26 September 2019

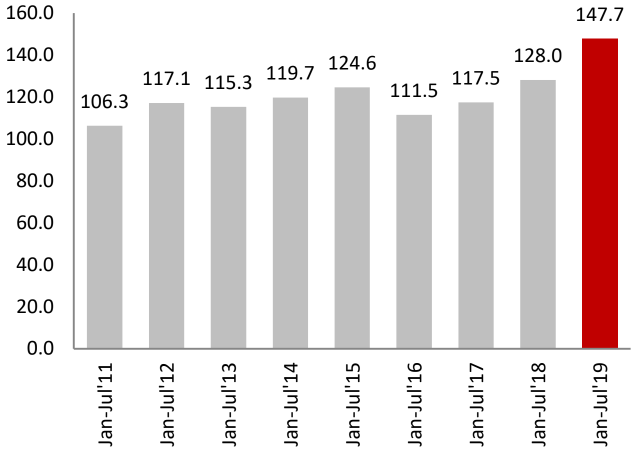
Budget 2020: Expansionary Policy amid Challenging External Environment

- *Malaysia's economy continues growing at steady pace. Malaysia's economy is showing resilience and continues to perform however at moderating pace. We expect the economic growth to stay around the estimate of 4.5%-5.0% in 2020 due to less growth impetus from external sources.*
- *Higher revenue and development expenditure. In line with the expansion in domestic economy, revenue to the government is expected to grow higher this year and stay on upward trajectory in 2020. The increase in revenue is expected to come from various sources.*
- *Based on our estimates, the budget deficit is predicted to improve at gradual pace, reaching 2.8% by 2020. The prospect of achieving a balanced budget over the next 3 years is indeed tough.*
- *We opine the government will set its oil price assumption at $60-$65. Even the oil price not as lucrative as before, oil & gas players are still able to keep pumping output and remain steady in the business.*

Budget 2020: Continuation of expansionary policy. Malaysia's upcoming fiscal policy is an expansionary policy with greater focus on development expenditure. From macro standpoint, economic outlook is not optimistic for 2020 particularly due to downside risks among others with ongoing USA-China trade war, USA presidential elections, protectionist EU, geopolitical tensions in Middle East and volatility of commodity prices. Externally is pessimistic while domestically is expected to stay resilient amid solid domestic demand, stable job market and expansionary government budget. Budget 2020 is predicted to boost domestic economic activities, gain advantages of the USA-China trade war and offset external trade slowdown. We can also expect further increase in minimum wage from RM1,100 to RM1,200, lower trade and investment barriers and provision of incentives & grants for local SMEs.

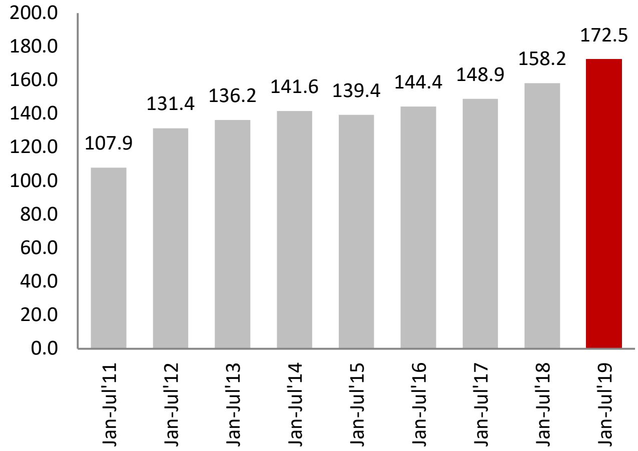
Strong recovery in government revenue. As of Jan-Jul'19, government revenue recorded at RM 147.7b. On monthly basis, the average revenue is RM 21.1b. The monthly revenue has been consistent above RM 20b since Aug-18. Despite no GST and lower crude oil prices, revenue growth surged to 8-year high at 15.4%yoy. On expenditure side, total spent for the first seven months is RM 172.5b. The total expenditure grew strongly by 9%yoy, fastest since the same period of 2013. Strong pick up in government expenditure is possibly due to GST refunds payment and high development expenditure mentioned in the previous budget.

