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APAC Economic Comment

Malaysia: Out of the frying pan, into the fire

Economics

Malaysia

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Fiscal dependence on oil: foible or fatality?

Back in October 2014, with oil prices at a buoyant $95 per barrel, the Malaysian government announced their budget for 2015 – 26% of which was supposed to be funded by petrol and oil related revenues (see figure 11). These revenues are now at risk: with oil prices possibly still in freefall the fallout for the Malaysian government looks difficult in 2015, but dangerous in 2016.

Difficulties in the short-run…

We discussed the impact of lower oil on the Malaysian economy in our note Malaysia: oil prices – adding fuel to the fire (December 2014). An unhealthy mix of lower oil income and a maturing credit cycle should induce lower investment, a shrinking current account surplus, and slowing domestic demand. Our 2015 real GDP growth forecast is just 4.5%. One potential issue we weren't overly concerned about with oil at $75 was the fiscal position. Any dent in revenue was, more or less, made up for by windfall savings from scrapping fuel subsidies. With oil having fallen further, this is no longer the case. We calculate that if oil prices are sustained at 175 ringgit pb in 2015 (roughly $50 pb), the Malaysian fiscal deficit would rise to 4.4% of GDP (figure 7). That's bad – but not as bad as it could be. As well as the scrapping of fuel subsidies to minimise losses there is another buffer. The Petronas dividend, penned as 29bn MYR in 2014, is paid in arrears. The effect of a lower 2015 dividend won't occur in 2015, but in 2016.

…but danger lies ahead

Ordinarily the dividend from Petronas is notionally "fixed". For the last 5 years the dividend has fluctuated between 30bn and 27bn MYR in spite of significant oil price volatility. This may no longer be the case. Petronas have advised that, with oil at $75 per barrel, the dividend would be cut to 17bn MYR in 2015 from 29bn MYR in 2014. Extrapolating this down to $50 per barrel leaves a payout of just 6bn MYR – if oil stays low in 2016 the combination of this loss with ongoing royalty and income tax losses, would stretch the deficit to a gaping 5.9% of GDP in 2016E, or 74bn MYR (figure 2, 9).

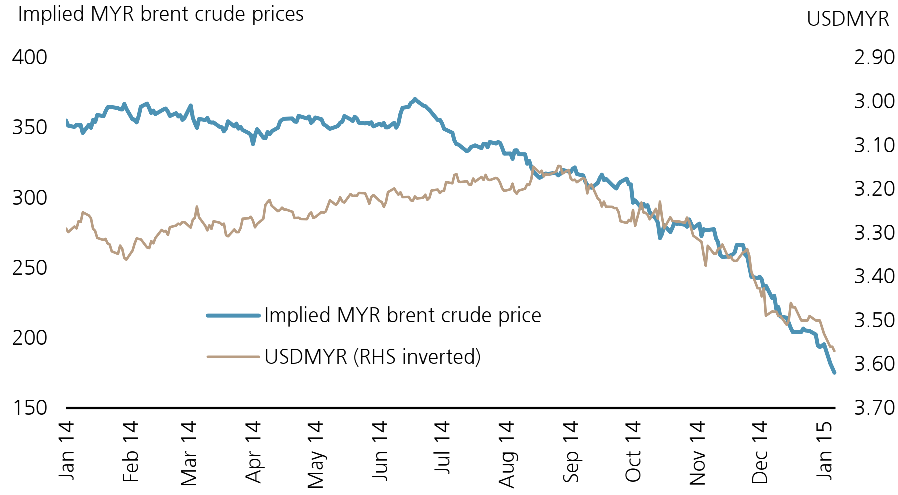
What can be done if oil stays low?

