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Malaysia Budget 2010

Back to consolidation

HIGHLIGHTS

- In a bold but necessary move the Government is resuming its prudent fiscal stance in 2010 amidst improvement in domestic and external demand. **With the less-expansionary-than-expected budget the deficit is projected to narrow to 5.6% of GDP in 2010 which is sharply lower than the consensus' 7.3% (KIB: 7.2%), along with dwindling revenue it raise concerns over the ability to fund big projects.** While the proposed Budget 2010 focuses on the *Rakyat* it also addresses the need to remain competitive and to set the stage for the transformation into a high-income economy.

- Driven by domestic spending and supported by recovery in external demand, **the Government is revising up its GDP forecast for this year to -3.0% from -4.0% to -5.0% and projects the economy to rebound to 2.0-3.0% in 2010**. Growth recovery is expected to be broad-based and private-sector driven as the Government is expected to gradually take the back seat Meanwhile, **due to over estimation of the recovery trajectory for exports, we are revising our GDP forecast to -2.1% this year from -1.3% and maintain our growth projection of 3.0%-4.0% in 2010.**

- Unlike its previous fiscal consolidation strategy (2004 till 2007), which focused on slashing development spending, **the one proposed for this budget mandates a rare big cut in operating expenditure (-13.7% or RM21.9b) to RM138.3b with a smaller cut in development expenditure (by 4.4% or RM2.2b to RM51.2b).** While we had expected the operating expenditure to be cut by just 5.0% with focus on reducing wastage and minimise leakages, the key issue now is execution.

- In spite of revenue projected to decline by 8.4% due to a modest economic recovery next year, **the aggressive cut in spending would help to mitigate the budget deficit which the Government expects to narrow to 5.6% of GDP from 7.4% in 2009**. However, on the assumption of cost over runs and implementation risk along with the sluggish global economic recovery scenario, **we project the deficit may still be wider at 6.3% of GDP in 2010**.

- **The further cut in personal tax and the creation of low tax haven in IDR is certainly a plus point and move towards a right direction in raising Malaysia's competitive edge**. Ultimately, it may help Malaysia's effort to lure both financial and human capital to contribute to growth.

- As the Government is already finalising the impact study on GST, we would not be surprise if it were to be announced next year as part of the 10MP.

- **Though there are still some political challenges to overcome and uncertainty to contend with, the current leadership has a better hand in managing the economy than the previous one.** Though this budget may not pack a punch, the PM might have a few more tricks under his sleeve next year when he announces the 10MP.

PP7004/03/2010 (023510)

Table 1: GDP Growth Forecast 2008 & 2009 (%YoY)

							MoF Forecast		KIB Forecast	
By Sector	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2009**	**2010**
Agriculture	6.0	4.7	2.6	5.2	1.4	4.0	-2.3	2.5	-0.7	2.9
Mining	6.1	4.1	-0.4	-1.0	2.0	-0.8	-2.9	1.1	-2.2	1.8
Manufacturing	9.2	9.6	5.2	6.7	3.1	1.3	-12.1	1.7	-9.8	3.9
Construction	1.8	-0.9	-1.5	-0.3	4.7	2.1	3.5	3.2	3.5	3.1
Services	4.2	6.4	7.2	7.4	9.6	7.2	2.1	3.6	2.1	4.2
Real GDP	**5.8**	**6.8**	**5.3**	**5.8**	**6.2**	**4.6**	**-3.0**	**2.0-3.0**	**-2.1**	**3.0-4.0**
By Aggregate Demand										
Consumption	8.2	9.4	8.5	6.4	9.6	9.0	1.7	1.6	1.3	2.3
Public	8.6	7.6	6.5	5.0	6.5	10.9	2.2	-3.4	2.3	-3.3
Private	8.1	9.8	9.1	6.8	10.4	8.5	1.6	2.9	1.7	3.7
Investment	2.8	3.6	5.0	7.5	9.6	0.8	1.0	0.0	0.7	0.2
Public	-0.3	-21.5	6.8	5.8	7.1	0.7	24.8	-2.5	24.5	-2.3
Private	8.8	46.5	3.3	9.2	11.8	0.8	-20.0	3.4	-20.3	3.1
Aggregate Demand (ex-stock)	6.6	7.7	7.6	6.7	9.6	6.8	1.5	1.2	1.5	1.8
Exports	5.1	16.1	8.3	6.6	4.5	1.3	-15.6	3.5	-13.2	4.3
Imports	4.5	19.6	8.9	8.1	6.0	1.9	-14.4	5.2	-14.5	6.1
Real GDP	**5.8**	**6.8**	**5.3**	**5.8**	**6.2**	**4.6**	**-3.0**	**2.0-3.0**	**-2.1**	**3.0-4.0**