Chart 1: Govt. Revenue (RM B)



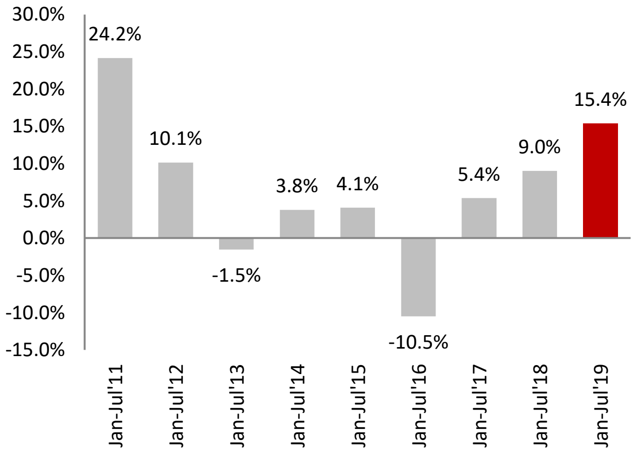
Source: CEIC, MIDFR

Chart 2: Govt. Total Expenditure (RM B)



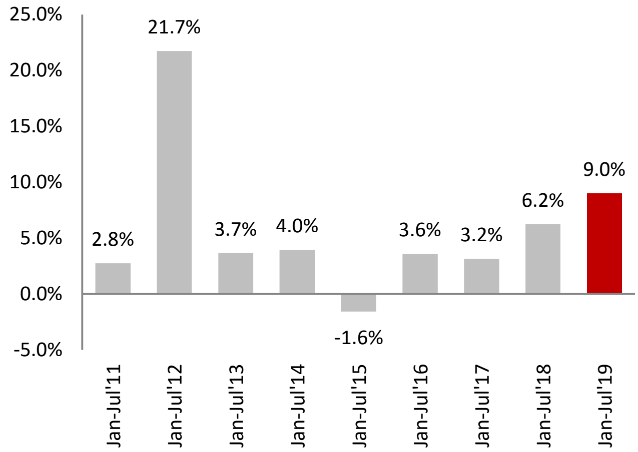
Source: CEIC, MIDFR

Chart 3: Govt. Revenue (YoY%)



Source: CEIC, MIDFR

Chart 4: Govt. Total Expenditure (YoY%)

