ISSN 2335-6677

ISEAS perspective

#56
2013

RESEARCHERS AT SINGAPORE'S *INSTITUTE OF SOUTHEAST ASIAN STUDIES* SHARE THEIR UNDERSTANDING OF CURRENT EVENTS

Singapore | 10 Oct 2013

The Tough Task of Narrowing Malaysia's Fiscal Deficit

*By Khor Yu Leng **

EXECUTIVE SUMMARY

- The July 2013 outlook downgrade by Fitch Ratings is understood to have triggered foreign investors to reduce their holdings in Malaysian public debt securities. The risks of further foreign sell-downs and capital outflows roiling the Malaysian capital markets has turned the spotlight onto Malaysia's 15 years of fiscal profligacy.

- Prime Minister Najib Razak has signalled a first step into fiscal restraint for Malaysia and announced that state fuel subsidies will be trimmed. Public sector construction projects (except the Klang Valley mass rapid transport projects) are to be delayed and rescheduled; especially those with a high import content.

- For the Malaysian government, serious fiscal belt-tightening will however have to deal with business lobbies and balance the interest of parts of the country's GLC sector. However, a large stable of state-dependent concessionaires and private companies enjoying business deals linked to the state is compounding the problem. The Prime Minister will need to challenge the patronage-ridden state outsourcing contract system, especially since key sectors are embedded in Malaysia's capital markets.

** **Khor Yu Leng** is visiting fellow at ISEAS. She specializes in customized industry research and strategic analysis on agribusiness in Southeast Asia and frontier markets, and the political-economy of Malaysia; email: yulengk@iseas.edu.sg*

- The recent 14 September announcement reinforced measures to benefit the country's ethnic Malay majority despite an earlier pledge to reform the controversial affirmative action policy favouring the group. The announcement is widely seen as aimed at rallying UMNO ahead of party elections and shoring up support of the Malay community, particularly its businesses and contractors.

- Narrowing Malaysia's fiscal deficit will not be easy. A high level of household debt and property-driven growth in the most recent period remain unresolved while emerging market woes abate and global growth reignites. If such external forbearance is not forthcoming, Malaysia may find it difficult leaving its fiscal fixation behind.

INTRODUCTION

In its July 2013 outlook report, global ratings agency Fitch Ratings revised Malaysia's sovereign credit rating outlook from stable to negative as the country's possibility of addressing public finance weaknesses had deteriorated after the general election held two months earlier. The news came as the Malaysian ringgit slid to three-year lows against the US dollar and 15-year lows against the Singapore dollar, making imports more expensive. While Fitch Ratings affirmed the country's long-term foreign and local currency issuer default ratings at A- and A respectively, the outlook downgrade was widely blamed for triggering foreign investors to trim their holdings in Malaysian government and corporate debt securities.

Following the lesson the country learned from the Asian Financial Crisis, this debt is almost entirely local currency denominated (instead of in USD). Given relatively lower foreign and domestic investments in the Malaysian economy since then, the debt build-up has not been in the corporate sector, but through public sector efforts to stimulate the Malaysian economy. Public debt has been used to expand public sector and government-linked corporation (GLC) employment as well as to fund Malaysian policy makers' penchant for big projects in property development, transport infrastructure and dams, etc. Just prior to the General Election in May, there was even an unusually large USD 3 billion debt issuance to pre-fund a set of to-be-determined investment by 1MDB, Malaysia's second sovereign wealth fund. Concerns about Malaysia's governance and the problems of wastage and corruption have therefore become more prevalent.