Source: Ministry of Finance Economic Report 2009/10, Kenanga Research

Overview

The virtue of prudence. True to our expectation, the focus of the proposed Budget 2010 is to make sure that the public coffers are well spent during this trying time. This requires fiscal discipline. Hence, in a bold but necessary move the Government is resuming its prudent fiscal stance in 2010 amidst improvement in domestic and external demand. **With the less-expansionary-than-expected budget the deficit is projected to narrow to 5.6% of GDP in 2010 which is sharply lower than the consensus' 7.3% (KIB: 7.2%), along with dwindling revenue it raise concerns over the ability to fund big projects.** While the proposed Budget 2010 focuses on the *Rakyat* it also addresses the need to remain competitive and to set the stage for the transformation into a high-income economy.

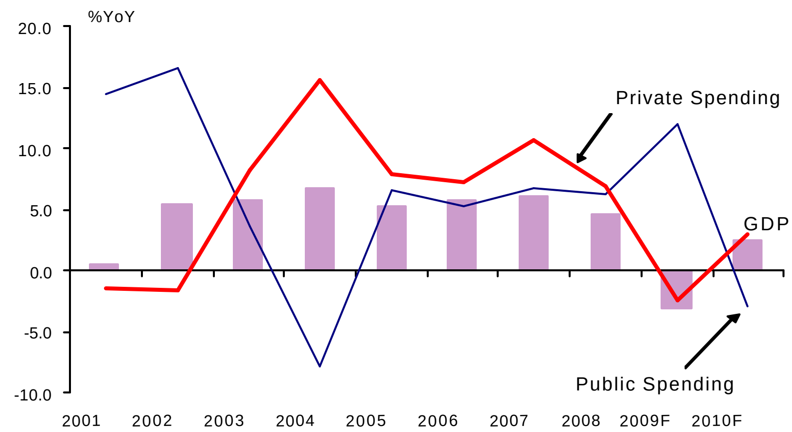
Restarting the discipline. In view of an improvement in the economy following the sharpest slowdown since the Asian Financial Crisis in 1997/98, it is a window of opportunity for the Government to restart consolidating its account after implementing it a few years ago (2004 till 2007). The need to reduce its deficit and achieve a balance budget is positive move given that Malaysia's fiscal account has been in deficit since 1998. **A reduction in the budget deficit would also augur well for Malaysia's sovereign credit rating and its effort to promote inward investments flows.**

Preparing for 10MP. Apart from addressing the needs of a wider spectrum of income group, from the poor to the rich, as well as promoting private investment and luring back overseas Malaysian, the Budget doesn't really pack a punch. However, we believe, it tries to condition the public psyche to make do with the current fiscal constraint. More importantly it sets the stage for the Government's plan to develop a new economic model and integrate that in the five-year 10^{th} Malaysia Plan (10MP) starting in 2011.

Growth Outlook

On the mend. Judging by the slew of improvement in economic data in advance as well as emerging economies including Malaysia, it is safe to conclude that the global economy is on the mend. Aided by speedy implementation of stimulus packages along with monetary easing, Malaysia's real GDP registered a smaller decline of 3.9% in 2Q09 from -6.2% in 1Q09. Given the faster-than-expected global economic

Malaysia's Real GDP, Private and Public Spending Growth Trend (%YoY)



Source: Ministry of Finance,Dept of Statistics, Kenanga Research

recovery supported by a pick up in domestic demand, **the Government is revising up its GDP forecast for this year to -3.0% from its earlier projection of -4.0% to -5.0%.**

Slower traction. Meanwhile, the lethargic growth recovery of the US economy would continue to weigh on a strong growth comeback for Malaysia in 2H09. Though the US economy is stabilising, its rising unemployment will remain a major impediment to a swift recovery in external demand. This is evidence in the relatively weak exports and manufacturing growth data in 3Q09. **Going by the current trend, we have over estimated the external demand trajectory for 2H09 which still reels from the sharp inventory adjustment in 1H09.** As we aptly re-input adjustments to our exports forecast into the growth model**, the new GDP growth projection for 2H09 is 0.9% compared with our earlier forecast of 2.1%. Hence, for the whole of 2009, our new GDP projection is -2.1%, slower than our earlier forecast of -1.3%.**

