Economic Research

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Fuel Hike: Darkest Before Dawn

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Rationale for the hike

The government unveiled a new subsidy scheme structure in view of the increasing burden it will have to shoulder following a significant jump in the global crude oil prices. Prior to the revamp, the government estimated that total subsidy would increase to RM 53 bn in 2008, up from RM 35 bn due to a substantial rise in oil prices. Total fuel subsidy including revenue foregone at the federal level has escalated to RM 16.2 bn in 2007 from RM 6.6 bn in 2003.

On top of that, the government has also spent a total amount of RM 9.3 bn on various subsidies in 2007. These include subsidies for rice, education, transport and social purposes. The amount has climbed steadily from RM 5.1 bn in 2003.

Table 1: Historical Fuel Hike

Date	RON 97	Diesel
May-02	1.32	0.72
Nov-02	1.33	0.74
Mar-03	1.35	0.76
May-04	1.37	0.78
Oct-04	1.42	0.83
Apr-05	1.42	0.88
May-05	1.52	1.08
Jul-05	1.62	1.28
Feb-06	1.92	1.58
Jun-08	2.70	2.58

Source: Media Announcement

Why such a steep increase?

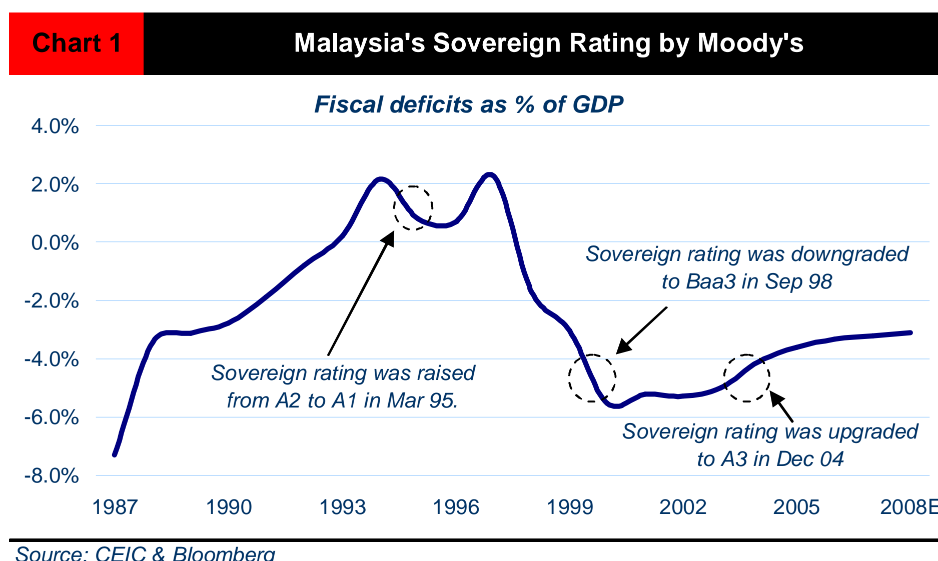
From an economic point of view, a small increase will only lead to further speculation that more increases are on the cards. Besides, with an unprecedented increase in global crude oil prices, it will just be a matter of time before the government needs to adjust the prices upward again in the near term. That will be more disastrous for the overall sentiment among consumers. Following the increase, the government pointed out that it will be “impractical” to raise fuel prices again in the short-term, at least until March next year.

Impact of fuel hike

i. Improvement in fiscal deficit

Malaysia's fiscal deficit has been an ongoing issue since the Asian Financial Crisis. The deficit originated from pump priming efforts following a collapse in domestic and external demand during the AFC. In an effort to revive the economy, the government turned to public spending and as a result, budget deficit bloated to as much as 5.5% of GDP in 2000, a stark contrast with a surplus of 2.3% of GDP posted in 1997. The weakness in Malaysia's financial position was also exacerbated by rising fuel subsidies as a result of a continuous rise in global crude oil prices. Following an effort to close the budget shortfall, mega projects were scaled down in recent years and the deficit was trimmed to 3.1% in 2007. It is noteworthy that Malaysia's unfavorable fiscal position vis-à-vis its peers is one the critical factors that come under close scrutiny by international rating agencies in their evaluation of its sovereign rating. Hence, the expected reduction in subsidies will likely impact favourably on Malaysia's fiscal position and the country's sovereign rating.

