Malaysia 2019 Budget Preview – A derailed fiscal consolidation

Sweeping policy changes under the Malaysian government's drive to improve people's standard of living and drive out political corruption have strained public finances. We expect this to push the fiscal deficit above 3% and keep it there through 2019

Malaysian Prime Minister, Mahathir Mohamad

Long-term inclusive growth, sustained development

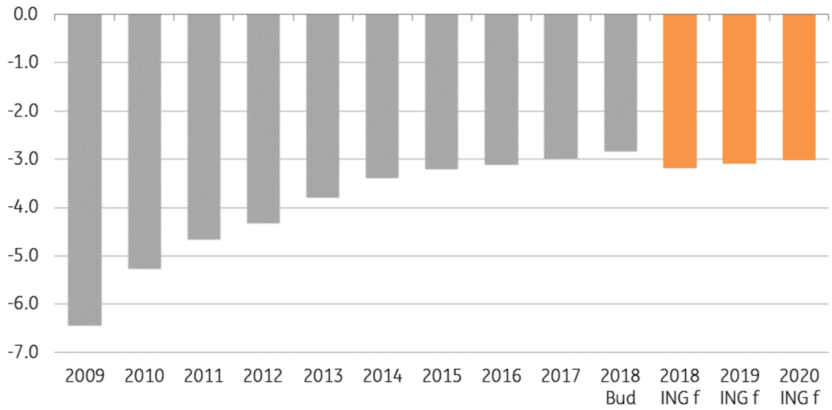
The Mid-term Review of the 11th Malaysia Plan 2016-2020 (11MP) unveiled by Prime Minister Mahathir earlier this month (18 October) sets a clear tone for the upcoming Federal Budget for 2019 – a derailed fiscal consolidation. The first budget of the Pakatan Harapan [Alliance of Hope] coalition government will be presented to the parliament by Finance Minister Lim Guan Eng on Friday next week, 2 November.

As per the 11MP review, the fiscal policy by the new administration will be driven by objectives of an 'inclusive growth and sustained development'. As tighter fiscal stance and risk from global trade tension slam the breaks on the economy, the government has downgraded GDP growth target for the remaining plan period, 2018-2020, by half a percentage point, from 5-6% in the original plan to

4.5-5.5%. The target for inflation is also revised slightly from 2.5-3% to 2-3%. And, contrary to the earlier target of a balanced budget by 2020, the fiscal deficit is now projected at 3% of GDP over the plan period.

Notwithstanding its drive to rein in high public debt the focus remains on continued fiscal consolidation. Yet the year 2018 will see the trend of steadily falling fiscal deficit underway since 2009 coming to an end; the deficit hit a record 6.7% of GDP in 2009 and has more than halved to 3% by 2007 (see below). The initial budget for 2018 under the previous administration had projected a further fall in the deficit to 2.8% this year. That's not going to materialise.

A decade-long fiscal consolidation coming to end - fiscal deficit (% of GDP)



Source: CEIC, ING

Sweeping policy changes – elimination of GST and more

The economic policies took a significant turn, either for good or bad, after Dr Mahathir's coalition took over the helm in May this year. Keeping with its election agenda of boosting people's standard of living and cleaning the corrupt political machinery, the new administration launched sweeping policy changes. The most prominent among these are elimination of Goods and Services Tax (GST), replacement of GST with SST (Sales and Services Tax), and suspension of mega investment projects undertaken by the previous government in collaboration with foreign governments (China, Singapore, etc.). These policies certainly will have an adverse bearing on the fiscal situation in the current year and beyond.

The Finance Minister, Lim Guan Eng, is on record as saying that it would be "foolish" for the current government, which took power in May, to abide by "unrealistic" fiscal targets set by the previous administration. The policy shift makes the target of limiting the deficit at 3% a challenging task for the government as heightened global economic risks – the trade war, geopolitics, and emerging market routs – will undermine Malaysia's economic performance. As can be conjectured from the 11MP ditching of the balanced budget target, and holding a 3% line on the deficit over the remaining plan period, the fiscal deficit will have surged past the 3% mark in the current financial year itself and will likely prevail above that level in the medium-term.

Limiting the deficit at 3% will be challenging

A strong run for the economy in 2017, with close to 6% of GDP growth, and through the first quarter of this year and a boost to petroleum revenue from higher oil price might have supported total government revenue in the current year. Indeed, the 10% year-on-year revenue growth in the first half of 2018 compares with 0.8% growth in the same period last year. The growth of operating government spending also accelerated to 6% from 1.5% over the same period, though it was offset by slower development spending to -0.7% from 1.9%. This left the fiscal deficit at 4.5% of GDP in the first half of the year, not unusual for the period yet raising the risk of an overshoot in the full-year deficit.

