Economics

Malaysia: Fuel subsidy cuts and monetary policy

DBS Group Research

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Summary

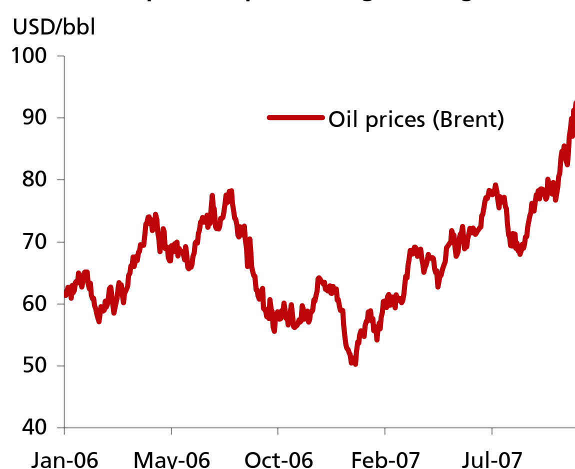
With oil prices remaining high, the burden of the fuel subsidy on the government budget is up sharply soaring and jeopardizes the deficit target of 3.1% of GDP in 2008. A cut in the fuel subsidy would help solve the problem but risk stoking inflation due to higher petrol prices. Inflation would likely rise to about 2.8% for the coming year if the cut in fuel subsidy materialised. However, a monetary policy response – interest rate hikes – solely because of that is unlikely as the growth outlook remains uncertain and the inflationary impact would be transient.

Hike in petrol prices

The fiscal burden of fuel subsidies is rising sharply

Malaysia is a net exporter of crude oil and has been subsidising its domestic petrol prices heavily. With record high oil prices grabbing the limelight lately, questions have been raised on whether the Malaysia government will cut fuel subsidy, thus leading to a rise in petrol prices ***(Chart 1)***.

Chart 1: Oil prices kept breaking new highs



Cuts in subsidies are unavoidable

Indeed, Prime Minister Badawi mentioned in his closing address during the UMNO's week-long annual assembly on 9 Nov07 that the government has planned to do so. The key message from his address on this issue was that the government is finding it increasingly difficult to sustain the large oil and gas subsidy. Last year, direct fuel subsidies totalled MYR 15bn (2.6% of GDP). In the first 8 months of this year, Malaysia has already spent some MYR 16bn in subsidising petrol prices. The amount of subsidy given to keep petrol prices low will likely exceed MYR 20bn this year based on current trends, or about 3.1% of GDP. With prices edging towards US$100/bbl, the 2008 government budget deficit target is plainly at risk of being exceeded.

Subsidy cuts – painful but necessary

The benefits of better resource allocation are realized over time

The pain of a subsidy cut is immediate

A cut in the fuel subsidy, although unpopular, would reduce the burden on the government's fiscal position and free resources for better uses. Given the burden and the benefits of removing it, a subsidy cut appears unavoidable. The trouble is, the benefits are reaped in the longer-term while the pain is immediate. And with an election looming, the government will have to tread carefully. A subsidy cut sooner rather than later seems likely and politicians have hinted as much already. The first quarter of next year seems a likely bet for the subsidy cut and a progressive reduction over 1-2 years (as favored in the past) would be favoured, rather than a one-off reduction.

Pump prices increased by an average of 21% on 28 Feb06 due to previous cut of about MYR 4bn in the fuel subsidy. We expect fuel subsidy to be reduced by

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about MYR 2-3bn this time round, which should translate to about 10-15% increase in petrol prices.

Inflation higher but only temporary

Inflation will be higher at about 2.8% next year

The impact of a cut in fuel subsidy is akin to a tax on consumption and its inflationary effect is transient. Inflation rose to 4.8% in Mar06, up from 3.2% in Feb06 during the last fuel subsidy cut. The bulk of the price increase came from transportation costs which went up by 9.3% on a monthly basis ***(Chart 2)***. However, inflation quickly dissipated to about 1.9% in Mar07. The hike in fuel prices this time round should lift inflation by about 0.8-1ppt in the month of implementation. Average inflation for 2008 should read about 2.8% ***(Chart 3)*** if the cut in fuel subsidy materialised in 1Q08.

Chart 2: Effects of hike in fuel prices

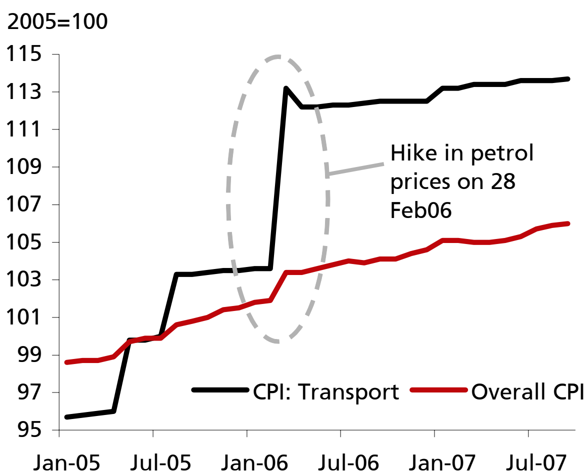
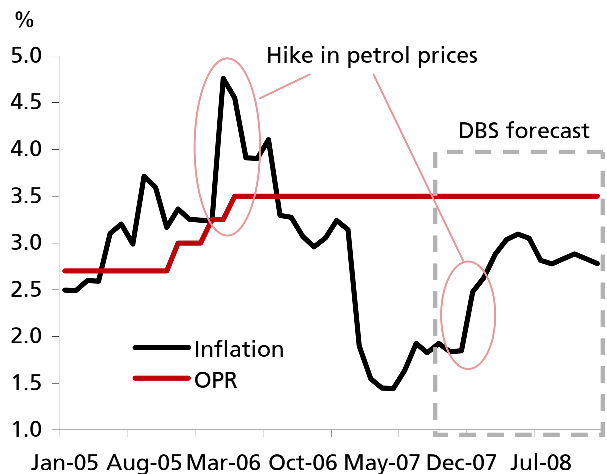


Chart 3: Inflation outlook for 2008



While the inflationary impact of a hike in fuel prices is usually temporary, it can persist if second-round effects, such as higher wage demands come into play. The risk of that occurring, along with higher global food prices, a hike in toll charges and demand pressure from an expansionary fiscal policy will make inflation a key concern for policymakers next year.

No impact on monetary policy in 2008

Bank Negara is expected to keep the overnight policy rate at 3.50% for the course of 2008

The cut in fuel subsidy may bring inflation higher next year but will have little impact in the longer term. Thus, Bank Negara is expected to uphold its monetary policy and keep the overnight policy rate at 3.50% for the course of 2008 ***(Chart 3)***. A tightening move from the central bank is not on the card yet as uncertainties in the external environment continue to plague growth outlook in the short term. A rate hike under such circumstances may well depress growth substantially. Furthermore, we have been through similar scenario before in 2006 where the policy rate was lifted to 3.50%. At 3.50%, the policy rate is still appropriate in curbing the inflationary pressure arising from the next hike in petrol prices, especially when the increase is relatively smaller. Essentially, a "repeat telecast" of the fuel hike at a smaller degree will not be sufficient for the central bank to move on policy in 2008.

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