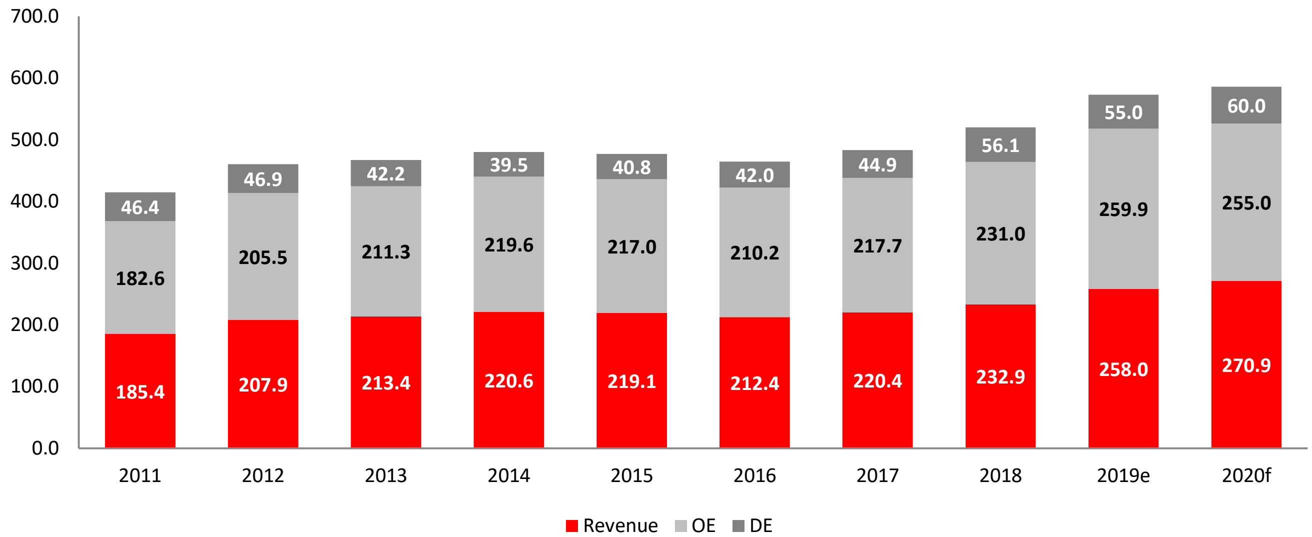


Source: CEIC, MIDFR

Malaysia's economy continues growing at steady pace. Malaysia's economy is showing resilience and continues to perform however at moderating pace. We expect the economic growth to stay around the estimate of 4.5%-5.0% in 2020 due to less growth impetus from external sources. Externally, USA-China trade war, USA presidential elections, protectionist EU, geopolitical tensions in Middle East and volatility of commodity prices are the downside risks in the medium term for the Malaysian economy. On the other hand, easing monetary policy by developed and emerging markets may boost global demand and trade flows in 2020. As for 2019, we forecast the economy to grow by 4.9%.

Higher revenue and development expenditure. In line with the expansion in domestic economy, revenue to the government is expected to grow higher this year and stay on upward trajectory in 2020. The increase in revenue is expected to come from various sources, including corporate, individual income taxes and petroleum tax amid improving economic activities. Moving forward, we forecast the government revenue to increase by 5% in 2020, in tandem with expectant of GDP growth of 4.5%-5.0%. For the expenditure side, we expect slightly lower operating expenditure as compared to 2019. GST refund payment was among main factors for the high operating expenditure recorded in 2019. Development expenditure is expected to touch RM 60b mark with greater focus on development projects including transport, industry and agriculture & rural developments.

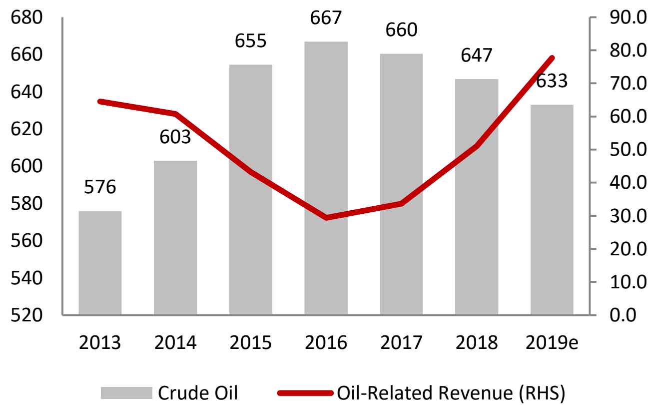
Chart 5: Government Revenue, Operating & Development Expenditures (RM B)



