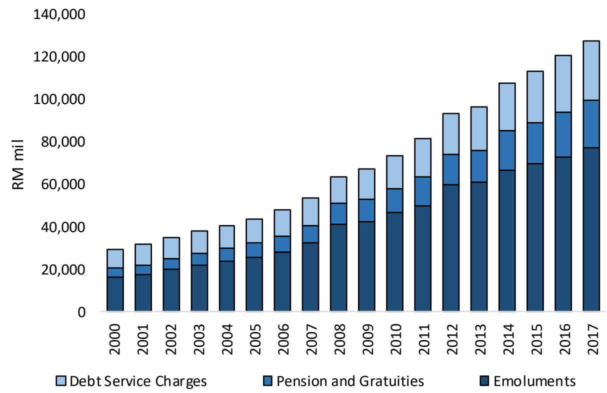
**Current calculation assumes crystallisation of some contingent liabilities and lease payments. It is not directly comparable with the previous statistics.*

Chart 3: Direct debt and debt guaranteed by the federal government, 2000 - 2017



Source: CEIC, MARC Economic Research

Chart 4: Operating expenditure breakdown, 2000 - 2017



Source: CEIC, MARC Economic Research

Drastic increase in contingent liabilities is viewed unfavourably by the government.

- There will be a continued focus on trimming contingent liabilities as the government views its sharp increase over the past 10 years unfavourably. Such liabilities surged by 14.7% p.a. on a CAGR basis over the 2008-2017 period as a means to manage debt levels. Against such a backdrop, it is now likely that the issuance of unrated government guaranteed bonds that had grown at a CAGR of 34.5% p.a. between 2010-2017 will be sharply reduced in the future.

To further rationalise OPEX but sustain DE

OPEX will continue to be rationalised as actual OPEX exceeded budgeted amount in the past.

- The focus will continue to be on rationalising OPEX which grew at a CAGR of 4.0% p.a. between 2008-2017. During the period, actual OPEX was on average RM7.5 billion more than was originally budgeted p.a.. While the bulk of OPEX comprised emoluments (35% of OPEX in 2017), a sharp growth in expenditure for pension & gratuities as well as debt service charges (2008-2017: 9.6% and 9.0% on a CAGR basis respectively) explains the surge in the overall OPEX.

DE, on the other hand, has remained stagnant over the years.

- DE, on the other hand, remained stagnant during the 2008-2017 period, edging by merely 0.5% p.a.. While expenditure for economic services grew at a CAGR of 1.4%, those for social services fell by 1.1% p.a. over the period. The overall decline in DE partly reflects the government's difficulty in generating sufficient revenue for development purposes due to sharp increases in OPEX.

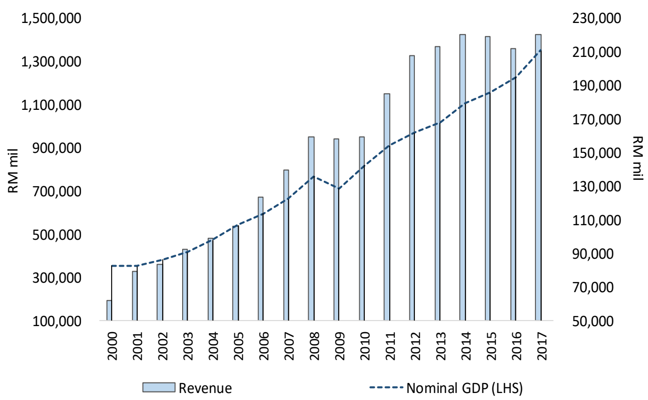
Room for further OPEX reduction is diminishing.

- Going forward, while the government will continue to rationalise OPEX, the room for further reduction is diminishing. Trimming emoluments will be politically difficult while debt service charges could increase due to rising interest rates. This suggests that further efforts will be carried out to plug leakages through more efficient procurement processes of supplies and services, contract negotiations and transparent processes.