It is UBS's view that oil prices average $70 per barrel in 2015, but, if prices undershoot, letting the fiscal deficit balloon long term is not an option. A tempting solution would be for Petronas not to inflict further cuts to the dividend (see figure 10), which could be achieved through raising leverage or cutting capex. Foisting debt on Petronas instead of the government won't fool anyone – including the ratings agencies, two of which have Malaysia on negative watch. Cutting capex is an option for Petronas, but will damage growth – either way this will only recover 10bn of the 30bn MYR or so that would be needed to bring the deficit back in the realm of 3%. Thus Malaysia may face a political problem: where can it increase taxes or cut spending if oil does not recover? Looking at Malaysia's ASEAN contemporaries (figure 3,11) the share of revenue collected through indirect taxes is small, in particular from GST taxes. Due in April, the introductory GST rate of 6% is the regional low. Malaysia could raise roughly 4bn MYR per percentage point increase, but, unfortunately, doing so would be very unpopular. Elsewhere, development spending (42bn MYR in 2013), which includes spending on education and transport, tends to lag oil and gas revenues (figure 5). It is discretionary by definition, unlike operating expenditure on salaries and pensions, and can more easily be cut.

No easy way out

However the shortcoming is made up it is unlikely to be good for growth. If things did not look pretty for Malaysia with oil at $70 a barrel, they look downright ugly now. The lower the oil price sinks, the greater the risks to growth and the currency. Expect the ringgit to keep shadowing movements in the oil price (figure 1).

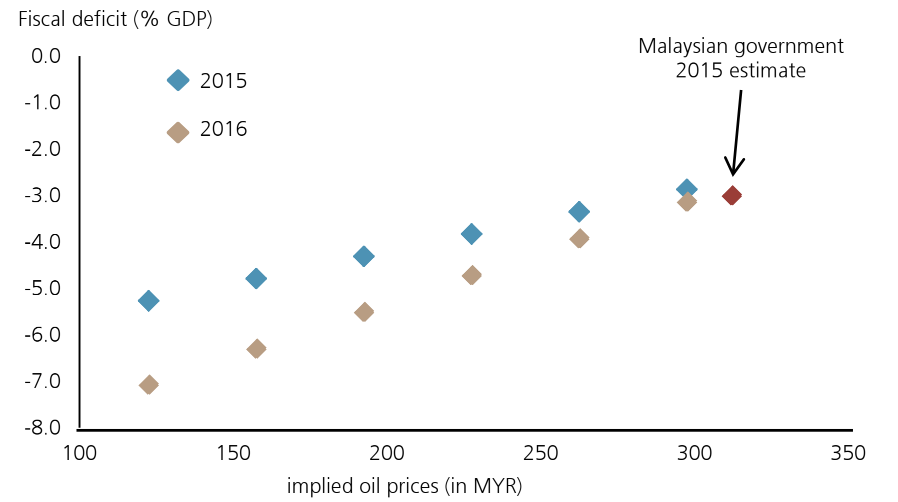
Figure 1: The ringgit has followed oil prices (in ringgit terms) since September



Source: UBS, Haver, CEIC

The ringgit has been held hostage by oil prices since August. We should expect this to continue: the implications of weak oil prices for investment, consumption, the current account, and the fiscal deficit are not encouraging.

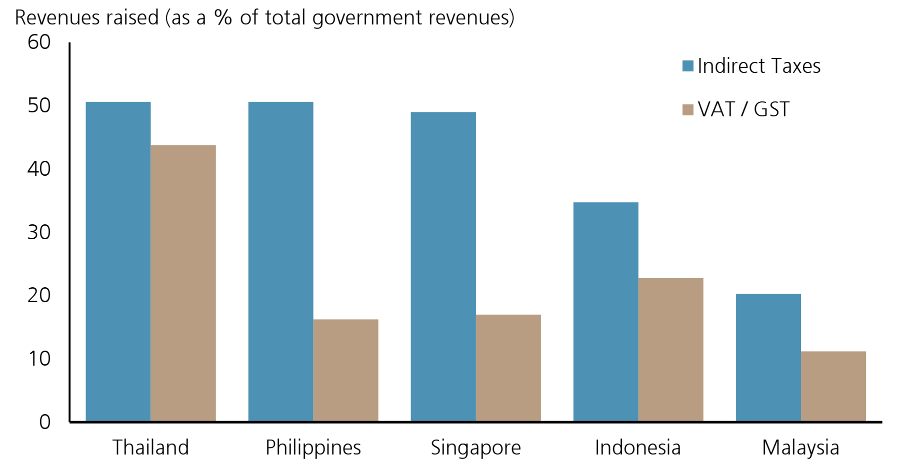
Figure 2: The deficit has some cushioning in 2015, but is at greater risk in 2016



Source: UBS, Haver, World Bank, Petronas annual report. USDMYR assumed at 3.50 (apart from the government budget estimate, which uses 3.2850). For notes on calculation of scenario analysis please see figure 5.