Chart 1 **Malaysia's Sovereign Rating by Moody's**



Source: CEIC & Bloomberg

ii. Continuing subsidies on essential food items

Following the steep reduction in the fuel subsidy, the government can now allocate a larger portion of its coffers to meet other pressing needs of the *rakyat,* especially alleviating the burden caused by rapid increase in food prices. Such effort is crucial in offsetting the financial strain on the middle-and-lower income groups. Higher allocation for rice subsidies for instance may still continue considering the fact that growth in the amount allocated has recently accelerated to an average rate of 24% between 2005 and 2007, compared with only 9.5% pace in 2004. Similarly, the amount of subsidy for education has risen by 28% in 2007, double the rate it recorded in 2005.

Table 2: Government Subsidies

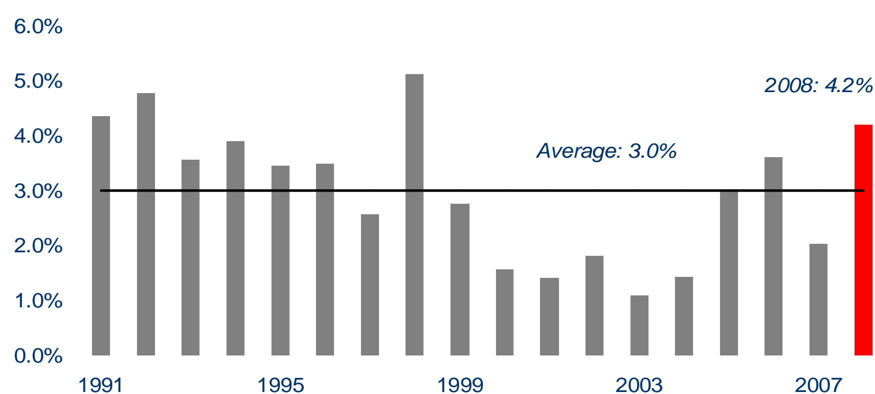
RM Billion	2005	2006	2007
Fuel subsidies			
:Direct Subsidies	8.2	7.3	8.8
:Taxes Foregone	7.8	7.4	7.4
:Gas subsidies from Petronas for power & ind. sector	14.3	15.6	18.0
Total fuel subsidies	30.3	30.3	34.2
Non-fuel Subsidies	6.3	8.1	9.2
Total subsidies	**36.6**	**38.4**	**43.4**

Source: Economic Planning Unit (EPU)

iii. Higher headline inflation

The impact of the fuel hike will be manifested in rising inflation in the immediate term. The rising inflation rate will not only be as a result of higher fuel prices, but will also be driven by higher electricity tariffs which will be raised by 18% for households and 26% the commercial and industry users. While the authorities are projecting inflation to average around 4.2% for 2008 following the hike, we foresee a slightly higher upside to the consumer prices as the spillover effects start to filter through the economy. Specifically, with a total weightage of 7.3% in the CPI, a 1% rise in the fuel cost would translate into a 0.07 percentage point increase to the overall CPI. The tariff hike in electricity, although immaterial, would add to inflationary pressure. During the last hike in February 2006 when petroleum prices were raised by 18%, the inflation rate rose by an average of 3.6% in that year, compared with 3% in 2005.

Chart 2 **Inflation rate is likely to surpass historical average in 2008**



Source: CEIC & MARC Estimates

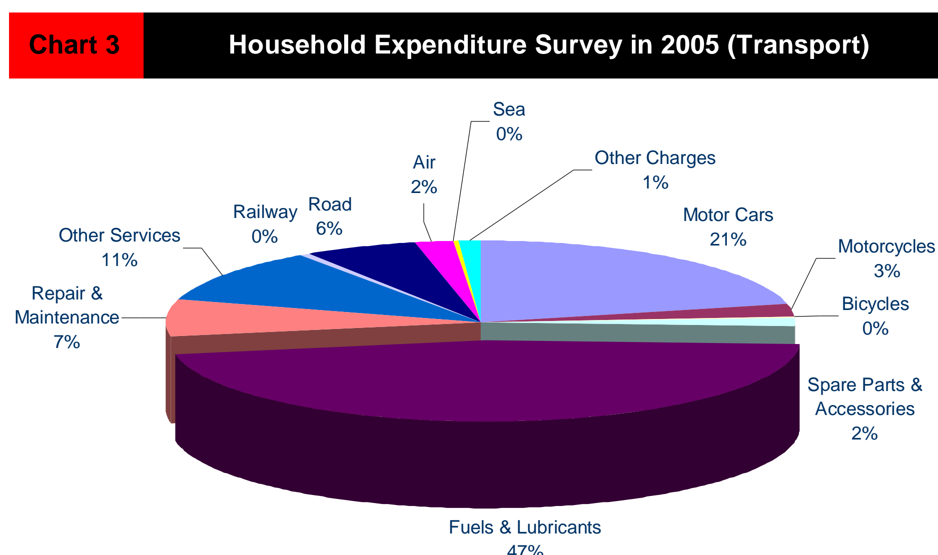
On top of that, there is an increasing risk of demand for higher wages (i.e. MTUC has proposed minimum wages for certain segment of labour force), suggesting that the second round effect may slowly seep into the economy if left unchecked. A sharp increase in transport cost might also have ripple effects on the other components of the CPI. Another critical, but yet difficult factor that needs to be considered in gauging the magnitude of potential increase in the CPI is a build up in inflation expectations resulting from the higher-than-expected increase in fuel prices. All these factors will heighten the prospect of actual CPI level surpassing the preliminary estimate by BNM for 2008. Looking from a more positive angle however, one can expect the CPI to normalize after the first half of 2009 as the initial high base effect starts to filter into the calculation.