2010 Outlook – Past lessons pays. According to International Monetary Fund's latest world economic report, emerging and developing economies are further ahead on the road to recovery, led by resurgence in Asia's emerging economies which have withstood the financial turmoil much better than expected based on past experience. IMF attributes this largely to improved policy frameworks following painful adjustments in particular during the Asian Financial crisis more than a decade ago. With a sound and more resilient financial system as well as **improving domestic and external demand along with prudent fiscal stance, the Government expects the economy to grow between 2.0% and 3.0% in 2010. Meanwhile, we are maintaining our GDP forecast at 3.0-4.0%, which still remains well below its long term potential growth trend.**

Domestic-driven private sector-led growth. Growth recovery is expected to be broad-based and private-sector driven as the Government is expected to gradually take the back seat. On the expectation of higher disposable income arising from better commodity prices, more stable employment conditions and strong stock market performance, private consumption is projected to grow 2.9% (2009: 1.6%). Private investment is expected to turn around 3.4% from -20.0% in 2009. Hence, total **private sector expenditure is projected to rebound to 2.9% from -2.4% in 2009**. On the other hand, overall **public sector expenditure is expected to decline 3.0% after a sterling 12.0% growth in 2009 on the back of fiscal prudence**.

Fiscal Balance Management

Reducing operating cost. Unlike its previous fiscal consolidation strategy (2004 till 2007), which focus on slashing development spending, **the one proposed for this budget mandates a rare big cut in operating expenditure (-13.7% or RM21.9b) to RM138.3b with a smaller cut in development expenditure (by 4.4% or RM2.2b to RM51.2b).** While we had expected the operating expenditure to be cut by just 5.0%

with focus on reducing wastage and minimise leakages , the key issue now is execution.

Malaysia's Federal Government Finance Trend and Projection

RM Billion	2004	2005	2006	2007	2008	MoF Forecast 2009	MoF Forecast 2010	KIB Forecast 2009	KIB Forecast 2010
Revenue	**99.4**	**106.3**	**123.5**	**139.9**	**159.8**	**162.1**	**148.5**	**162.7**	**150.1**
Operating Expenditure	**91.3**	**97.7**	**107.7**	**123.1**	**153.5**	**160.2**	**138.3**	**160.4**	**148.5**
Current Surplus/deficit	8.1	8.6	15.9	16.8	6.3	1.9	10.2	2.3	1.7
Gross Dev. Expenditure	**28.9**	**30.5**	**35.8**	**40.6**	**42.8**	**53.6**	**51.2**	**54.0**	**52.3**
Gross Lending	1.2	1.5	2.3	2.6	2.6	2.9	2.7	2.9	2.8
Minus Loan Recoveries	1.3	3.3	0.9	3.1	1.0	0.5	0.6	0.5	0.6
Net Dev. Expenditure	**27.5**	**27.3**	**35.0**	**37.5**	**41.9**	**53.0**	**50.6**	**53.5**	**51.7**
Overall Surplus/deficit	**-19.4**	**-18.7**	**-19.1**	**-20.7**	**-35.6**	**-51.1**	**-40.5**	**-51.2**	**-50.0**
% of GDP	*-4.1*	*-3.6*	*-3.3*	*-3.2*	*-4.8*	*-7.4*	*-5.6*	*-7.4*	*-6.3*
Sources of Finance:									
Net External Borrowings	0.1	-3.5	-3.1	-4.3	-0.5	-6.4	0.1	NA	NA
Net Domestic Borrowings	25.7	12.7	17.8	25.8	35.7	56.9	40.5	NA	NA
Change in Assets	-6.4	9.5	4.4	-0.8	-0.4	0.6	-0.1	NA	NA
% YoY Growth									
Revenue	7.3	6.9	16.2	13.2	14.2	1.4	-8.4	1.8	-7.7
Operating Expenditure	21.4	7.1	10.2	14.3	24.7	4.3	-13.7	4.5	-7.3
Gross Dev. Expenditure	-26.7	5.8	17.3	13.3	5.6	25.0	-4.4	26.0	-2.4