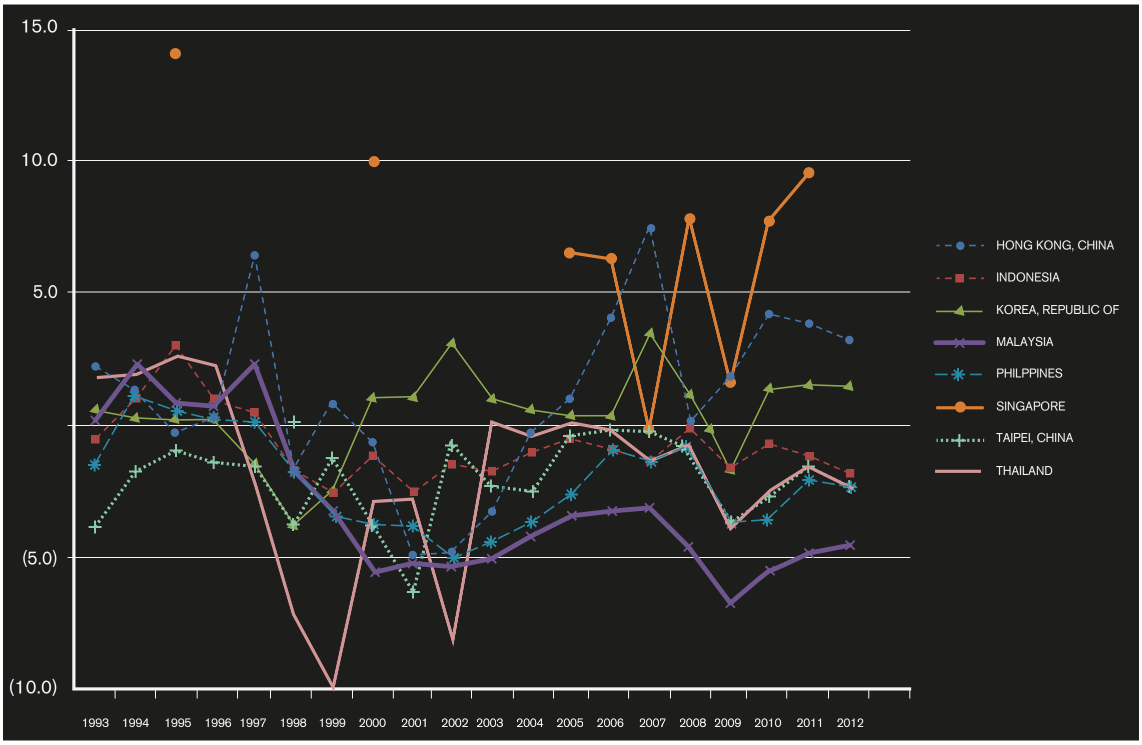
Malaysia is caught up in a sell-down of emerging market debt together with the Fitch credit outlook downgrade. Official data from Bloomberg showed that foreigners sold about RM 20.8 (USD 6.3) billion of Malaysian public debt between April and July 2013. Foreigners still own RM 201 (USD 61) billion or 28 per cent of Malaysia local currency public debt, down from RM 222 (USD 67.5) billion or 32 per cent in April 2013. According to a Bloomberg report on 6 September 2013, Malaysia's default risk surpassed that of the Philippines for the first time and contracts insuring Malaysian bonds against non-payment rose 63 basis points this year to 141. The report also noted that Malaysia's 10-year ringgit yield jumped 44 basis points to 3.92 per cent. These key indicators of the bond market point toward lowered investor confidence in the country as investors pay more to insure against default, and the selling of bonds resulted in an increase in yields. Due to the risks of further foreign sell-downs and capital outflows roiling the Malaysian capital markets, attention has finally turned to Malaysia's 15 years of fiscal indiscipline.

A FIRST STEP INTO FISCAL RESTRAINT?

Once known as a "tiger cub economy", Malaysia grew rapidly in the 1970s, and more or less respectably after that. Post-Asian Financial Crisis, however, Malaysia became a laggard according to many economic and financial indicators–including in its fiscal deficit–despite enjoying revenues from oil and gas (see Figure 1). As foreign and domestic private investments became anaemic, public spending was boosted. Judging by fiscal revenue outcomes, returns have been somewhat disappointing nevertheless.

Soon after the damaging July report, Prime Minister Najib Razak pledged measures to tackle risks to the fiscal position of the country. For the first time in over two years, Malaysia cut fuel pump price subsidies. The petrol subsidy was trimmed by 20 sen (6 US cents) a litre for the widely-used RON 95, and on diesel by 20 to 80 sen a litre. Najib said these cuts would help the government save about RM 1.1 billion ringgit this year and RM 3.3 billion annually in the future. It should be noted that while Malaysia's government spent RM 24 (USD 7.3) billion on fuel subsidies last year, the bulk of this went to corporate industrial users. This largesse contributed to the widening budget deficit which stood at 4.5 per cent of GDP in 2012. The move to cut fuel subsidies to beef up the country's fiscal position can be read, then, as a way to sidestep political opponents while tempering market jitters.