Government will likely aim for higher utilisation of DE

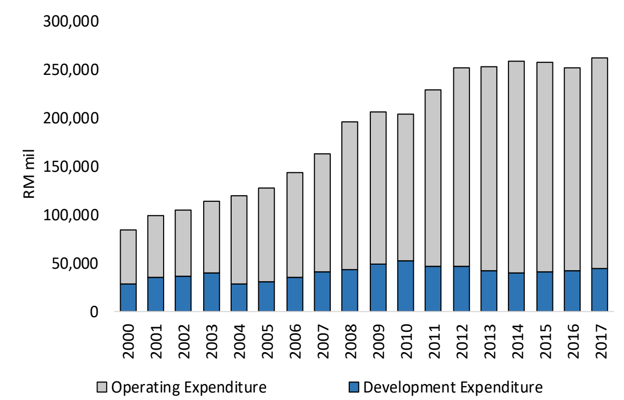
- The proposed allocation for DE in Budget 2019 could be lower than the average of past Budgets (2010-2017: RM50 billion p.a.). While this may be so, MARC expects the government to push for higher utilisation of the budgeted allocation in 2019 (2010-2017: 89% utilisation of the budgeted allocations).

Chart 5: Nominal GDP versus revenue, 2000 - 2017



Source: CEIC, MARC Economic Research

Chart 6: Expenditure breakdown, 2000 - 2017



Source: CEIC, MARC Economic Research

To introduce alternative revenue stream

Additional revenue to be raised in the absence of GST.

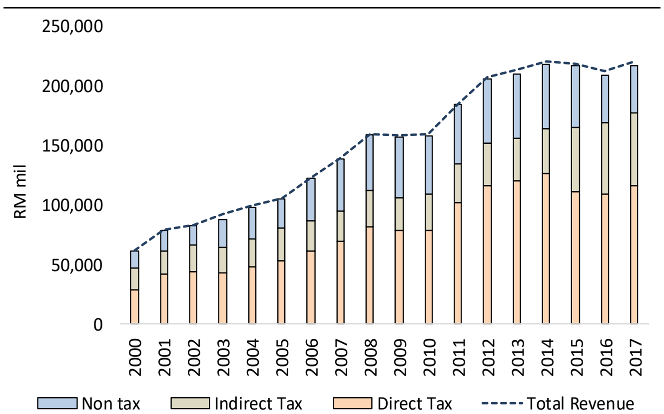
Revenue gap will be met by additional taxes.

- The urgent need to raise additional revenue in the medium- and long-term arises from the abolishment of the GST in June 2018. The estimated RM20 billion - RM25 billion gap in revenue (GST 2017: RM 44.3 billion; SST 2014: RM 17.2 billion) will be met by additional taxes, according to the government. Several options have been discussed including taxes on foreign providers in the digital economy, higher stamp duties for property transactions by foreigners, sin taxes, etc. Current tax incentives given to different industries could be made conditional (i.e. based on productivity improvements).

Inheritance tax will not be effective in generating much revenue. Property-related and digital taxes are in the offing.

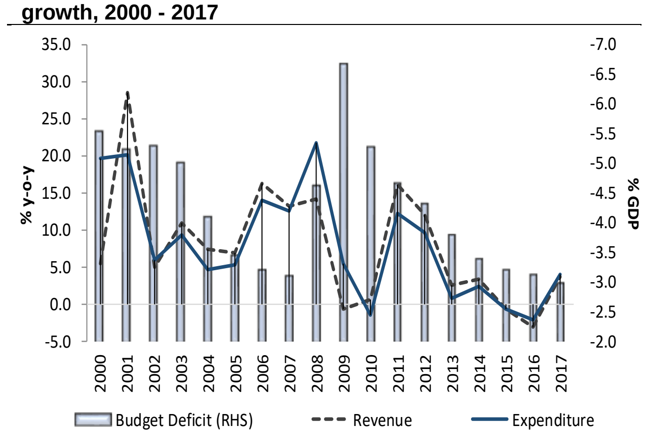
- According to the news cycle, the government will further study the viability of imposing inheritance and capital gains taxes in the future. MARC opines that inheritance tax will not be effective in generating much revenue. Taxes on capital gains (financial market transactions) could also affect investor sentiment. Taxes on property-related transactions (i.e. higher stamp duties for property transactions by foreigners) and foreign providers in the digital economy are likely, although their effectiveness would depend on the details to be announced.

Chart 7: Revenue breakdown, 2000 - 2017



Source: CEIC, MARC Economic Research

Chart 8: Budget deficit versus revenue and expenditure growth, 2000 - 2017



Source: CEIC, MARC Economic Research

To sustain reasonable expansion of the economy

Economic growth will not be compromised despite cuts in expenditures and debts.

Government will ensure a decent economic growth trajectory.