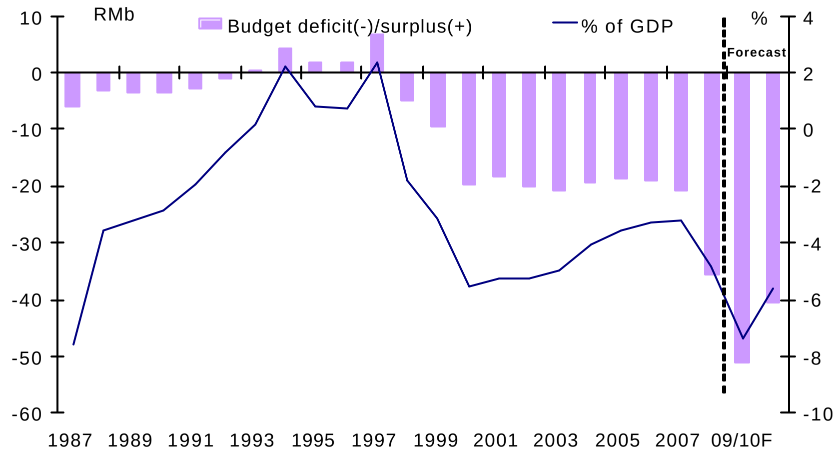
Source: Ministry of Finance Economic Report 2009/10, Kenanga Research

Unconventional fiscal discipline. Its rare, in fact almost never that the Government choose to cut on the operation side when it usually would be discretionary reduction in development spending if it aims to balance its budget or consolidate. The last reduction in operating expenditure was in 1998 when the Government decided to take up austerity measures to weather the debilitating effect of the Asian financial crisis. But it was reduced by just a marginal 0.2% and prior to that it has never been reduced since data was made available from 1970. One could say this is the first purposeful operating expenditure cut in 40 years.

Where it hurts most. The marked reduction in operating expenditure largely affects its major components led by other expenditure consist of grants to statutory funds and public enterprises (-RM18.3b) and supplies and services (-RM6.0b). Meanwhile the reduction in overall subsidies is just RM3.6b from an estimated RM24.5b this year to RM20.9b in 2010, a huge reduction from the record RM35.2b in 2008. This is due to the absence of subsidies on food security, fuel cash rebate, sugar, flour and bread. However, **fuel subsidy will be increased by 10.7% to RM10.0 b or almost half of the total allocation for subsidies (RM20.9b) in anticipation of rising crude prices.**

Less spending - No worries. The 4.4% reduction in development spending for 2010 to RM51.2b is more or less expected as spending is expected to taper off with the completion of projects scheduled under the Nine Malaysia Plan (9MP). **With rebound in global economy along with the residual impact of concerted monetary and fiscal measures, the reduced fiscal spending may not dampen economic growth prospects**. Furthermore, the 2010 allocation would also jive with the total allocation under the 9MP (2006-2010) minus the Private Financial Initiative portion (RM220.0b – RM20.0b) plus the two stimulus packages announced earlier (RM22.0b). The first stimulus package in November 2008 totalled RM7.0b and the mini budget announced in March this year was RM15.0b. With the 2010 proposed allocation, the five year total development spending (2006 till 2010) would amount to about RM224.0b.

Federal Budget Balance Trend

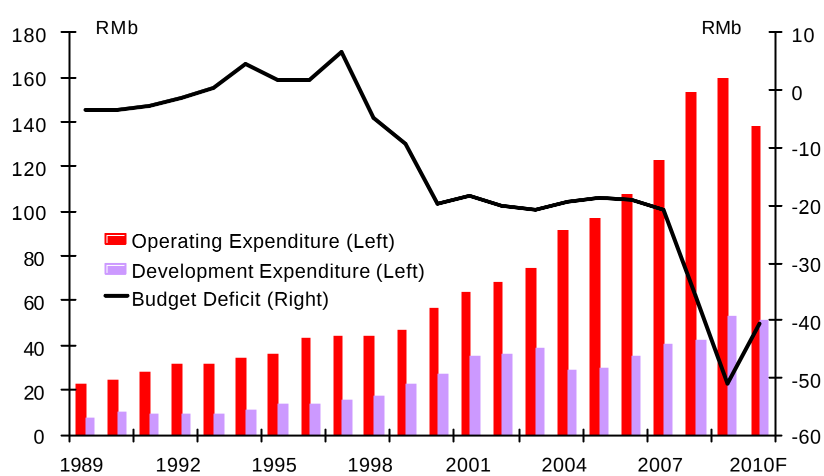


Source: Ministry of Finance, Kenanga Research

Lower revenue - expected. Decline in petroleum income tax (-28.3% YoY) due to lower production and crude prices in 2009 (assessed on a preceding year basis), and returns on investments (-23.7% YoY), with a combined total of almost 40.0% of total revenue, was the main reason for the projected decline in overall federal revenue of 8.4% in 2010. It is the sharpest decline since 1998 (-13.7%). However, corporate and individual taxes, export and excise as well as stamp duties are expected to improve in line with recovery in domestic economy and external sector next year.