iv. Lower consumer spending

Consumer spending will likely be the component of GDP that will be significantly affected by the recent fuel hike. Feeling the pinch from higher monthly expenditure on fuel, consumers will likely resort to curtailing their conspicuous consumption. The latest household expenditure survey shows that among households with income bracket of RM 700 – RM 5000, 13% of total monthly income was spent on transportation cost. A 41% increase in fuel prices will likely result in a reduction in expenditure on more 'luxury' items like entertainment and leisure activities.Another factor that may contribute to the moderation in consumer spending is higher inflation expectations and the anticipation of an increase in borrowing costs. Based on past experience, consumer sentiments reacted negatively to petroleum price hikes as inflationary expectations started to build up while consumers adjusted to higher cost of living.

Although private consumption still grew at a double-digit rate of 11.8% in the first quarter 2008, the pace has actually moderated from a high 12.3% in the second quarter 2007. In 2006, when fuel prices were raised by 18%, growth in private consumption softened to 6.5% from 9.1% in the earlier year. As such, a crude estimate suggests that a 41% increase in fuel prices this time may trim the growth in private consumption by 4-5 percentage points to circa 6% - 6.5% for 2008.

Chart 3 **Household Expenditure Survey in 2005 (Transport)**

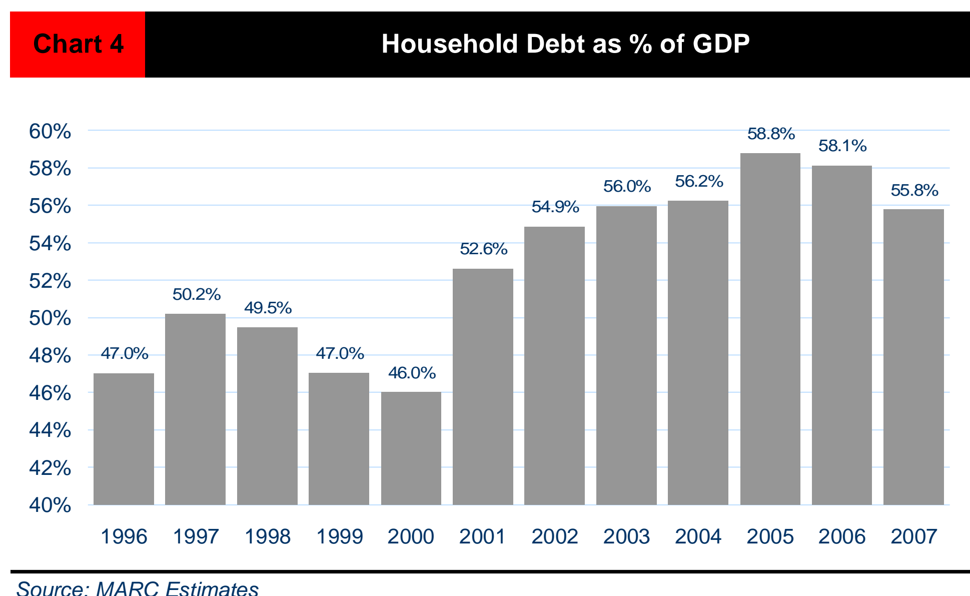


Source: CEIC & Department of Statistics

v. *Moderation of loan growth*

One other possible impact of the recent fuel hike is a moderation of the banking sector's loan growth as seen during previous hikes. Total loan outstanding in the banking system has grown at an average rate of 9.7% in the first quarter 2008. Consumer balance sheets have been rather stretched in the recent quarters. The year-on-year growth in personal loans jumped by 102% in April 2008 while the amount of household debt has increased