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Friday, 16 October 2009

Flash Notes

Malaysia 2010 Budget Preview

The Malaysian government is due to announce its 2010 Budget on October 23. This will be PM Najib's first Budget announcement in his capacity as the Finance Minister and his bold approach towards the removal of the Foreign Investment Committee (FIC) guidelines on equity stakes and M&As for the non-strategic sectors in June suggests that there could well be some surprises in store. Nonetheless, the government is facing significant constraints from the hefty budget deficit which is estimated to reach 7.6% of GDP in 2009 and the expected slow recovery in the domestic economy will continue to be a drag on revenue next year. This leaves the government with limited capacity to increase spending. Furthermore, given the domestic economy has bottomed out and the MYR60bn package announced in March will run until end-2010, significant increase in budget spending is fairly unlikely in this announcement. Indeed, the government's surprise move to raise the excise duty on tobacco by around 5.6% on October 1, ahead of the 2010 Budget demonstrated its resolve to boost the revenue.

Fiscal deficit to remain high

While the government has said that the fiscal deficit will be reduced from an estimated 7.6% of GDP in 2009 (highest on record), we expect the shortfall to remain high at around 7% of GDP in 2010, in part due to lower oil revenue and a slow recovery in the economy. As much as 40% of the government's revenue comes from the oil and gas sector. This also warrants some mention on how the government can diversify the revenue source during the Budget which is a grave concern for the country which could turn into a net oil importer within the next decade.

We expect it would take a while before the budget deficit can return to pre-crisis levels of under 5% of GDP (between 2004 to 2008). PM Najib has set a target to bring down the budget deficit to below 4% of GDP by 2015.

Announcing the new GDP growth target

Besides the Budget, the government is also slated to announce its revised GDP growth forecast on October 23. Its growth forecast currently stands at -4% to -5% for 2009. We expect an upward revision to the forecast given that the economy contracted by a better-than-expected 5.1%y/y in 1H09. With the better-than-expected 2Q GDP data, we have revised up our growth forecast for the country to -3.0% for 2009 and +4.9% next year. We expect the GDP to contract in 3Q09 before turning positive in the last quarter of the year, probably growing by slightly more than 1%y/y. As a result of basis effect, economic growth will continue to strengthen in 1H10.

Budget Highlights

We expect the following areas to be highlighted on October 23:

Cutting government expenditure and probably subsidies

The highlight of the budget will probably be on controlling the government's expenditure, particularly the operating portion given the concerns over the high budget deficit. The country has been consistently running fiscal deficits since the Asian Financial Crisis in 1998. There could be some focus on subsidies, particularly on fuel and food which accounted for the bulk of Malaysia's subsidy programme. Subsidies took up around a fifth of the government's total expenditure in 2008.

Probably not ready for GST yet

On the revenue side, possibility of a broad-based consumption tax - the Goods and Services Tax - has been much debated as the government ponders over ways to rein in its record high budget deficit. However, the timing is highly unfavourable for the implementation given the economy is only beginning to recover from the global financial crisis and the GDP is expected to contract by around 3% in 2009. Other alternatives cited include the expansion of the 5% service tax to include services provided by the financial services industry. For the longer term, we do expect the government to move gradually towards a consumption tax and might want to take the opportunity to set the timeline for introducing GST in Malaysia in the Budget speech.

Corporate and Personal Income Taxes unlikely to be reduced further in 2010

We do not expect further cuts to the personal and corporate income tax rates in 2010 Budget after the 1 percentage point cut in the top income tax rate to 27% for 2009, closing the gap with the corporate income tax rate which dropped to 25% in the same year. This is particularly since the government is hard-pressed to find alternative sources of revenue to close the large fiscal gap. While a broad tax rate cut is unlikely, we would certainly anticipate some tax breaks or tax reliefs for certain targeted industries or social groups. Besides that, there are also calls for the government to tweak the personal income tax bracket. This will help to ease the tax burden for the middle-income group which is currently taxed at the top rate if their income exceed MYR100,000 per annum.

Targeted measures to boost the services sector and FDI

PM Najib is committed to attract FDI and push the services sector as the key engine of growth in Malaysia. We are likely to see some initiatives in 2010 Budget to push forward this goal, including tax incentives for some of these target industries.