A tough task. In spite of revenue projected to decline by 8.4% in 2010 due to a potentially modest economic recovery next year, **the aggressive cut in spending would help to mitigate the budget deficit which the Government expects to narrow to 5.6% of GDP from 7.4% in 2009.** However, given the uncertainty as to where the still weak US financial sector and its economy is heading next year, there is the tendency that the Government could under estimate the amount it needs to spend to sustain the recovery momentum and contingencies going forward. Plus overdependence on oil and gas revenue would also undermine efforts to reduce deficit in view of the volatile nature of the commodity. However, **on the assumption of cost over runs and implementation risk along with the sluggish global economic recovery scenario**, **we project the deficit may still be wider than what the Government expect at 6.3% of GDP in 2010**.

Fiscal Operating and Development Expenditure Vs. Budget Balance (RMb)



Source: Ministry of Finance, Kenanga Research

Strategy and Measures - Highlights

Realignment of tax rates. The proposed reductions of the highest marginal tax rate for individuals by 1 percentage point (ppt) to 26% from 27%, its second year in row, reaffirm our earlier expectation that the process of corporate and personal tax realignment would continue until the later eventually matches the former. **Based on historical trend the personal income tax (highest marginal rate) would eventually catch up with the corporate tax rate with an average lag of three to four years (see table below). Hence, we expect another rate cut of 1 ppt to 25% in assessment year 2011.** Though Malaysia's income tax rate remains relatively high compared with its neighbour Singapore (20%), in the long term, the continued review of the tax rates will help to make it more competitive to foreign corporate and talent.

Malaysia Corporate and Personal Income Tax Rate Trend – Alignment of Tax Rates(Shaded Area)

Year	1990	91	92	93	94	95	96	97	98	99	2000	01	02	03	04	05	06	07	08	09	10	11F
Personal[1]	40	35	35	35	35	32	30	30	30	30	29	29	28	28	28	28	28	28	28	27	26	25
Corporate	35	35	35	34	32	30	30	30	28	28	28	28	28	28	28	28	28	27	26	25	25	25

Source: Ministry of Finance, [1] Highest Marginal Rate, F=Forecast

Boost disposable income. To sustain consumer spending and more importantly to ease the pain in view of escalating cost of living and slower growth the Government has also raised the personal tax relief to RM9,000 from RM8,000. As opposed to cuts on income tax, the impact on raising personal income relief would put less strain on the current fiscal budget.

Luring back talent. If the above tax benefits are not enough the income tax of Malaysians and foreign knowledge workers (in selective specialised sectors) residing and working in Iskandar Development Region (IDR) will be at 15% indefinitely if they commence work before end of 2015. Though we do not expect a stampede from overseas Malaysian particularly from Singapore to set up camp in IDR pronto it would definitely create an attractive base to attract talent back as well as speed up its infrastructure development.

Hinting on GST. Realising that adequate revenue collection is vital to support rising expenditure as well as reduce the nation's increasing debt level one of the measures that the Government is looking to explore is to introduce the goods and services tax (GST). A study to identify the social impact of GST on the *rakyat* is at the final stage of completion. The core of the study is to ensure that if GST is to be implemented to stabilise Government finance it will not burden the people. While replacing the current sales tax and service tax, the Government hinted that rates will likely be lower and exemption will be granted to the low-income group.

Re-imposing RPGT. The proposal to reintroduce tax gains from the disposal of real property at 5.0% may have a deterrent effect on excessive real estate speculation. Partly the move may have been triggered from lessons learnt from the US subprime housing crisis. Existing tax exemption will be retained for gifts between parent-child, husband-wife, and grandparent-grandchildren.

Promoting home ownership. Meanwhile, the Government remain committed to promote home ownership and is proposing to launch a scheme that would enable EPF contributors to utilise current and future savings in Account 2.

Encourage savings. To encourage saving at a younger age, the Government has declared that the existing personal tax relief of RM6,000 for Employment Provident Fund and life insurance premiums be increased to RM7,000 from January next year for those with annuity schemes.