Figure 1: Malaysia Government Finance, percent of GDP at current market prices, Overall budgetary surplus/deficit, 1993-2012



*Note: *Bank Negara Malaysia's Annual Reports typically present data for HK, Indonesia, Korea, Philippines, Singapore, Taiwan and Thailand for comparative purposes. Malaysia's fiscal position is indicated by the thick purple line.*

Source: Asian Development Bank, Key Indicators for Asia and the Pacific 2013.

However, Fitch Ratings, in its 3 September 2013 report, said that Malaysia's latest measures to lower fuel prices was "too small" to alter its "negative outlook" on Malaysia's A- sovereign rating issued in July (a downgrade from a "stable" rating). The rating agency reported it had already factored in a 1 per cent of GDP reduction in government spending for the period to 2015, so these cuts in themselves did not significantly alter the agency's analysis. The ratings agency argued that only sustained reform implementation, accompanied by structural measures to broaden the revenue base, would make a difference to the sovereign's credit profile. In the same report, import-intensive public investments were identified as a risk factor that may cause near-term fiscal overruns, and current account slipping into a deficit. It was estimated that Malaysia's current account surplus will fall sharply to 3 per cent of GDP this year after averaging 11 per cent over 2009-2012.

Najib's administration disputed the analysis by Fitch and revealed its hopes for a better review by Moody's and Standard and Poor's. In particular, Treasury secretary-general Tan Sri Mohd Irwan Serigar Abdullah argued that young analysts from Fitch Ratings had slashed Malaysia's financial outlook despite the government's brief on proposals, saying that those from Moody's and Standard and Poor's were more understanding of the challenges faced by the government.[1]

WILL BUSINESS LOBBIES CONFOUND CHANGE?

If its fiscal belt-tightening is to have proper effect, Malaysia's government will have to deal with business lobbies and balance the interest of parts of Malaysia's GLC sector. Many companies are active in infrastructure and construction, the key sector that is facing spending delays. These include IJM Corp, Gamuda, MMC, MRCB, UEM, and WCT Engineering and a full range of suppliers from industrial pipe makers to steel, cement and chemical producers. Investment analysts remain sanguine about the implications for the corporate sector as they generally expect existing projects to be untouchable. If so, it may happen only in two years' time, when these current projects are completed, that some results in fiscal restraint can be seen, as new orders may be cut.

Also there are bigger issues permeating the large GLC sector in Malaysia – notably its role in crowding out private investment[2]. In particular, a recent Asian Development Bank paper suggested that to revive private investment in Malaysia, the government must not only redress its growing fiscal deficit, but also expedite its program of divestment:

[1] *"Treasury blames young Fitch analysts for Malaysia's outlook cut," 29 August 2013, themalaymailonline.com.*

[2] *"Are Government-Linked Corporations Crowding out Private Investment in Malaysia?" Jayant Menon and Thian Hee Ng, April 2013, ADB.*

To revive private investment in Malaysia, government must not only redress its growing fiscal deficit, but also expedite its program of divestment. While a growing fiscal deficit and rising dominance of GLCs may both be crowding out private investment, a genuine privatization program designed to reduce the role of GLCs would also address the fiscal constraint, providing a further boost to the investment climate.[3]

Malaysia has also developed a large stable of state-dependent concessionaires. These are the private companies enjoying business deals linked to the state, directly or indirectly (for example, as business partners of GLCs), with a significant number apparently enjoying long-term deals. Many are also politically-linked. These junior versions of their GLC-big brothers do not often hit the news headlines as most are not listed on the stock market. However, because many of them have gone to the local bond market to issue debt–in order to fund their projects or cash out their interest–there is some information on them to be found via Malaysia's credit rating agencies. Below are two examples.

Encorp Systembilt[4] has been granted a 30-year concession to build 10,000 units of teachers' quarters throughout Malaysia on a build-transfer-finance contract. The company completed all the units in early 2004 and a senior analyst (author's interview in September) notes that it collects RM11.4 million from the government on a monthly basis (payment starts upon building completion). Using a simple calculation of 12 months x RM11.4 million x 24 years (2004 to 2028), the nominal value appears to be over RM3 billion, or RM 300,000 per unit. This is an example of a company with a rather long-term non-strategic direct state concession deal. The concession holder is a subsidiary of Encorp Berhad, a public-listed company founded and helmed by Effendi Norwawi (giving his initials to the company name) who is a former Federal Minister of Agriculture and Minister in the Prime Minister's Department in charge of the Economic Planning Unit or EPU. On 19 July 2013, Norwawi sold off all his shares in Encorp in a management buyout.