However, the real hit to the budget will have started after the removal of the GST in June, while the overall economic performance also started to weaken from the second quarter of the year - a double whammy to government revenue. The launch of the SST in September will make up for some of the GST revenue loss, but not all.

On the spending side, PM Mahathir has assured steady operating expenditure in a drive to fulfil election promises. The suspension of public investment projects will have kept development expenditure well under MYR 46bn planned in the original budget, of which only less than half was incurred in the first half of the year. While the revenue loss from consumer tax reforms will far outweigh saving on development spending, weak investment will further compound GDP growth slowdown and pressure the deficit in relation to GDP higher.

With this backdrop, we anticipate fiscal deficit in the current year rising to 3.2% of GDP from 3.0% in 2017.

What's in store from the 2019 Budget?

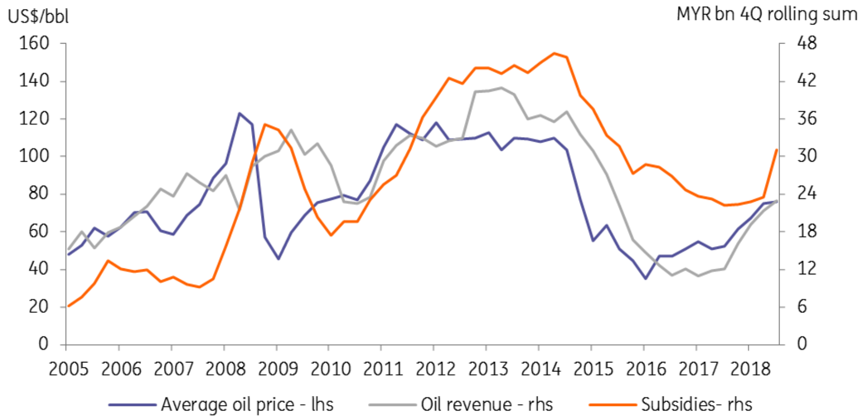
The forthcoming budget will set the course for the fiscal policy in the coming years. And, in all likelihood, it will be a tightening rather than easing. Here are some of the revenue and spending side factors deserving attention in the 2019 budget formulation:

- The tighter fiscal policy stance combined with sustained external risk suggests Malaysia's GDP growth will remain under pressure in 2019, more likely staying close to the low end of 4.5-5.5% target.
- Slower GDP growth will be associated with a continued slowdown in government revenue in 2019, while the MYR 23bn revenue gap left consumer tax reforms – MYR 44bn loss from the elimination of the GST as against MYR 21bn revenue from SST – will need to be plugged. However, the loss to the government is gain to the people. And the increase in household disposable income will sustain private consumption as a strong driver of GDP growth in the next year.
- Just a few weeks ago PM Mahathir signalled introduction of new taxes as well as the sale of assets to boost the revenue and curb the debt. However, media reports suggest some of the widely talked new taxes -- capital gains and inheritance taxes, as well as an extension of SST net to online business (digital tax) – might not be part of the 2019 budget. Indeed, they will need a thorough public consultation before implementation.
- Higher oil price will be the key positive for the economy and the public finances. It will not only soften the impact of the global trade war on Malaysian exports but also will increase the petroleum revenue to the government (see below). But a high oil price also means higher government expenditure on fuel subsidies to the public. The reports of $70 per barrel oil price assumption for the 2019 Budget may be an understatement in view of the current

level of about $80 per barrel, and the likelihood of geopolitics keeping it on the upward pressure in 2019.

- While the plan to significantly cut down on public debt, estimated over MYR 1 trillion (80% of GDP), over next two years faces headwinds from slower revenue growth, the cancellation costs of some of the infrastructure projects undertaken with other countries could blunt the debt reduction efforts. Moreover, the drive to cut down on development spending also bodes ill for the overall economic outlook.

Higher oil price raise government revenue but also lift spending on subsidies



Source: Bloomberg, CEIC, ING

Still, a healthy policy balance overall

We think the pressure to bring public finances back on track to consolidation without hampering economic prospects, especially in an environment of elevated external economics risks, will be a challenging task for policymakers in the near-term. We expect the budget deficit to remain elevated above 3% in coming years, with our forecast of 3.1% of GDP for 2019 and 3% for 2020.

Hopes are also pinned on higher oil prices

The downside risk to our deficit forecast stems from a significant reduction in development spending, though that also means a greater downside GDP growth risk. The hopes also are pinned on higher oil price providing positive terms of trade shock to Malaysia's net oil exporting economy, while the economy continues to be largely driven by domestic demand that will get further support from consumer-friendly tax reforms as well current low level of inflation. We maintain our 4.5% GDP growth forecast for this year and revise the forecast for the next year slightly downward to 4.6% from 4.8%.