The deficit should deteriorate, all else equal, if oil prices remain low in 2015. Further deterioration in 2016 will follow if the Petronas dividend is cut (see figures 8, 9).

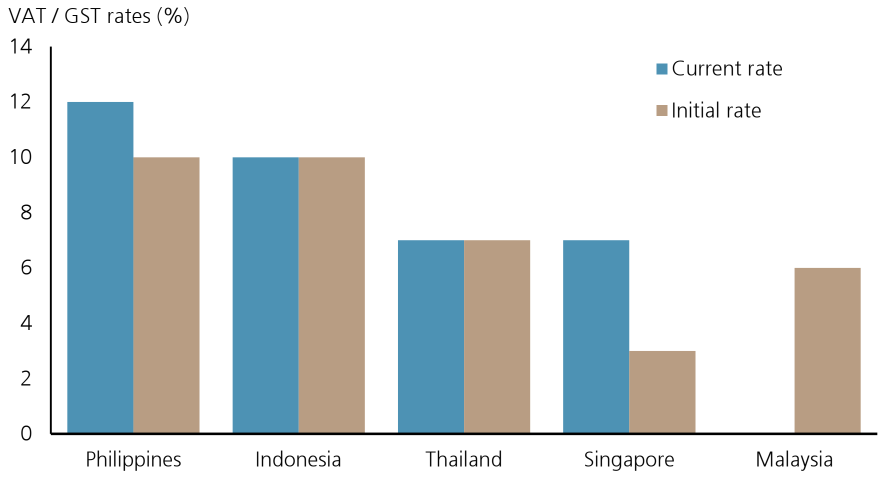
Figure 3: Relative to the ASEAN-5 Malaysia raises far less revenues via GST



Source: UBS, Haver, CEIC, Ministry of Finance Republic Indonesia, Ministry of Finance Malaysia, Republic of the Philippines Department of Budget and Management, Ministry of Finance Singapore, Thailand Bureau of the Budget

Malaysia raises far less of its revenues from indirect taxes, in particular the GST, than do the rest of ASEAN. This could be a source of additional financing.

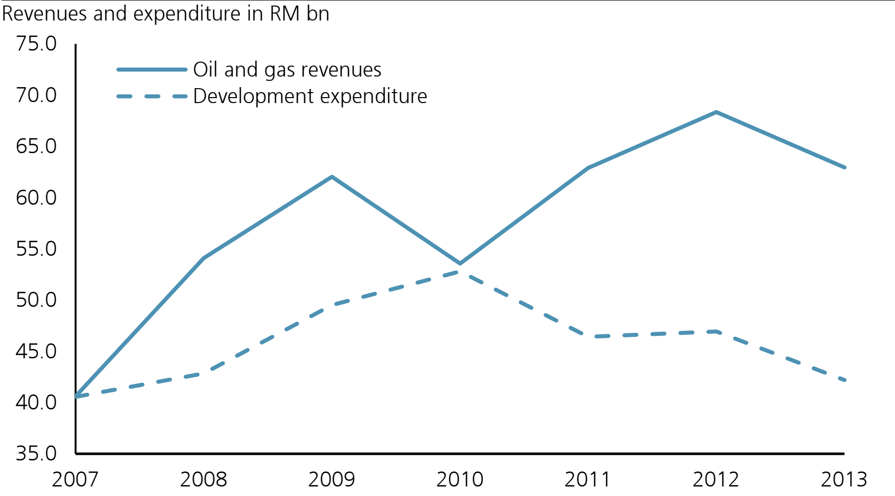
Figure 4: GST rates are higher across ASEAN, there is scope to increase



Source: UBS, Haver, CEIC, Ministry of Finance Republic Indonesia, Ministry of Finance Malaysia, Republic of the Philippines Department of Budget and Management, Ministry of Finance Singapore, Thailand Bureau of the Budget

Malaysia's GST, when introduced in April, will be one of the lowest across the ASEAN-5. Raising this rate could provide an extra 4bn MYR of funding per percentage point increase, though this maybe be politically difficult.