FEC Cables[5] manufactured and sold mainly low- and medium voltage power and telecommunication cables to two clients: Tenaga Nasional and Telekom Malaysia, the two big state-controlled utility companies. Permodalan Nasional Bhd or PNB (a key Bumiputera investment holding company and trust agency), the majority shareholder, gave the company a strongly worded letter of support to meet its financial obligations when it was weighted down by high debt. PNB has announced its

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[3] *Ibid.*

[4] *Credit rating information on Encorp Systembilt Sdn Bhd (RM1.575 billion Sukuk Murabahah 2012/2028), RAM website, accessed 4 September 2013.*

[5] *Credit rating information on FEC Cables (M) Sdn Bhd (RM130 million Islamic Medium-Term Notes Facility and RM20 million Murabahah Underwritten Notes Issuance Facility 2006/2013), RAM website, accessed 4 September 2013.*

intention to divest FEC Cables by the end of this year; the first of five non-core assets to be sold to qualified Bumiputera companies. This is an example of a key state-linked agency supporting a non-strategic company in a highly competitive industry, and whose core clients are GLCs.

These are just two examples of junior concessionaires that have enjoyed access to non-strategic long-term contracts and/or special guarantees. It is thought that there are a slew of such companies, many reliant on government contracts and vulnerable to any slowdown in spending. Can this interest group hinder change? Certainly. Those who use the bond market to lock-in their interest (and the holding of such bonds by local institutional investors) will discourage adjustments to their contract terms to save cost for the state. Some analysts go so far as to say that the corporate bond market has been used to de facto poison-pill or prevent change in special concession deals.

PM Najib's Economic Transformation Program has been much trumpeted, but economists are cautious of the proclivity for property development (a low quality investment sector) and the lack of real economic reforms; RHB Research reports that property investment accounted for 43.7 per cent of RM58.1 (USD17.7) billion of new investments in the first half of 2013 (cited in The Malaysian Insider, 30 August 2013). Furthermore, Malaysia has even come to rely on Petronas for some 40 per cent of its fiscal revenue. This over-reliance on the national oil company may be compounded by greater risk at Petronas via its focus on marginal fields and de facto service contracts (instead of traditional risk sharing). The Petronas-fiscal situation bears close scrutiny.

WHAT NEXT?

Worriers have much to gnaw on. Exogenous factors and global perceptions are highly important for Malaysia's small open economy. The vagaries and shifting concerns of the global investment community could turn a long ignored chronic economic problem into an acute situation. Malaysians will hope for success in Najib's new efforts to shore up the deteriorating perception about Malaysia's economic outlook. All eyes will be on further announcements on the promised fiscal consolidation; the upcoming Budget to be tabled on 25 October 2013 will be keenly watched. Analysts think that Malaysia is vulnerable to further foreign fund outflows.

Global financiers will be interested to see how Najib plans to deal with Malaysia's weakening balance of payments (under orange alert by CIMB Research, refer to Figure 2), its immediate fiscal balance and government debt (red and orange alert), its private debt (red alert) and its domestic credit of about 134% of GDP (orange alert). CIMB Research concludes[6]:

[6] *"More than twin deficit concerns," CIMB Research, 25 Aug 2013.*

Malaysia, Korea and Thailand are the economies most at risk behind Indonesia and India if capital flight becomes more widespread. However, Thailand has already announced policy measures to stabilize the baht and support growth while we expect Malaysia to implement a 3-pronged strategy to contain the budget deficit and debt as well as ease the pressure on the current account in the 2014 budget.

In the longer term, the country needs to get out of its middle-income trap. According to the author's interview with a public policy expert, the country's macro-economic conditions and public financial management are acting as constraints. The longer the delay, the more difficult may be the situation.