Source: CEIC, MIDFR

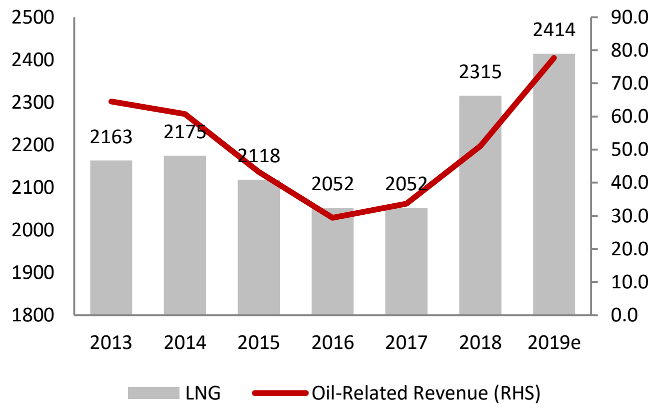
Full-capacity production and PFLNG 2. For 2020, we forecast Brent crude oil price to average at USD 65pb. The average price during Jan-Aug'19 was USD 65.10pb. We opine the government will set its oil price assumption at $60-$65. Even the oil price not as lucrative as before, oil & gas players are still able to keep pumping output and remain steady in the business. For 2018 and 2019 Malaysia had a supply disruption particularly at Kebabangan Gas Field. The field is expected to run at full-capacity in Aug-19. Furthermore, Petronas's second floating liquefied natural gas named PFLNG 2 will be operational in 2020. Looking ahead, we predict oil & gas output to expand firmly next year underpin by encouraging oil price and higher productions of crude oil and natural gas. This may translate into better oil-related revenue to the government's coffer.

Chart 6: Crude Oil Production vs Oil-Related Revenue



Source: CEIC, MIDFR
*(Thousand Barrel per Day vs RM B)

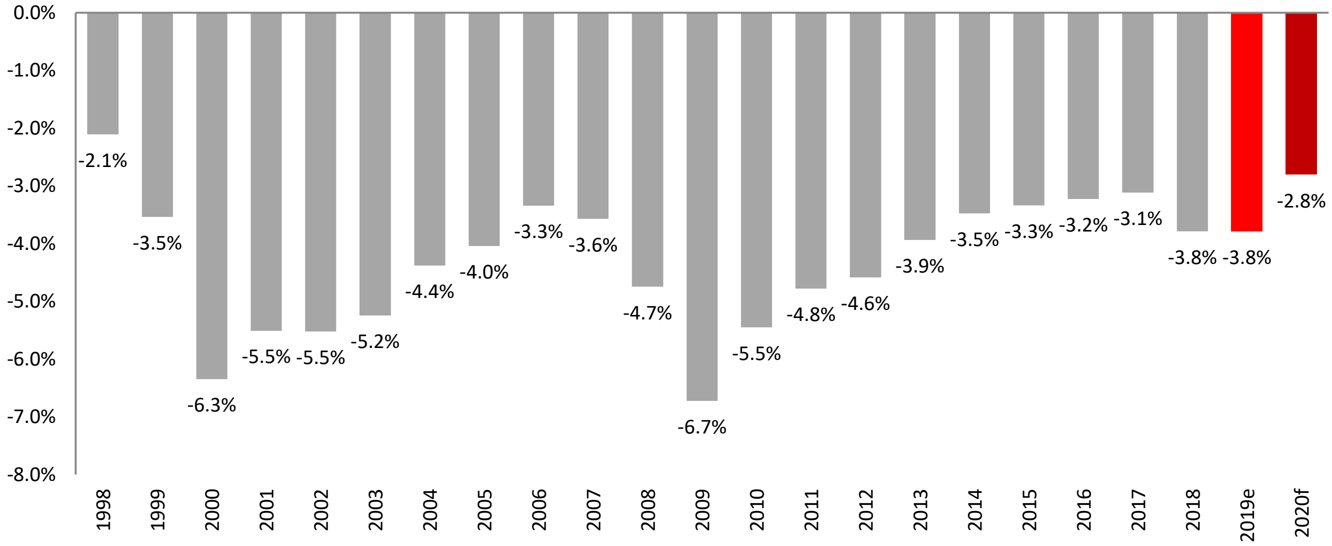
Chart 7: LNG Production vs Oil-Related Revenue



Source: CEIC, MIDFR
*(Metric Ton per Month vs RM B)

Moving towards a balanced budget. We forecast budget deficit to hit 3.8% this year underpinned by better government revenue, lower operating expenditure and moderating economic growth. Malaysia Government is still steadfast with the fiscal consolidation plan and our budget deficit has been in a gradual decline since 2009, from the height of -6.7% to -3.8% in 2018. Based on our estimates, the budget deficit is predicted to improve at gradual pace, reaching 2.8% by 2020. The prospect of achieving a balanced budget over the next 3 years is indeed tough particularly with the environment of global economic and market uncertainties as well as volatile commodity prices.

