

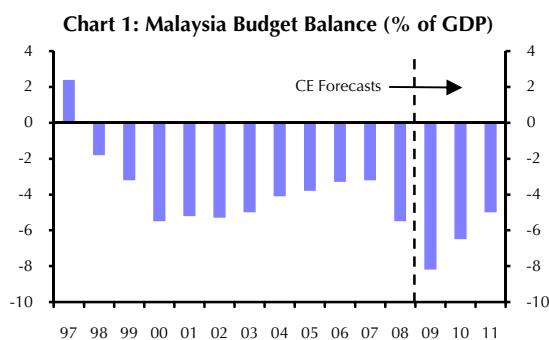
EMERGING ASIA ECONOMICS UPDATE

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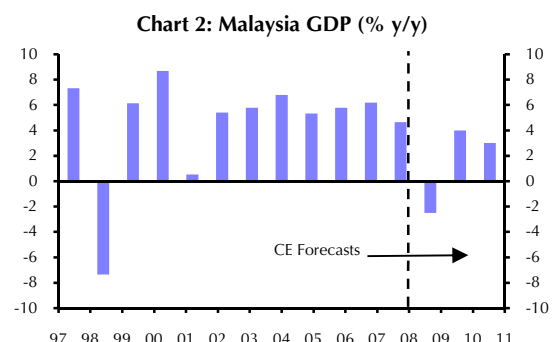


Malaysia plans slow exit from fiscal stimulus

- **Today's 2010 budget aims to cut the fiscal deficit but Malaysia's move to the exit will be more of a stroll than a sprint. Lower personal tax rates and higher relief on incomes will support household spending. Partly as a result, the GDP upswing is likely to surprise on the upside. Over the long term, Malaysia needs to improve the implementation of structural reforms to lift foreign direct investment.**
- **The target reduction of the budget deficit looks ambitious.** The aim is to reduce the shortfall from around 8% of GDP this year down to 5.6% in 2010, on the back of an 11% cut in spending. The savings are slated to be achieved via the better targeting of subsidies on food and fuel, through the more competitive tendering of government contracts, and through cuts in "operating expenditures" even in the context of more being spent on public sector salaries. The upswing will increase tax revenues but it is probable that the budget shortfall will only drop to around 7% of GDP next year. **Nevertheless, it is unlikely that any fiscal slippage would be severe enough to cause significant financing problems. Government debt is low, foreign debt is very low, and Malaysia's foreign surpluses will stay large.**
- **The government remains committed to structural change but the implementation of reforms needs to improve.** There was some push forward on recent initiatives, which for Malaysia were bold, to open up services to foreign investment and to relax ethnic Malay ownership requirements. Personal income tax rates were also cut for a second consecutive year. But the implementation of a goods and services tax remains some way off. The key structural weakness of public finances, which is an overdependence on revenues from commodities, will therefore persist for a while. This is unlikely to become a big issue but limits the scope to provide further fiscal support in future if Malaysia does soon suffer another downturn.
- **The budget GDP forecast appears too conservative.** The economy is picking up on the back of firmer domestic demand whilst foreign conditions have improved too, which is now providing some lift for exports. With the lion's share of the March 2009 fiscal stimulus still to come through, the government expects the upswing to gather momentum and forecasts that the y/y GDP gain will return to positive territory by Q4 this year. We agree and still believe that there is a chance of a y/y GDP gain in Q3.
- For next year, the government is forecasting GDP growth of 2-3% with household spending leading the way on the back of improved labour market conditions. This to us appears too cautious. We expect strong upswings in Asia and in the US over the next few quarters which will help Malaysia's exports. The follow-through from this year's fiscal stimulus, low rates, as well as today's budget benefits, should also keep lifting consumer spending. We forecast that GDP growth will accelerate to 4% in 2010, which for Malaysia would be around its long-run trend rate. The upswing and the unwinding of base effects will lift consumer price gains in 2010 but substantial spare capacity is likely to keep inflation subdued. **We forecast that inflation will pick up to around 3.0% in 2010, not enough to worry Bank Negara, which over the next 12 months will likely stay in Asia's slow lane in terms of policy rate hikes.**



Sources – IMF, Capital Economics



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