steadily at a rate which corresponds to 8% annually in the recent months. While the first likely consequence of higher prices would be an expansion of consumer debt (through higher borrowings), an increase in risk aversion among banking institutions will likely result in higher lending standards, causing a moderation in the overall loan growth in the banking system. When petrol prices were raised by 35% between the period of March 2005 and February 2006, loan growth in the banking system declined to 6.3% in 2006 from 8.6% in the earlier year. The recent 41% hike in petrol prices will likely bring about the same repercussions in terms of banking system loan growth. Such moderation, if significant, will adversely affect the economy's headline growth going forward.

Chart 4 — Household Debt as % of GDP



Source: MARC Estimates

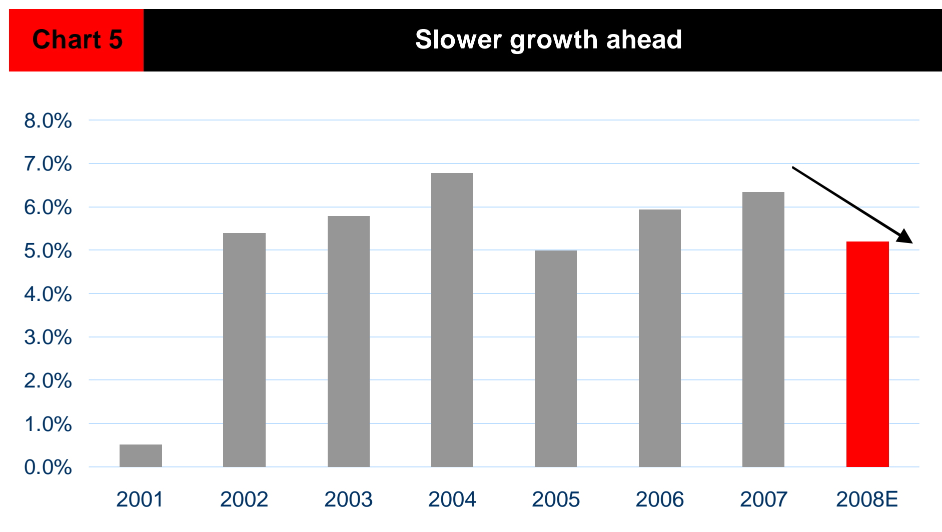
vi. *Softer headline GDP growth*

The impact on the overall headline growth of the Malaysian economy would primarily come from a possible weakness in private consumption. Private consumption has been a major pillar for the economy in the past few years evidenced by its rising share to total GDP of 51.1% in 2007 from 48.6% previously.

While the direct impact on private investment may look rather negligible, other indirect factors may come into play. Such factors may, in time, increase the possibility of a moderation in investment spending as critical domestic factors like larger-than-expected rise in the cost of doing business and an increase in the volatility of financial markets are taken into consideration.

Taking account the above factors, we foresee a likelihood of a softer headline GDP growth for this year compared with our earlier base line projection of 5.9%. Nevertheless, the final outcome will critically hinge on the dynamics of macro variables responding to the anticipated price increases in the economy. At this juncture, our preliminary judgment indicates a possible 0.5 – 0.7 percentage reduction in GDP growth from our initial forecast.