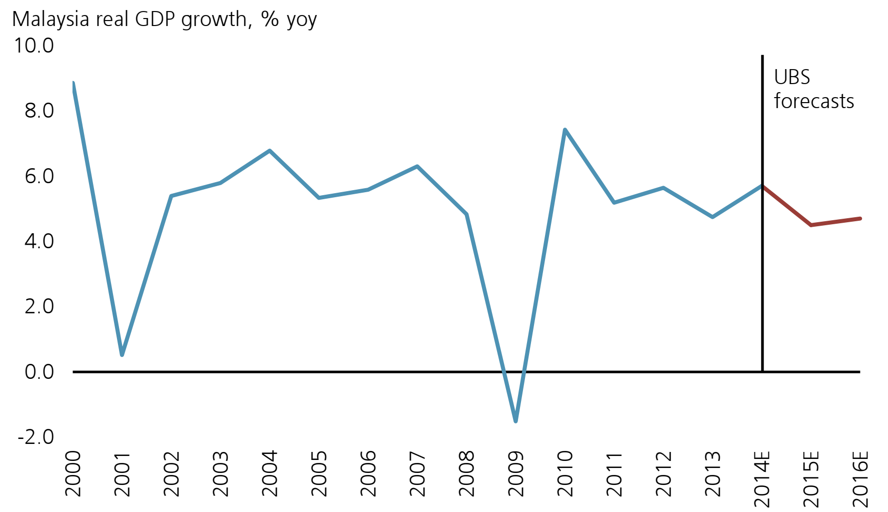
Figure 5: Development expenditure tends to lag oil and gas revenues



Source: UBS. Haver. Petronas annual reports

Federal government development expenditure, which includes spending on education, transport, and trade, will likely have to be cut in the face of lower oil and gas revenues.

Figure 6: We forecast a slowdown in real GDP growth in 2015



Source: UBS estimates, Haver, CEIC

We are forecasting a slowdown in real GDP growth to 4.5% in 2015E, and 4.7% in 2016E. If oil prices stay low growth may disappoint, which would put even further pressure on the deficit.

Figure 7: Current account and fiscal balance under different oil scenarios

% GDP					Oil price (USD/barrel)	
	80	70	60	50	40	30
2015 current account	4.2	3.4	2.6	1.7	0.9	0.0
2015 fiscal balance	-2.9	-3.4	-3.9	-4.4	-4.9	-5.3

Source: UBS, CEIC, Haver

Growth is likely to slowdown in 2015 through a number of channels if oil prices stay weak, or get weaker. A reduced current account surplus as well as through weaker investment and potential government cut backs may hurt growth.

Figure 8: Simulation of fiscal impact in 2015 of lower oil

RM bn unless otherwise stated	2013	2014 Budget	2015 Budget	2015E	2015E	2015E	2015E	2015E	2015E
Fuel subsidies	**26.5**	**23.2**	**19.0**	**8.0**	**8.0**	**8.0**	**8.0**	**8.0**	**8.0**
of which: Cash assistance	*3.0*	*3.6*	*5.0*	*5.0*	*5.0*	*5.0*	*5.0*	*5.0*	*5.0*
of which: LPG & diesel for public transport	*23.5*	*3.0*	*3.0*	*3.0*	*3.0*	*3.0*	*3.0*	*3.0*	*3.0*
of which: Petroleum & diesel subsidies		*16.6*	*11.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
Oil revenues	**63.9**	**66.0**	**64.4**	**60.6**	**55.0**	**49.4**	**43.8**	**38.2**	**32.6**
of which: Petronas dividend(cash basis)*	*28.0*	*27.0*	*29.0*	*29.0*	*29.0*	*29.0*	*29.0*	*29.0*	*29.0*
of which: Income taxes & royalties	*35.9*	*39.0*	*35.4*	*31.6*	*26.0*	*20.4*	*14.8*	*9.2*	*3.6*
Oil price assumption (MYR/bbl)	**343**	**344**	**312**	**298**	**263**	**228**	**193**	**158**	**123**
Oil price assumption (USD/bbl)**	**109**	**105**	**95**	**85**	**75**	**65**	**55**	**45**	**35**
Net gain (loss) vs. 2015 budget	N/A	N/A	N/A	7.2	1.6	-4.0	-9.6	-15.2	-20.8
Net gain (loss) vs. 2013	N/A	5.4	8.0	15.2	9.6	4.0	-1.6	-7.2	-12.8
Fiscal deficit	-38.4	-39.1	-38.7	-31.5	-37.1	-42.7	-48.3	-53.9	-59.5
Deficit (% GDP)	**-3.9**	**-3.5**	**-3.0**	**-2.7**	**-3.2**	**-3.7**	**-4.1**	**-4.6**	**-5.1**