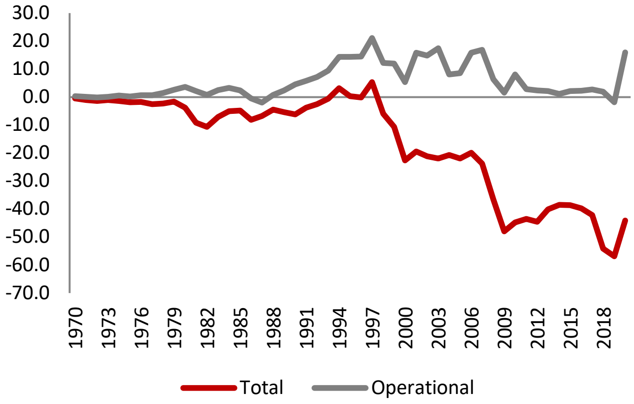
Chart 8: Budget Deficit to GDP Ratio (%)



Source: CEIC, MIDFR

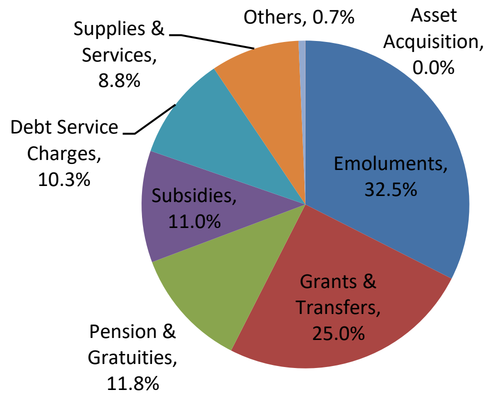
Fiscal stays in positive operational balance. Government revenue has always been enough to cover operating expenditure even during economic crises. 2019 is an exceptional year due to the GST refund payment worth between RM 30-37b. The largest component of operating expenditure is emoluments (32.5%), grants & transfers (25%) and pension & gratuities (11%). Malaysia's fiscal deficit also affected by higher development expenditure. The widening development expenditure was aimed to counter two economic crises, Asian Financial Crisis 1998 and Global Financial Crisis 2009.

Chart 9: Budget Balance (RM B)



Source: CEIC, MIDFR

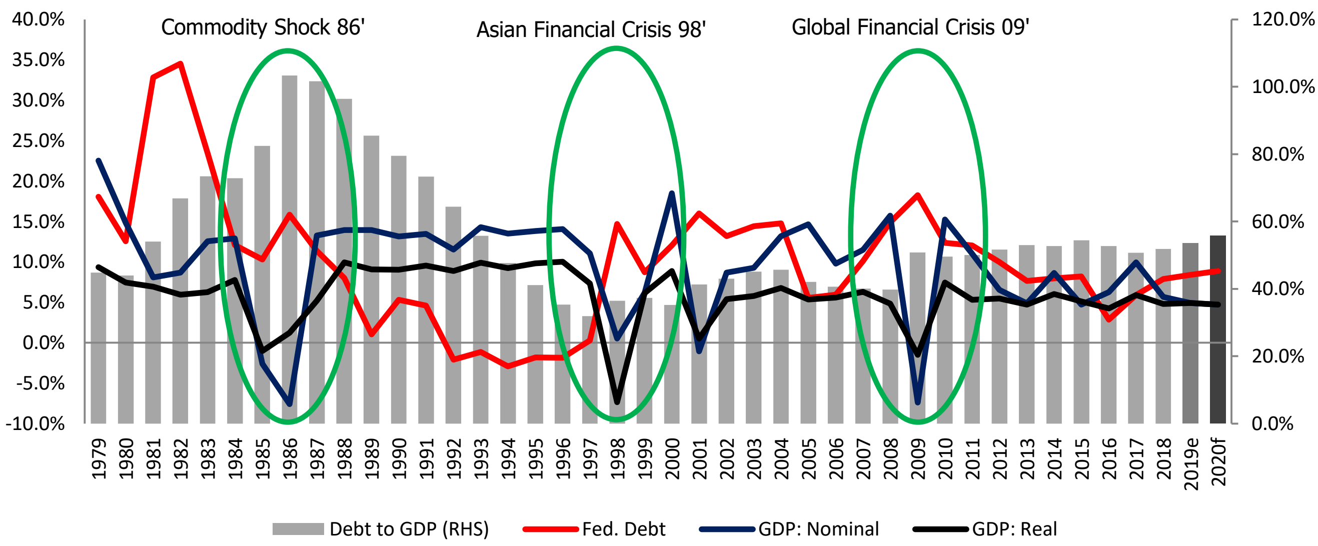
Chart 10: Operating Expenditure Components (%)