Chart 5 **Slower growth ahead**



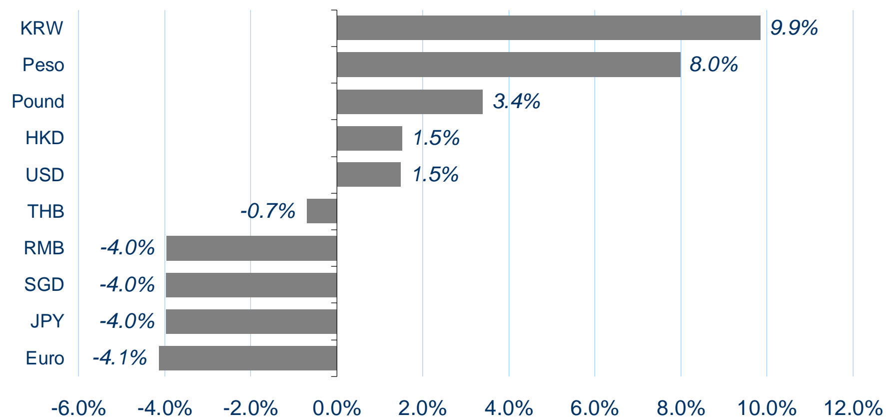
Source: CEIC & MARC Estimates

vii. Short-term consolidation in Ringgit's movement

There are two major opposite forces that are working on the Ringgit at this juncture. First, the prospect of slower economic growth as a result of the fuel hike will induce market participants to minimize their exposure to Ringgit and Ringgit-denominated assets. Second, a possible policy response from the BNM in an event of inflation running out of its trajectory will provide incentive for market players to have long positions in Ringgit and increase their accumulation of Ringgit denominated assets in the near future.

Of the two, we are of the opinion that economic growth considerations will dominate, at least in the immediate time frame. A toxic combination of weaker global demand, softer domestic activity and challenging political landscape will likely create speed bumps along the Ringgit's journey towards stronger levels against the greenback in the near future. The longer term prospect however remains promising especially if one were to value the Ringgit from the perspective of real effective exchange rate level.

Chart 6 **Ringgit vs. regional currencies (Y-T-D performance %)**



Source: CEIC & MARC Estimates

viii. Higher risk of monetary adjustment

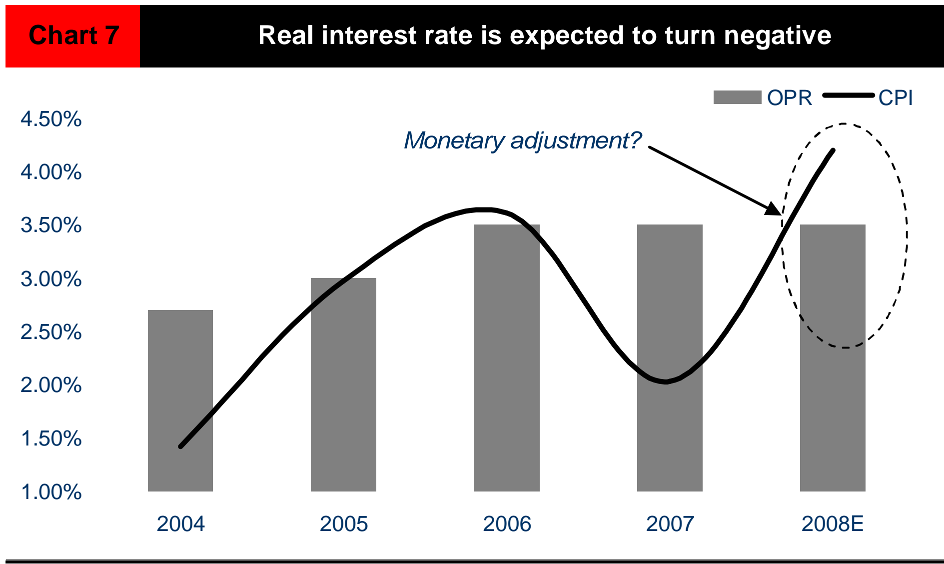
A prospect of nasty combination of slower growth and higher inflation will probably leave the BNM in a classic squeeze. Under the current situation, growth is not only being undermined by unfavorable external condition and demanding domestic environment, but also by a challenging political landscape. Such a scenario will call for a continuation of an accommodative monetary policy. On the other side of the coin, rising inflationary pressure as a result of high commodity prices and a sharp reduction in fuel subsidy will necessitate flexibility in the maneuvering of monetary policy.

The recent MPC meeting has concluded that the upside risks to inflation are roughly in balance with the downside risks to growth. At the same time, the recent comment by the central bank governor also indicated that there is no urgency to call a special meeting of the monetary policy meeting despite the recent upward revision in forecast inflation. There appears to be no immediate pressure for BNM to change its interest rate policy.

While we foresee the urgent need to support the overall economy at this juncture following possible negative repercussions of the fuel hike on the growth trajectory, we also sense an increasing risk of a possible monetary adjustment to respond to stronger upward price pressure. Even the financial market is beginning to discount a possible adjustment in the borrowing cost evidenced from the 5-year interest rate swaps which rose by 27.5 bps within a day on June 5th.

We believe that the final outcome will be very much dependent on factors like sources of inflation, the quantum of price increases in the next few months and the possible emergence of second round effects of inflation in the economy.

Chart 7 **Real interest rate is expected to turn negative**



Source: CEIC

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