- Recent comments by government officials indicate that economic growth will not likely be compromised despite the government's conscious efforts to rationalise expenditure and reduce the debt. Rhetoric on how unrealistic fiscal deficit targets are in the short term and the need to grow the economy in order to shrink the debt ratio suggests that the government will try to ensure a decent economic growth trajectory in near term. We anticipate the government will target a real GDP growth rate of 4.5%-5.5% in 2019 (MARC 2018F: 4.8%; 2019F: 4.6%).

Overall implication

Expenditure allocations could be slimmer but conducive for economic growth.

- Excluding a one-off commitment for GST refund, we expect lower allocations for Budget 2019 (Budget 2018 allocation: RM280.3 billion, 6.9% more than Budget 2017) as the government focuses on being lean in its expenditure. In the past 10 years, the government announced lower allocations in Budget 2010 and 2016, the year following the GFC and the year after global crude oil prices declined sharply by 74.0% (peak to trough).

Slower GDP growth in 2019 amid decelerating private consumption and moderating exports.

- Our in-house forecast for real GDP is 4.6% for 2019, slightly slower than our revised 4.8% growth in 2018. The deceleration in private consumption growth to 6.0% from 6.8% in 2018 and a moderation in exports are the underlying factors behind the softer headline GDP growth. Private investment will stabilise slightly while public investment will show a positive growth on the back of the low base in 2018.

Consumer spending could turn cautious due to adverse reaction on new taxes and tight financial conditions.

- Consumer spending is expected to turn cautious if the government's announcements on new taxes cause an adverse reaction in consumer sentiment. Increased financial constraints among civil servants who, according to a Bank Negara Malaysia study, are left with only 15% of their monthly salaries to spend on discretionary items, is also a negative factor for consumer spending in the near term.

Inflation to remain benign. Downside pressure will be limited by ringgit weakness.

- Inflation will remain benign on the back of moderating domestic demand and a weaker external environment. The GDP deflator is also flashing a signal of lower overall prices in the economy (2Q2018: 0.9% versus 2Q2017: 4.5%). However, the relatively weak ringgit will to some extent, limit the weakness in CPI numbers. We expect CPI inflation to be in the range of 2.0%-2.5% in 2019.

Low real GDP growth could lead to an OPR cut and reduction in SRR.

- A monetary policy adjustment could lead to a 25-bps cut in the OPR in 2019 if real GDP growth starts to skid towards the bottom range of 4%. This is in view of low inflation that results in a still positive real interest rate of 0.5%-1.0% in 2019 (2018: 2.0%). The SRR could also be adjusted downward in an effort to enhance the liquidity support of the economy. We foresee a possibility of a 50 bps-100 bps reduction in the SSR if growth numbers start to look vulnerable from the viewpoint of policy makers.

Budget deficit target could be lifted significantly but does not imply a medium-term fiscal slippage.

- The budget deficit target could be adjusted upwards significantly to ease the pressure on growth. This is despite the increasing risk of a greater scrutiny on Malaysia's sovereign rating outlook by international CRAs. MARC anticipates the budget deficit target to be lifted significantly to circa 3.5%-3.8% of GDP in 2018 before moderating to 3.4% of GDP in 2019. MARC sees this spike in budget deficit as a one-off event as the government implements measures to repair its balance sheet.

Future rating outlook will hinge on medium-term budgetary landscape and debt position.

- Anxiety over a possible adjustment in Malaysia's sovereign rating outlook by international CRAs could resurface going forward. Key to Malaysia's future rating and rating outlook are CRAs' medium-term assessments of its budgetary landscape and debt position. A convincing and detailed narrative of how the new fiscal trajectory will pan out in the near term will be credit positive. In any case, MARC sees the following factors remaining supportive of Malaysia's rating outlook at this juncture: decent headline GDP growth, benign inflation, relatively favourable external position and better perception of improving transparency and governance.

Focus of investment fraternity will likely be on ringgit's future trajectory as market assesses medium-term budget deficit trajectory, new revenue measures and initial reactions by international CRAs.

- The focus of the investment fraternity will likely be on the ringgit's future direction as attention will be on the market's reaction towards a medium-term budget deficit trajectory, the government's new revenue-generating measures, new growth forecasts and initial assessments by international CRAs.
- The recent drop in the ringgit has made the currency look attractive from the real effective exchange rate point of view. Notwithstanding this, against the backdrop of a strong USD owing to global and domestic uncertainties, the ringgit will likely remain vulnerable in the near term.

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