Mizuho Flash: Malaysia

Economics & Strategy | Asia ex-Japan

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Malaysia: Current Account, Fiscal and Inflation Sensitivities to Oil

*In a nutshell: While oil prices grab global headlines, gas exports in Malaysia continues to play their traditional role as one of the main drivers of the trade surplus while petroleum products remain supportive. Assuming that natural gas prices remain at the average of the first two months of 2022 for the rest of the year, we expect the **trade balance to be boosted by 0.3-0.5% of GDP** to give near 3% of GDP contribution to the current account surplus up from 2.4% in 2021, after accounting for the **drag from coal**.*

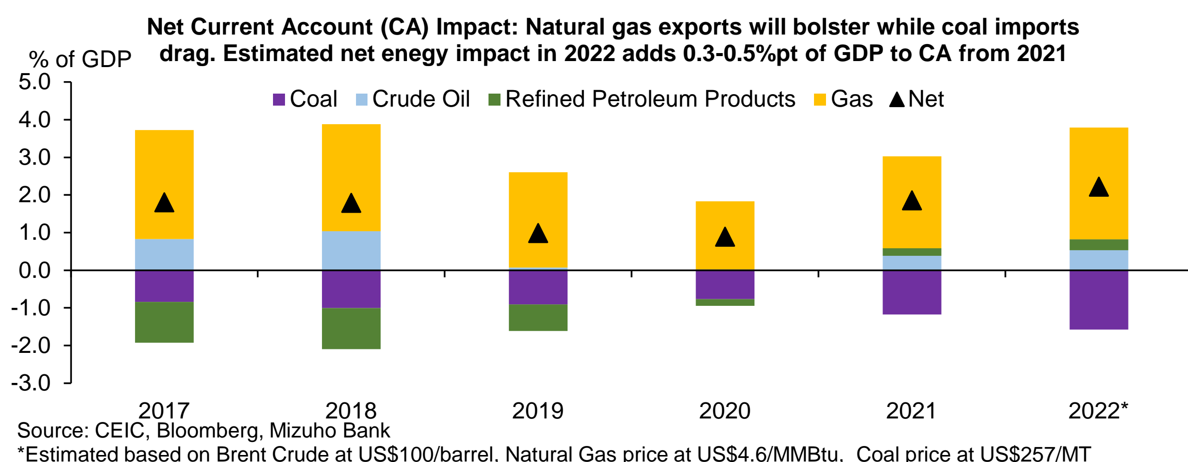
More importantly, the trade-off between high inflation and sustained fiscal deficit will mean that sensitivities to oil prices has escalated and will increasingly factor into policy calculus for both fiscal authorities and Bank Negara Malaysia. On one end of the spectrum, in the absence of fiscal intervention, higher oil prices will directly pass through to transport costs and utilities charges, pushing headline inflation higher. Under the scenario of US$100/barrel for Brent crude in 2022 which constitutes a near 40% annual increase, we project an estimated impact of a 2.3-2.5%-points rise in inflation. Meanwhile, indirect spillovers through the services sectors such as retail and restaurants will also exert inflation pressures.

*On the other hand, fuel price ceilings keep a lid on inflation at the expense of fiscal slippage. While fiscal deficit was projected to be 6% of GDP in 2022, inherent tensions are revealed by examining **underlying fiscal assumptions** of the Medium-Term Fiscal Framework which projected crude oil prices at **$67/barrel**. As the working assumption has undershot current prices, fiscal consolidation plans in 2022 face further complications. Assuming Brent crude prices at US$100, it is estimated that additional fuel subsidies (above baseline) amounts to ~1.3%-point of GDP. While **estimated windfall fiscal gains** from higher petroleum income taxes, royalties and dividends add 1.4% of GDP into state coffers, these streams are subjected to **greater uncertainty and duration mismatches— not outright buffers against expenditure needs**.*

Policy trade-offs will involve dynamic optimisation which evolves in tandem with the path of energy prices (with height and duration are both critical) alongside ever-changing state of inflation and fiscal positions.