Source: UBS estimates, Haver, CEIC, World Bank, Petronas annual report
Notes: *The dividend earned in 2014 is paid in 2015. ** USDMYR: 2013: 3.155 / 2014 budget: 3.275 / 2015 budget: 3.285 / 2015/2016: 3.5. *** 2015 budget deficit number (% GDP) is the government forecast whereas for 2015E we use UBS forecasts for nominal GDP therefore these numbers are not directly comparable as a % of GDP.

Given changes to subsidy policy the fiscal impact is muted above $75 per barrel. We foresee losses to the government through royalty and income tax channels in 2015 if oil prices remain lower than $75.

In 2016, if oil prices remain low the Malaysian government will continue to lose out on income tax and royalties but will also lose some revenues from the Petronas dividend. This scenario looks at what would happen if the dividend fell pro-rata with the oil price.

Figure 9: Simulation of fiscal impact in 2016 of lower oil, falling dividend

RM bn unless otherwise stated	2013	2014 Budget	2016E	2016E	2016E	2016E	2016E	2016E
Fuel subsidies	**28.9**	**23.2**	**8.0**	**8.0**	**8.0**	**8.0**	**8.0**	**8.0**
of which: Cash assistance	3.0	3.6	5.0	5.0	5.0	5.0	5.0	5.0
of which: LPG & diesel for public transport	23.5	3.0	3.0	3.0	3.0	3.0	3.0	3.0
of which: Petroleum & diesel subsidies		16.6	0.0	0.0	0.0	0.0	0.0	0.0
Oil revenues	**63.9**	**66.0**	**52.9**	**43.0**	**33.1**	**23.2**	**13.3**	**3.6**
of which: Petronas dividend(cash basis)*	28.0	27.0	21.3	17.0	12.7	8.4	4.1	0.0
of which: Income taxes & royalties	35.9	39.0	31.6	26.0	20.4	14.8	9.2	3.6
Oil price assumption 2015/16 (MYR/bbl)	**343**	**344**	**298**	**263**	**228**	**193**	**158**	**123**
Oil price assumption (USD/bbl)**	**109**	**105**	**85**	**75**	**65**	**55**	**45**	**35**
Net gain (loss) vs. 2015E with oil constant	N/A	5.4	-7.7	-12.0	-16.3	-20.6	-24.9	-29.0
Fiscal deficit	-38.4	-39.1	-39.2	-49.1	-59.0	-68.9	-78.8	-88.5
Deficit (% GDP)	**-3.9**	**-3.5**	**-3.1**	**-3.9**	**-4.7**	**-5.5**	**-6.3**	**-7.1**

Source: UBS estimates, Haver, World Bank, Petronas annual report
Notes: *The dividend earned in 2015 is paid in 2016. ** USDMYR: 2013: 3.155 / 2014 budget: 3.275 / 2015/2016: 3.5