Figure 2: Malaysia and regional economic risk factors

Balance of payments						Public debt		Private debt		Capital markets	
	Current A/C 2012 (% of GDP)	Current A/C 2013 (% of GDP)	Months of retained imports	International reserves /ST ext debt	ST external debt (% of GDP)	Fiscal balance (% of GDP)	Government debt (% of GDP)	Household debt (% of GDP)	Domestic credit (% of GDP)	Foreign ownership of govt bonds (% of total)	Foreign ownership of equities (% of total)
Indonesia	-2.8	-2.9	5.8	2.1	5.1	5.1	23.7	10.0	42.6	31.3	35.3
Malaysia	6.4	2.6	8.4	4.7	9.9	-4.0	54.1	80.2	133.8	31.0	24.6
Philippines	2.8	2.7	16.0	9.8	3.4	3.4	39.7	6.0	50.9	na	na
Thailand	0.7	-0.2	9.5	2.8	16.6	-4.0	47.5	77.6	169.3	17.9	35.9
Singapore	18.6	17.8	8.2			8.0		59.8	99.5	na	na
China	2.3	2.6	23.1	6.5	6.6	-2.1	21.3	31.1	155.1	na	na
India	-4.5	-4.9	6.1	4.2	4.8	-4.8	66.4	12.2	51.5	1.6	19.9
South Korea	3.8	2.7	7.6	2.6	11.2	0.7	32.5	91.1	168.7	7.5	30.6
Taiwan	10.5	10.3	18.2	3.7	23.2	-1.5	40.2	96.4	163.0	na	na

Note: The issuances of external and government debt are for objectives unrelated to financing, but to promote Singapore's domestic debt markets and position as a regional financial centre. Hence they have been excluded. Foreign ownership data for China, Singapore and Philippines are unavailable. Sources: CIMB Research
Source: "More than twin deficit concerns," CIMB Research, 25 Aug 2013.

CONCLUSION

Malaysia has reached a turning point and needs to show that it is ready to embark on bold fiscal reform and economic restructuring starting with a move to rein in the budget deficit.[7] The upcoming Budget 2014 proposals, to be unveiled on 25 October, comes amidst the risk of sovereign rating downgrades and investors' focus

[7] *"Budget 2014 a watershed moment: CIMB Research,"23 September 2013, The Star Online.*

on the vulnerabilities of the domestic and external sectors when foreign capital is flowing out. At the same time, Najib is entering a "hot" political phase. He has UMNO elections to manage while he is hobbled in his legitimacy; his Barisan Nasional coalition winning power despite losing the national popular vote in the recent general election. Analysts also note that he has lacked strong policy direction and public presence in the early part of his new administration.

There has been contestation over his push to join the US-led Trans-Pacific Partnership (TPP). Amongst other concerns, NGOs have highlighted negative implications for local contractors over state procurement. The TPP is an unusual agreement[8] that aims to set high economic and trading standards. It may unsettle the long-standing pro-Bumiputera New Economic Policy that has enriched Malaysia's politically-linked elite. Ex-Prime Minister Mahathir Mohamad, long suspicious of Western dominance and neo-colonialism, has come out strongly against the TPP.

Thus, there is much to deal with to effect change in a country that has grown used to fiscal generosity and big projects to feed key business sectors. Najib is tasked with making some necessarily tough decisions to reassure investors that the government has the political resolve to address the country's fiscal issues. Malaysia's economy has deep business-political networks with a special category of state dependent long-term concessionaires who have issued numerous bonds. In this way, political patronage has become embedded in Malaysia's bond market[9] and fiscal adjustments will be more difficult to engineer. To implement a fiscal policy change, Najib may have to face-off with various business lobbies. On 14 September this year, Najib announced fresh measures to benefit the country's ethnic Malay majority despite an earlier pledge to reform the controversial affirmative action policy. The announcement has been widely seen as aimed at rallying UMNO ahead of party elections and shoring up support of the Malays, particularly businesses and contractors.

It may not be easy to narrow Malaysia's fiscal deficit. Najib will no doubt hope that Malaysia's other latent economic risks—a startlingly high level of household debt and property-driven growth in the most recent period—remain on the side-line, while emerging market woes abate and global growth reignites. If such external forbearance is not forthcoming, Malaysia may have to work hard to turn away from its fiscal fixation.

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[8] *Currently under negotiation and described by Brookings Institution, a key US think tank as a "platinum standard" deal.*

[9] *This overview suggests that state dependent concessionaires and the politicization of Malaysia's bond market should be the subject of more detailed study. It should involve reviews of Malaysia issued bonds and an examination of the holders of the concessionaire bonds.*

ISEAS Perspective is published electronically by the Institute of Southeast Asian Studies, Singapore.

Institute of Southeast Asian Studies
30, Heng Mui Keng Terrace
Pasir Panjang, Singapore 119614
Main Tel: (65) 6778 0955
Main Fax: (65) 6778 1735

Homepage: www.iseas.edu.sg