Push for investment and privatisation. The need to encourage investments precedes the drive the nation towards a high income economy. Top of the Government's proposal is to intensify efforts to attract FDI by allowing equity ownership and joint ventures in local projects. Plus there are also plans to accelerate the privatisation of companies under the Ministry of Finance and other Government agencies.

Promoting financial industry. One of the key initiatives for the financial sector is the liberalisation of the commission-sharing arrangements between stockbrokers and remisiers and the increase of the foreign equity participation in corporate finance and financial companies to 100% from 30%. For Islamic finance, the government has proposed extension of the existing tax incentives to 2015. Additionally, the initiatives will also be extended to include stamp duty exemption of 20% on Islamic financing instruments and tax exemption on banking profits derived from overseas operations.

Boosting broadband usage. To increase the broadband penetration rate, which is currently just 25% compared with 95% in South Korea and 64% in Singapore, the Government proposed to give taxpayers tax relief on broadband subscription fee up to RM500/year from 2010 to 2012. Then again it depends on how fast the broadband providers would lay out the infrastructure and improve service.

Curb excessive credit card usage. To promote prudent spending, a service charge of RM50/year to be imposed on each principal credit and charge card; and RM25/year on each supplementary card, effective Jan 1, 2010. Knowing that credit card marketers are a creative lot, we reckon they may find ways to promote the cards to new and existing cardholders.

Targeted subsidy scheme. To ensure that fuel subsidies only benefit targeted groups, the Government will enforce a fuel subsidy management system by early next year which will utilise the MyKad.

Sector allocation. Among the sectors that received the biggest allocation are:

- **Education** – RM30.0b will be allocated to enhance primary and secondary education nationwide in a bid to develop high quality human capital**.**
- **Construction** – RM9.0b to finance infrastructure projects including road, bridges, rail, sea ports and airport facilities.
- **Agriculture** – RM6.0b for paddy field irrigation, fish production, fruit farming, livestock farming infrastructure and training. Plus RM2.0b subsidy for farmers and fishermen for fertilisers, incentives for paddy yields and allowance for fishermen.

Crime prevention. The Government will allocate RM1.0b to the police force in its effort to reduce crime by 5.0% in 2010. One of the major proposed measures include to increase police presence by providing mobile police stations in 50 crime hot spots.

Conclusion

Neutral. This round we observe that the Government is making sure the benefits are spread to a wider spectrum of income group. Unlike the previous budget the allocation and measures appears to be more evenly spread to all classes of society; from the poor to the rich and in particular the middle income group which were subjectively missed out in the last budget. However, given that most of the key measures have been announced earlier in the mini budget in March this year as well as in November last year in the form of stimulus packages, the current budget appear to pack with less punch. Perhaps it is the final stage of the 9MP and most projects have been implemented and the fact the new PM wants to save some bullets for the 10MP, which is to be announced next year, kicking off with the 2011 Budget.

Tax cut - a plus point. The further cut in personal tax and the creation of low tax haven in IDR is certainly a plus point and move towards a right direction in raising Malaysia's competitive edge. Ultimately, it may help Malaysia's effort to lure both financial and human capital to contribute to growth. More importantly it signals that the time to implement the GST system would be sooner than expected.

Moving closer towards GST. As we have highlighted before, the gradual reduction and realignment of both personal income tax and corporate tax rate is a step closer towards converting Malaysia's current tax regime to the GST system which has been postponed indefinitely since it was first announced in the 2005 Budget. Alternatively, the broader tax base under the proposed GST is expected to be able to increase the Government's coffer and would likely more than compensate the shortfall in corporate and individual tax collection. With Singapore and Australia as a role model of a successful GST regimes and the fact that they are less prone to declining income during an economic downturn compared with nations that adopt conventional tax regime, it is timely for Malaysia to implement the GST. **As the Government is already finalising the impact study on GST, we would not be surprise if it were to be announced next year as part of the 10MP.**

Gaining political milage. Unlike the previous administration, the current PM appears to be more hands on with regards to economic issues and more receptive with new ideas. He has already made a mark for himself with two stimulus packages under his belt and introducing a monitoring system to allow the public to see the progress of the implementation of projects. More importantly, most of his policies tend to be market friendly and popular with investors. **Though there are still some political challenges to overcome and uncertainty to contend with, the current leadership has a better hand in managing the economy than the previous one.** Though this budget may not pack a punch, the PM might have a few more tricks under his sleeve next year when he announces the 10MP.

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