Source: CEIC, MIDFR

Debt to GDP ratio is influenced by growth and inflation. Stagnant debt with solid economic expansion will lower down the ratio level and vice versa. For instance, the ratio hits record high in 1986 at 103.4% amid of huge contraction in Malaysia's nominal GDP by -7.6% with the government debt expanding at 15.9% during the year. Since the Commodity Shock 1986, Malaysia's government debt has been growing at moderating pace and in fact experiencing contractions during 1992-1996 as Malaysia had budget surplus during those years. At the moment, the debt-to-GDP ratio was stable, at below 55% ceiling level and reflecting resilient macroeconomic foundation for the country. With the uncertainties on the geopolitical front that continue to rein on global economic growth and fuelling concern over looming recession, there is a risk that the debt ratio will breach the 55% ceiling level from a slower Malaysia GDP growth and higher federal debt from expansion in development expenditure.

Chart 11: Govt. Debt & GDP Performances (YoY%)

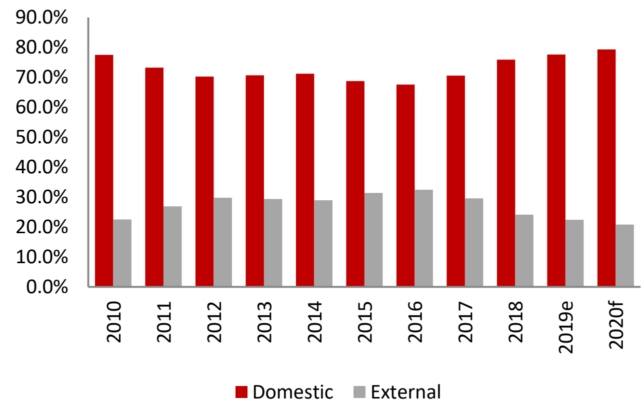


Source: CEIC, MIDFR

Domestic debt largest stakeholder. For every RM1 debt owned by the Malaysian government, 76 cents belongs to domestic while 24 cents to foreign in 2018. The share of foreign debt is expected to fall further. In 1H19, foreign debt grew by 3.3%yoy while domestic debt jumped 12.5%yoy. With the current structure of government debt, risk of contagion effects is minimal due to trifling exposure to foreign debt.