We believe the lower inflation allows for some policy balance, by letting the central bank (Bank Negara Malaysia) to maintain an accommodative monetary policy stance as the government has now embarked on a fiscal tightening to rein in the large public debt burden. We expect inflation to average around 1% this year and to come in at the low end of the 2-3% official medium-term target in 2019.

The MYR has weakened to almost a year-low level against the USD of 4.18 on growing fiscal jitters ahead of the 2019 budget presentation next week. However, with sufficiently positive real interest rates the MYR should retain its year-to-date Asian outperformer position over the rest of the year. We consider our end-2018 USD/MYR forecast of 4.20 subject to upside risk, while we expect the pair to hover around that level through most of 2019.

Malaysia - Key economic forecasts

Malaysia	2015	2016	2017	2018F	2019F	2020F
Real GDP (% YoY)	5.1	4.2	5.9	4.5	4.6	5.0
CPI (% YoY)	2.1	2.1	3.8	1.0	2.0	1.9
Fiscal deficit (% of GDP)	-3.2	-3.1	-3.0	-3.2	-3.1	-3.0
Current account (% of GDP)	3.0	2.4	3.0	2.1	1.8	1.6
BNM o/n policy rate (%, eop)	3.25	3.00	3.00	3.25	3.25	3.50
3M interbank rate (%, eop)	3.84	3.41	3.44	3.70	3.80	3.90
10Y govt. bond yield (%, eop)	4.19	4.23	3.91	4.30	4.30	4.00
MYR per USD (eop)	4.29	4.49	4.05	4.20	4.18	4.05

Sources: CEIC, Bloomberg, ING forecasts

Source: Bloomberg, CEIC, ING

Author

Alissa Lefebre
Economist
alissa.lefebre@ing.com

Deepali Bhargava
Regional Head of Research, Asia-Pacific
Deepali.Bhargava@ing.com

Ruben Dewitte
Economist
+32495364780
ruben.dewitte@ing.com

Kinga Havasi
Economic research trainee
kinga.havasi@ing.com

Marten van Garderen
Consumer Economist, Netherlands
marten.van.garderen@ing.com

David Havrlant
Chief Economist, Czech Republic
420 770 321 486

david.havrlant@ing.com

Sander Burgers
Senior Economist, Dutch Housing
sander.burgers@ing.com

Lynn Song
Chief Economist, Greater China
lynn.song@asia.ing.com

Michiel Tukker
Senior European Rates Strategist
michiel.tukker@ing.com

Michal Rubaszek
Senior Economist, Poland
michal.rubaszek@ing.pl

This is a test author

Stefan Posea
Economist, Romania
tiberiu-stefan.posea@ing.com

Marine Leleux
Sector Strategist, Financials
marine.leleux2@ing.com

Jesse Norcross
Senior Sector Strategist, Real Estate
jesse.norcross@ing.com

Teise Stellema
Research Assistant, Energy Transition
teise.stellema@ing.com

Diederik Stadig
Sector Economist, TMT & Healthcare
diederik.stadig@ing.com

Diogo Gouveia
Sector Economist
diogo.duarte.vieira.de.gouveia@ing.com

Marine Leleux
Sector Strategist, Financials
marine.leleux2@ing.com

Ewa Manthey
Commodities Strategist
ewa.manthey@ing.com

ING Analysts

James Wilson
EM Sovereign Strategist
James.wilson@ing.com

Sophie Smith
Digital Editor
sophie.smith@ing.com

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com

Adam Antoniak
Senior Economist, Poland
adam.antoniak@ing.pl

Min Joo Kang
Senior Economist, South Korea and Japan
min.joo.kang@asia.ing.com

Coco Zhang
ESG Research
coco.zhang@ing.com

Jan Frederik Slijkerman
Senior Sector Strategist, TMT
jan.frederik.slijkerman@ing.com

Katinka Jongkind
Senior Economist, Services and Leisure
Katinka.Jongkind@ing.com

Marina Le Blanc
Sector Strategist, Financials
Marina.Le.Blanc@ing.com

Samuel Abettan
Junior Economist
samuel.abettan@ing.com

Franziska Biehl

Senior Economist, Germany
Franziska.Marie.Biehl@ing.de

Rebecca Byrne
Senior Editor and Supervisory Analyst
rebecca.byrne@ing.com

Mirjam Bani
Sector Economist, Commercial Real Estate & Public Sector (Netherlands)
mirjam.bani@ing.com