*All in, a base case of **mild slippages** on multiple fronts: i) allowing inflation creep rather than acceleration, ii) fiscal demands outpacing subsequent inflows SOE contributions and iii) monetary policy standing pat for a few more months to allow growth durability which widens policy rate differential via-a-vis the US. **MYR weakness** in the face of twin deficits and eroding real policy rate spread risks may **continue in a restrained manner** before mild recovery takes hold in H2 2022.*

Gas and Oil – Current Account Windfall



Source: CEIC, Bloomberg, Mizuho Bank
*Estimated based on Brent Crude at US$100/barrel, Natural Gas price at US$4.6/MMBtu, Coal price at US$257/MT

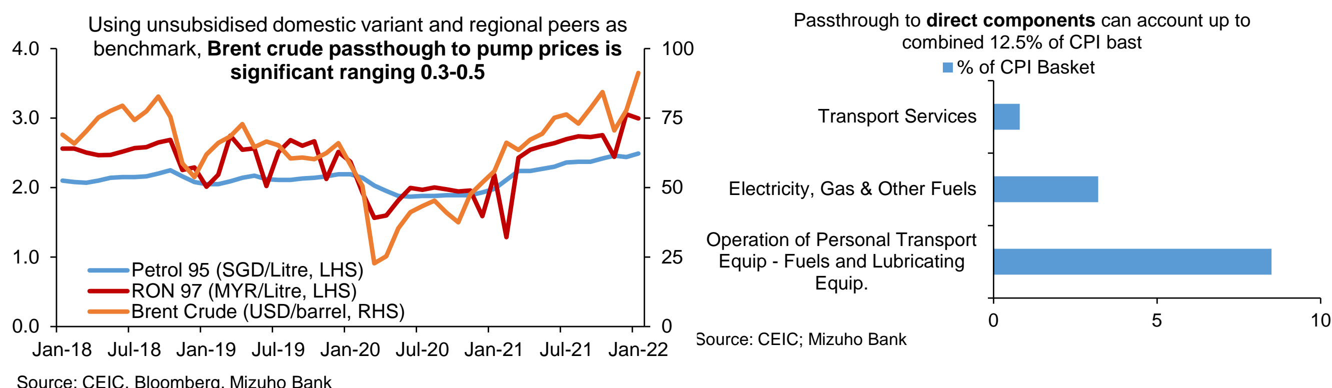
While oil prices grab global headlines, net gas exports will continue to be the focus in Malaysia. Assuming

gas prices around the average of Jan-Feb 2022 to persist for the entirety of 2022, gas exports will add substantially to **trade balance at an incremental 0.5%point of GDP** while oil export contributes marginally.

On the flip side, a **significant reliance on coal for energy generation** imply that the energy price increases are **not one way gains**. Consequently, higher coal prices will drag and offset revenue from gas and oil exports. On balance, assuming coal prices sustain at the average levels similar to the first two months of 2022, **higher energy prices (oil, gas and coal) will engender a 0.3%-0.5% point (of GDP) addition to the current account balance** and backstop the MYR.

The importance of our range estimate takes into consideration that while prices remain a favourable tailwind, the ability of crude production to take advantage remains in doubt **as Malaysia has struggled to fulfil their OPEC+ quota** and rising **domestic energy needs** amid global shortages (from geo-political conflicts) **may restrain export ability** as the government will be wary of energy discomforts and **social unrest ahead of possible elections this year**.

Inflation Sensitivities



Source: CEIC, Bloomberg, Mizuho Bank

Source: CEIC; Mizuho Bank

While current account windfalls bring cheer, the inflation aspect of higher crude oil prices look to dampen unbridled joy. A three stage pass-through from crude oil to headline inflation ensues: i) **crude oil prices to petrol prices**, ii) **direct transmission** to headline inflation **via CPI basket items** (personal transport services etc) from petrol prices and iii) **indirect spillovers** to other CPI items (restaurants services, retail) through **higher production cost** (utilities, transportation etc).

Under the **assumed absence of fiscal subsidies,** soaring Brent crude prices will pass through to petrol pump prices and dent household budgets. Using both unsubsidised RON97 in Malaysia and Singapore's RON95 as benchmarks, historical pass-through stands at about 0.4-0.5% increase of petrol prices for every 1% increase in Brent crude prices.