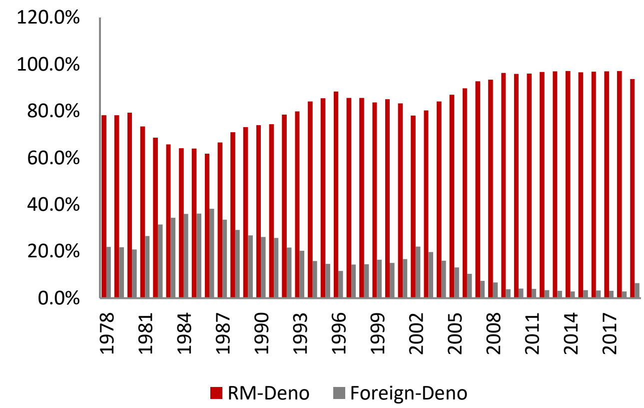
Government debt will still be mostly Ringgit-denominated. As of 1H19, most of government debt is RM-denominated close to 93.7%. Oppositely, only 6.3% of the debt is foreign-denominated. The foreign-denominated debt has been below 10% since 2006. Therefore, the government debt position is relatively safe and resilient even in the event of massive devaluation of RM. By type, government securities and investment issues are two main components under the RM-denominated debt. Government securities and investment issues constitute about 54% and 44.1% respectively last year while treasury bills and other loans hold another 4.7% in 1H19. Nevertheless, we think that the lower exposure to foreign currency denominated debt will provide some room for the government to proceed with the issuance of the second issuance of Samurai bond, especially at a much cheaper interest rate of about 0.5% compared to around 4% is issued domestically in Malaysia.

Chart 12: Govt. Debt Share by Source (%)



Source: CEIC, MIDFR

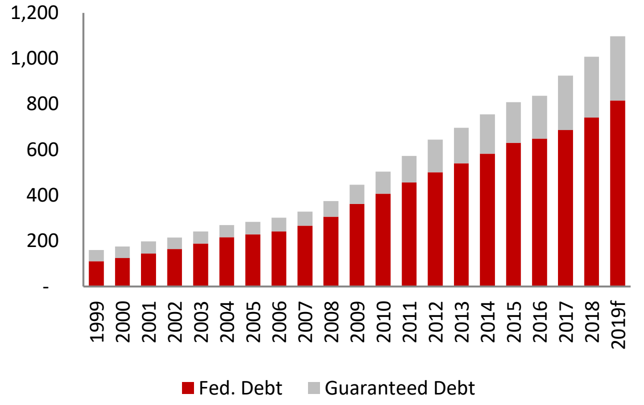
Chart 13: Govt. Debt Share by Currency (%)



Source: CEIC, MIDFR

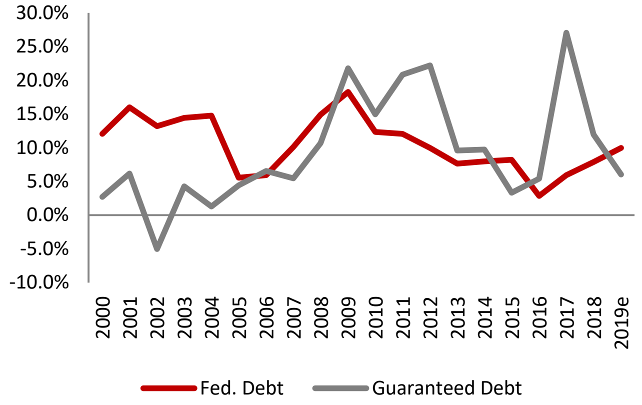
Reducing government guaranteed debt. As of 1H19, federal debt and government guaranteed debt totaled at RM 1.08t. Federal debt at RM 799b and government guaranteed debt at RM 276b. The debt level has breached the trillion marks since Dec-18. Nevertheless, the new government plans to reduce the guaranteed debt gradually. The growth pace of the debt has been on the reducing trend, from 27%yoy in 2017 and 12%yoy in 2018 to 6.8%yoy in 1H19. The process of reducing the guaranteed debt will take years but while in the short term it can reduce government's operating expenditure via debt service charges. Federal debt is usually on upside trend supporting development expenditure bills size.

Chart 14: Federal Debt. Vs Govt. Guaranteed Debt (RM B)



Source: CEIC, MIDFR

Chart 15: Federal Debt. Vs Govt. Guaranteed Debt (YoY%)



Source: CEIC, MIDFR

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