Timothy Rahill
Credit Strategist
timothy.rahill@ing.com

Leszek Kasek
Senior Economist, Poland
leszek.kasek@ing.pl

Oleksiy Soroka, CFA
Senior High Yield Credit Strategist
oleksiy.soroka@ing.com

Antoine Bouvet
Head of European Rates Strategy
antoine.bouvet@ing.com

Jeroen van den Broek
Global Head of Sector Research
jeroen.van.den.broek@ing.com

Edse Dantuma
Senior Sector Economist, Industry and Healthcare
edse.dantuma@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Rico Luman
Senior Sector Economist, Transport and Logistics
Rico.Luman@ing.com

Jurjen Witteveen
Sector Economist
jurjen.witteveen@ing.com

Dmitry Dolgin

Chief Economist, CIS
dmitry.dolgin@ing.de

Nicholas Mapa
Senior Economist, Philippines
nicholas.antonio.mapa@asia.ing.com

Egor Fedorov
Senior Credit Analyst
egor.fedorov@ing.com

Sebastian Franke
Consumer Economist
sebastian.franke@ing.de

Gerben Hieminga
Senior Sector Economist, Energy
gerben.hieminga@ing.com

Nadège Tillier
Head of Corporates Sector Strategy
nadege.tillier@ing.com

Charlotte de Montpellier
Senior Economist, France and Switzerland
charlotte.de.montpellier@ing.com

Laura Straeter
Behavioural Scientist
+31(0)611172684
laura.Straeter@ing.com

Valentin Tataru
Chief Economist, Romania
valentin.tataru@ing.com

James Smith
Developed Markets Economist, UK
james.smith@ing.com

Suvi Platerink Kosonen
Senior Sector Strategist, Financials
suvi.platerink-kosonen@ing.com

Thijs Geijer
Senior Sector Economist, Food & Agri
thijs.geijer@ing.com

Maurice van Sante
Senior Economist Construction & Team Lead Sectors
maurice.van.sante@ing.com

Marcel Klok
Senior Economist, Netherlands
marcel.klok@ing.com

Piotr Poplawski
Senior Economist, Poland
piotr.poplawski@ing.pl

Paolo Pizzoli
Senior Economist, Italy, Greece
paolo.pizzoli@ing.com

Marieke Blom
Chief Economist and Global Head of Research
marieke.blom@ing.com

Raoul Leering
Senior Macro Economist
raoul.leering@ing.com

Maarten Leen
Head of Global IFRS9 ME Scenarios
maarten.leen@ing.com

Maureen Schuller
Head of Financials Sector Strategy
Maureen.Schuller@ing.com

Warren Patterson
Head of Commodities Strategy
Warren.Patterson@asia.ing.com

Rafal Benecki
Chief Economist, Poland
rafal.benecki@ing.pl

Philippe Ledent
Senior Economist, Belgium, Luxembourg
philippe.ledent@ing.com

Peter Virovacz
Senior Economist, Hungary
peter.virovacz@ing.com

Inga Fechner
Senior Economist, Germany, Global Trade
inga.fechner@ing.de

Dimitry Fleming
Senior Data Analyst, Netherlands
Dimitry.Fleming@ing.com

Ciprian Dascalu
Chief Economist, Romania
+40 31 406 8990
ciprian.dascalu@ing.com

Muhammet Mercan
Chief Economist, Turkey
muhammet.mercan@ingbank.com.tr

Iris Pang
Chief Economist, Greater China
iris.pang@asia.ing.com

Sophie Freeman
Writer, Group Research
+44 20 7767 6209
Sophie.Freeman@uk.ing.com

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

James Knightley
Chief International Economist, US
james.knightley@ing.com

Tim Condon
Asia Chief Economist
+65 6232-6020

Martin van Vliet
Senior Interest Rate Strategist
+31 20 563 8801
martin.van.vliet@ing.com

Karol Pogorzelski
Senior Economist, Poland
Karol.Pogorzelski@ing.pl

Carsten Brzeski

Global Head of Macro
carsten.brzeski@ing.de

Viraj Patel
Foreign Exchange Strategist
+44 20 7767 6405
viraj.patel@ing.com

Owen Thomas
Global Head of Editorial Content
+44 (0) 207 767 5331
owen.thomas@ing.com

Bert Colijn
Chief Economist, Netherlands
bert.colijn@ing.com

Peter Vanden Houte
Chief Economist, Belgium, Luxembourg, Eurozone
peter.vandenhoute@ing.com

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

Gustavo Rangel
Chief Economist, LATAM
+1 646 424 6464
gustavo.rangel@ing.com

Carlo Cocuzzo
Economist, Digital Finance
+44 20 7767 5306
carlo.cocuzzo@ing.com