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ECONOMIC REPORT | Fiscal Review

9 June 2016

Plausible GST Rate Cut if Oil Prices Move Higher

- *Oil prices have rebounded significantly since January this year, from as low as USD28.9pb on January 15th to USD52.5 yesterday. Government recalibrated budget was conducted with the assumption of oil price hover between USD30-35pb.*
- *We calculated the possibility of oil price averaging around USD55pb next year and found that it is plausible for Government to reduce GST rate by 1% if the current fiscal consolidation level continues. If the oil price average at USD75pb, GST could be further reduced to 4%.*
- *We opine that fiscal policy should be in a counter-cyclical manner rather than to focus on the debt level. Reduction in GST rate should help to boost private consumption, providing a support to the domestic economy in the midst of slowdown in global trade activity.*

Brent oil price averaged at USD39pb in 1H16, higher than imputed price in 2016 recalibrated budget. For the first half of the year, Brent was averaging at USD39pb, USD4pb higher than the USD35pb oil price scenario imputed in the 2016 recalibrated budget. Year-to-date, oil prices rose by 40.8% to reach a 2016 high of USD52.5. If the price momentum continues, higher oil price should therefore translate into higher oil related revenues to Malaysia. Besides, at higher price, Petronas should be able to churn higher dividend, contributing more to the nation's coffer. For FY16, the national oil conglomerate is expected to contribute RM16 billion in dividends, the lowest in more than a decade.

Our current house call for average oil prices for FY16 stands at USD45pb. In order to match the forecast, oil prices basically only need to hold the current price for the rest of the year. This is highly plausible given that oil has been on the uptrend since hitting rock bottom earlier this year. The most recent spike in oil prices was largely attributed to the declining dollar after the Fed chairman, Yellen hinted on no exact timing on future rate hike following a disappointing May job report. Nevertheless, we believe the upside is limited due to the current dynamics of global demand and supply. While demand continues to see tepid growth, major oil producers have been improving their operating efficiency, bringing down their breakeven cost production level. Thus, more supply is expected to enter the market especially at higher prices.

Government could reduce GST the rate by more than 1%, should oil prices climb above USD55pb, ceteris paribus. The government had made its intention sky-clear that the GST implementation last year was to broaden its tax base and continue with its fiscal consolidation plan. The move, though unpopular, manages to mitigate the shortage in federal revenue due to the rout in global oil prices starting mid-2014 and received global affirmation from international rating agencies such as Moody's and Fitch. We estimate that if oil prices averaged at USD55pb in FY17, government could reduce GST rate by 1% bringing the rate to 5% (currently at 6%). At USD75pb, another 1% could be shelved while maintaining the current fiscal consolidation target.

Table 1: GST Collection (2017 Estimate)

<table>
<tr><th>GST Rate</th><th>GST Revenue (2017)</th><th>Oil Revenue (2017)</th><th>Total Revenue (GST + Oil)</th></tr>
<tr><td>6%</td><td>RM42 billion</td><td>Oil Price: USD35pb
RM27.5 billion</td><td rowspan="3">RM69.5 billion</td></tr>
<tr><td>5%</td><td>RM35 billion</td><td>Oil Price: USD55pb
RM34.5 billion</td></tr>
<tr><td>4%</td><td>RM28 billion</td><td>Oil Price: USD75pb
RM41.5 billion</td></tr>
</table>

Source: MIDFR

A reduction in the GST rate could boost higher private consumption. According to Bank Negara Malaysia (BNM)'s estimate, on average GST contributed 0.7 percentage points to inflation level while our own estimate was higher at 1.1 percentage points. Although we are not expecting significant reduction in the price level if GST is being reduced, we believe the inflation level could be suppressed, hence helping to boost private consumption. Note that the global economic condition is not doing well right now, and a boost in private consumption via lower GST should help Malaysia economy.

Fiscal policy should be counter-cyclical rather than focusing on the debt level. Despite debates among economists on the needs of Government intervention in the economy, we opine that fiscal consolidation had the same effect as a contractionary policy. With the current economic environment – particularly with the weaknesses in global trade activity, we believe that an expansionary fiscal policy should be employed in order to support domestic economy in the short term.

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