OCBC Bank

PRESS STATEMENT

BY SELENA LING, CHIEF ECONOMIST OF OCBC BANK – IN CONJUNCTION WITH THE RELEASE OF THE 2020 NATIONAL BUDGET

Kuala Lumpur, 11 October 2019 – As we noted yesterday, Finance Minister Lim Guan Eng will be walking a fine line in his second budget speech today. He would have to strike a right balance between the cyclical need of juicing up growth at a time of heightened global uncertainties, and the structural necessity of curtailing government debt build-up.

Selena Ling, Chief Economist of OCBC Bank

At the broadest level, by pencilling in a 3.2% fiscal deficit target as a proportion of GDP in 2020, he has managed to walk the middle way of some consolidation from 3.4% deficit expected this year and the original 2020 deficit target of 3.0% that he had first telegraphed last year. Any target of heavier consolidation been postponed, to a relatively vague promise of an average of 2.8% “over the medium term.”

Moreover, to directly zoom in on the concern that we have raised in our report yesterday, the incoming budget has also assumed a much more realistic Brent crude price of USD62 per barrel, compared to USD72 previously.

Petroleum revenue is slated to reach MYR50.5bn, about 2% lower than the 51.4bn expected this year, excluding the 30bn one-off dividend. Given the lower total revenue figure of MYR244.5bn (vs. MYR261.8bn of 2019), however, the proportion that petroleum revenues contribute to the total has stayed relatively high at 20.7%, compared to around 18% previously.

The still-high ratio of petroleum contribution might be less of an issue now with a lower built-in crude price assumption but may be an area of focus once more should oil price refuse to cooperate through the course of 2020.

Elsewhere, perhaps to bury the talks of any GST re-introduction once and for all, the Finance Minister reiterated that "To respect the mandate given by the Rakyat in last year's General Elections, the government does not intend to bring back the GST." With that, its successor SST regime is expected to take up the burden, slated to increase by 5.6% to MYR28.3bn, representing about 11.6% of total revenue. While PM Mahathir has said that the country should focus on improving the structure of the SST rather than abandoning it, the budget speech today does not mention any new measure such as reducing the exemptions list that might have helped the tax take.

One area in which market might latch on as it digests the budget speech further is the relatively lofty growth expectation for 2020 of 4.8%, which is higher than the 4.7% revised 2019 forecast that the government has. For context, the consensus forecast is at 4.3% while we have a more sanguine 4.2% pencilled in. In his speech, the minister did not spell out exactly how the ambitious growth target can be achieved, but we can surmise that it rests heavily on supporting the domestic consumption.

For one, the government has increased its allocation for subsidies and social assistance by 2.6% to MYR24.2bn in terms of welfare assistance, cash handouts, education assistance, etc. To great cheers from the rather vocal parliamentarians, toll payments will also be reduced. While fuel subsidies remain, there is a move towards greater rationalization by

gearing the subsidies towards the more needy, proxying by vehicle size and age.

In what is by now a perennial group to be taken care of, no matter who is in power, the budget is also allocating support measures for the civil servants, including an increase in living allowances and easier redemption of accumulated leave days. Given the size of the civil service – at 1.6 mn strong, more than 10% of working population – such measures are not to be ignored altogether.

Meanwhile, minimum wage level will also be increased further to MYR1200 per month for major cities in 2020, compared to MYR1100 currently.

Overall, however, even as these measures will help cushion private consumption – which is an important part of the economy at close to 60% of the total GDP by expenditure – we still think the overall growth target might be hard to reach.

That is because, while private consumption is still expected to grow relatively healthily, other engines of the economy might not be as robust. Specifically, we see the investment cycle experiencing some challenges in the periods ahead. A slump in the capital goods imports of late may be a sign that there is likely to be a slowdown in fixed capital formation, which comprises nearly a quarter of the economy. Meanwhile, even though exports may look like they are not a sizable contributor to growth in net-of-import terms, any marked slowdown in the global trade cycle would lead indirectly to employment and spending pullback.

If our less sanguine concerns prove to be correct and growth does not reach 4.8% as expected by the government, so what?

GDP growth would affect the deficit target in a few ways, starting from the denominator effect. Everything else equal, a smaller denominator would result in a larger deficit-to-GDP ratio on its own, from a purely arithmetic angle. From this effect alone, if growth does slow to 4.2%

compared to 4.8% in 2020, deficit ratio would go up to 3.267% level from the expected 3.249% - one is rounded up to 3.3% while the other is helpfully rounded down to 3.2%. If we were to consider that, in a slowing economy, government revenues in the form of direct taxes (corporate or personal income taxes, for example) and indirect taxes (SSTs) would also go down, we reckon that, at 4.2% growth, the deficit ratio may be close to 3.33%. Hypothetically speaking, if for some reason, growth slumps to 3.6%, we might well see the deficit ratio back to 3.4% that we see in 2019 – putting paid to the fiscal consolidation efforts.

All in all, while we do not think that reaching the 4.8% growth assumption and hence 3.2% fiscal deficit ratio target, as being impossible, we see the need for quite a few stars to be lined up for them to come true in 2020. One of those stars will include no more escalation in trade tensions between US and China in the coming months, unavoidably. Let's hope that is indeed so.

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