Higher petrol prices will then be filtered through direct components within the CPI basket such as higher personal transport cost and utilities charges. Through the combined 15% proportion of the CPI basket, the impact on headline inflation from a 1% increase in Brent crude prices will lead 0.06%-point rise in CPI inflation. Under the scenario of US$100/barrel price for Brent crude in 2022 which **constitutes a near 40% annual increase, we project an estimated impact of a 2.3-2.5%-points rise in inflation.**

With indirect spillovers not being accounted above for, the **second round inflationary impact can admittedly edge estimates higher.** That said, unfortunate demand destruction from high prices as well as producers' margins absorbing costs may mute these indirect effects.

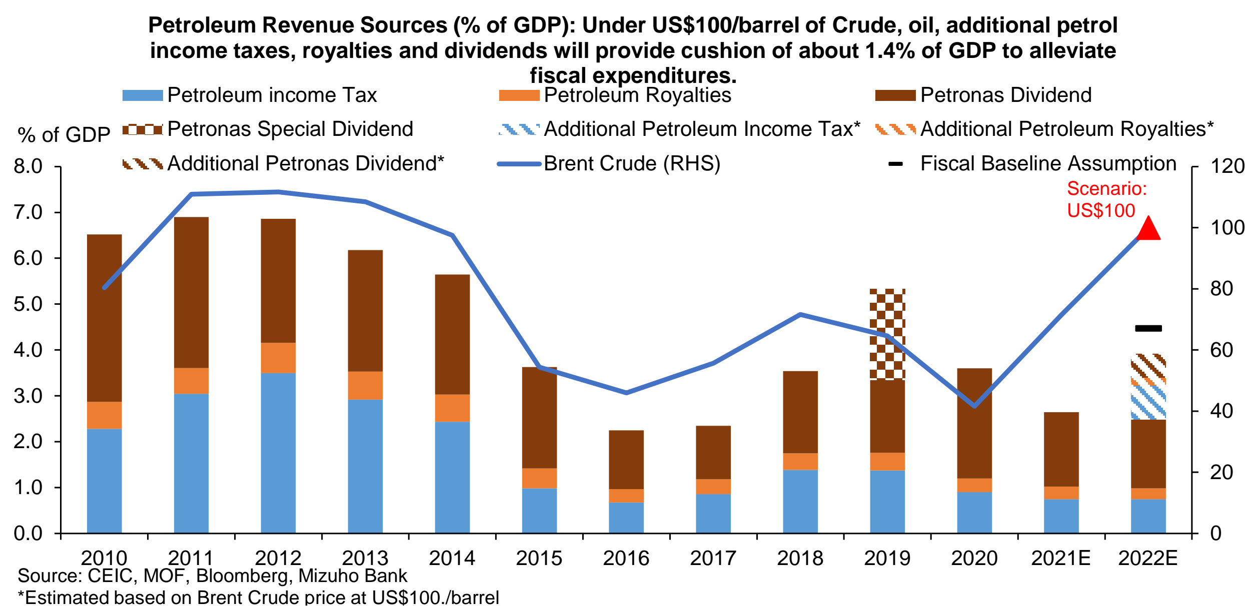
Fiscal Sensitivities – Subsidies and Dividend

Baseline (using fiscal assumptions)				Medium High				High			
RON 95		Diesel		RON 95		Diesel		RON 95		Diesel	
Actual Cost	2.6	Actual Cost	2.8	Actual Cost (RM/litre)	3.7	Actual Cost (RM/litre)	4	Actual Cost (RM/litre)	4.15	Actual Cost (RM/litre)	4.3
Retail Price	2.05	Retail Price	2.15	Retail Price	2.05	Retail Price	2.15	Retail Price	2.05	Retail Price	2.15
Subsidy/Litre	0.55	Subsidy/Litre	0.65	Subsidy/Litre	1.65	Subsidy/Litre	1.85	Subsidy/Litre	2.1	Subsidy/Litre	2.15
Subsidy (RM bn)	4.95	Subsidy	5.85	Subsidy (RM bn)	14.85	Subsidy (RM bn)	16.65	Subsidy (RM bn)	18.9	Subsidy (RM bn)	19.35
Brent Crude	$67			Brent Crude	$100			Brent Crude	$115		
Subsidies (% of GDP)	0.7%			Subsidies (% of GDP)	2.0%			Subsidies (% of GDP)	2.5%		

Assumptions: Diesel Consumption: 9 bn litres, RON 95 Consumption 9 bn litres
Source: Malaysia Energy Information Hub, Malaysia Parliament Speeches; MoF; CEIC; Mizuho Bank

Fuel subsidies in Malaysia has often kept a lid on the pass-through of higher crude prices to higher inflation in Malaysia. The resulting fiscal slippage worsens the fiscal deficit and overall public debt position. Given that the government's initial fiscal deficit of 6% of GDP was based on crude oil prices averaging US$67, the **current surge in oil prices may complicate their fiscal consolidation plans**.