Figure 10: Simulation of fiscal impact in 2016 of oil prices, sustained dividend

RM bn unless otherwise stated	2013	2014 Budget	2016E	2016E	2016E	2016E	2016E	2016E
Fuel subsidies	**28.9**	**23.2**	**8.0**	**8.0**	**8.0**	**8.0**	**8.0**	**8.0**
of which: Cash assistance	*3.0*	*3.6*	*5.0*	*5.0*	*5.0*	*5.0*	*5.0*	*5.0*
of which: LPG & diesel for public transport	*23.5*	*3.0*	*3.0*	*3.0*	*3.0*	*3.0*	*3.0*	*3.0*
of which: Petroleum & diesel subsidies		*16.6*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
Oil revenues	**63.9**	**66.0**	**58.6**	**43.0**	**37.4**	**31.8**	**26.2**	**20.6**
*of which: Petronas dividend**(cash basis)*	*28.0*	*3.0*	*27.0*	*17.0*	*17.0*	*17.0*	*17.0*	*17.0*
of which: Income taxes & royalties	*0.0*	*16.6*	*31.6*	*26.0*	*20.4*	*14.8*	*9.2*	*3.6*
Oil price assumption 2015/16 (MYR/bbl)	**343**	**344**	**298**	**263**	**228**	**193**	**158**	**123**
Oil price assumption (USD/bbl)**	**109**	**105**	**85**	**75**	**65**	**55**	**45**	**35**
Net gain (loss) vs. 2015E with oil constant	N/A	-57.0	-2.0	-12.0	-12.0	-12.0	-12.0	-12.0
Fiscal deficit	-38.4	-39.1	-33.5	-49.1	-54.7	-60.3	-65.9	-71.5
Deficit (% GDP)	**-3.9**	**-3.5**	**-2.7**	**-3.9**	**-4.4**	**-4.8**	**-5.3**	**-5.7**

Source: UBS estimates, Haver, World Bank, Petronas annual report
Notes: *The dividend earned in 2015 is paid in 2016. ** USDMYR: 2013: 3.155 / 2014 budget: 3.275 / 2015/2016: 3.5

In 2016, if oil prices remain low, the Malaysian government will continue to lose out on income tax and royalties but will also lose some revenues from the Petronas dividend. This scenario looks at what would happen if the dividend fell no further than level Petronas have stated it will fall to with oil at $75 pb. If oil is lower Petronas would have to cut capex more aggressively, hurting growth.

Figure 11: How governments across ASEAN generate revenues

	Budget revenues by source (% of total government revenue)				
	Indonesia	Malaysia	Philippines	Singapore*	Thailand
Direct Taxes	**31.3**	**57.7**	**42.5**	**45.0**	**40.4**
Personal income tax	26.2	11.3	42.3	13.0	10.8
Corporate income tax		30.9		24.0	25.6
Petroleum	5.1	10.9	-	-	4.0
Others	N/A	4.6	0.3	8.0	0.0
Indirect Taxes	**34.7**	**20.3**	**50.6**	**49.0**	**50.6**
VAT / GST	22.7	11.2	16.2	17.0	43.8
of which Petroleum related	-	-	-	-	*4.5*
Excise taxes	6.4	5.8	6.0	4.0	2.3
Customs taxes	3.4	2.1	20.2	0.0	4.4
of which Petroleum related	-	*0.9*	-	*0.0*	*0.0*
Other	2.2	1.2	8.2	28.0	0.1
Total tax revenues	**66.0**	**78.0**	**93.2**	**94.0**	**91.0**
Non-tax Revenues	**34.1**	**22.0**	**6.8**	**5.5**	**9.0**
*of which Petroleum related***	*14.4*	*14.3*	-	-	*1.9*
Total petroleum related revenues	**19.5**	**26.0**	**N/A**	**0.0**	**5.9**
Government revenues as % GDP	**18.1**	**20.2**	**16.5**	**15.0**	**20.6**

Source: UBS estimates, Haver, CEIC, IMF, Ministry of Finance Republic Indonesia, Ministry of Finance Malaysia, Republic of the Philippines Department of Budget and Management, Ministry of Finance Singapore, Thailand Bureau of the Budget
Notes: Percentages may not exactly add up due to rounding. In Malaysia, the Philippines, and Singapore 2015 forecast budget revenue data is used. In Indonesia 2012 and 2014 IMF information is used. In Thailand 2012 government data is used. *NIRC further supplements Singapore's revenues by around 2% of GDP every year. **for Malaysia the Petroleum related non-tax revenues are those earned in 2014. They comprise of the Petronas dividend (27bn MYR) and the Petroleum royalty (6.5bn MYR)

The energy importing countries (the Philippines, Singapore, and Thailand) generate revenues fairly equally between direct and indirect taxes – Indonesia and Malaysia stand apart as raising comparatively little through indirect methods. GST is one area in which it would be sensible (economically, but maybe not politically) for Malaysia to increase tax collections.

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