Under the assumed 'Medium High' scenario with Brent Crude at US$100, it is estimated that the fuel subsidies **required above baseline** amounts **to about 1.3%-point of GDP**. A further stress scenario of oil prices averaging $115 for 2022 will see total fuel subsidies amount to 2.5% of GDP — 1.8% point of GDP added to the fiscal deficit.



Source: CEIC, MOF, Bloomberg, Mizuho Bank
*Estimated based on Brent Crude price at US$100./barrel

On the **revenue front**, windfall fiscal gains can stem from higher petroleum income taxes, royalties and dividends from Malaysia's state-owned enterprise Petronas. (See chart above) Using the same assumption of Brent crude at US$100, these income gains are projected to add 1.4% of GDP into state coffers.

On balance, while acknowledging the incremental revenue edge over expenditures from higher oil prices, it would be **more prudent to conclude that revenue gains can alleviate fiscal subsidies pressures rather than being clear cut beneficial** as revenue gains such as Petronas **dividends are subjected to greater uncertainty given corporate investment needs**.

In addition, **subsidies for cooking oil as well as LPG will also likely be stretched beyond original fiscal estimates of the authorities** and weigh on fiscal consolidation efforts.

Fine Balance Between Policy Trade-offs

The **fine balance between fiscal and inflation trade-off** coupled with **possible flow mismatch** between subsides spending and revenue collections underscores **the fragility of the petrol subsidy cushion**

contrasting with the immense inflationary pressure. Broken price ceilings which allow petrol prices to float remains untenable with the acute awareness of the devastation of demand destruction and erosion of electoral support. A **quick light lift** of the **ceilings** remains the easiest outcome, though a revamp of price controls to targeted means-based subsidies to lower income groups may be the first best solution if worrisome implementation kinks are smoothed out.

Notably, for both the fiscal authority and Bank Negara Malaysia, the trade-off will be one involving **dynamic optimisation which evolves in tandem** with the trajectory of energy prices (with the **height and duration are both critical**) alongside the changing state of inflation. **Higher for longer energy prices will certainly entail pushing the inflation tolerance of BNM** as indirect spillovers of higher energy cost such as utilities and other imported costs such as food will reverberate as firms' margins are chipped away and inevitably pass-through to households.

The nature of **fiscal subsidies being operating expenditure will limit financing options** (borrowing), therefore budgetary re-allocations may be required which **will entail cutbacks in other sectors**. In addition, with fiscal tweaks (ranging from raising price ceilings to target subsidies), inflationary pressures will seep through and sharpen policy trade-offs for the BNM. On the contrary, accommodation from holding policy rates which is undeniably necessary to support growth will push the envelopes of fiscal constraints further as gaps between market prices (from petrol to food) and mandated ceilings widen.

MYR – Restrained Weakness Amid Contrasting Forces

With burgeoning fiscal subsidies leaning against uncertain windfall gains, various scenarios point to a base case of **mild slippages on multiple fronts**: i) allowing inflation creep rather than acceleration, ii) fiscal demands outpacing subsequent inflows SOE contributions and iii) **monetary policy standing pat** for a few more months to allow growth durability which **widens policy rate differential via-a-vis the US**. However, the dynamism of policy levers entails that these slippages may likely be managed such that the **MYR weakness in the face of twin deficits and eroding real policy rate spread risks may continue in a restrained manner** before mild recovery takes hold in H2 2022. The relatively restrained weakness stands in contrast with regional peers (such as the PHP) without the commodity cushions.

However, with a thin balance between multiple policies amid ever-changing geo-political context, **policy missteps into an unwanted conspiracy of simultaneous slippages is more than a tail risk for the MYR.**

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