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AmBank Research

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Malaysia

Fiscal deficit strain; limited monetary ammunition

Oil markets are crashing at the worst rate since the first Gulf war in 1991 amid a price war between Russia and Saudi Arabia. What we are witnessing now is similar to the 2008–2009 financial crisis – in which part of the rout can be attributed to panic selling. In a rush to find haven assets, the 10-year US Treasury yield plunged to a record low of 0.5% – the sharpest rally for US sovereign debt in more than a decade. In Malaysia, the 10-year MGS yield plummeted to an all-time low of 2.76%.

But this time around, the economic impact from the drop in oil prices due to Russia's reluctance to join Opec members could potentially result in serious geopolitical consequences in the Gulf area. Although major net oil exporters may be able to manage the crisis to some extent, challenges will emerge when their GDP growth continues to face downside risk compared to the rest of the world. Also, if spot crude oil prices fall well below their fiscal breakeven prices, it will heighten the challenge on their fiscal situation.

The reliance on oil revenue leaves the Malaysian economy vulnerable to global oil market movements. The risk stems from the government's estimate in Budget 2020 that the Brent oil price will be at US$62 per barrel. For every US$1 per barrel drop in the oil price, it will reduce oil revenue by RM300 million. Thus, pressure on the fiscal deficit/GDP, which is now at 3.4%, could rise to 3.6%–3.8% of GDP based on an RM8.1 billion loss in revenue. With the risk of the oil price weakening to US$20–25 per barrel, it could increase our revenue loss by RM RM11.1–RM12.6 billion.

Meanwhile, there can be a challenge to further ease the monetary policy. With a more flexible exchange rate, further easing of the policy rate is likely to add pressure on the ringgit to weaken against the USD. In part, this is because the ringgit is vulnerable to the movement of oil prices. A cheap ringgit due to falling oil prices compounded with monetary easing poses risk on potential inflationary pressure driven by higher import cost. This will not augur well in a slower economic growth environment

On the growth outlook, underpinned by current external headwinds and domestic challenges, our base-case growth projection for 2020 is between 2.5% and 3.0%, with an upside of 3.8%. Given the external challenges, much will now depend on how fast and effective the stimulus package as well as Budget 2020 initiatives are rolled out as these will help shore up the current weak consumer and business confidence and an increasingly tougher job market. The oil price's impact on the GDP is about 0.02% for every 1% change in price.

A. Global economy is now in a very serious situation

- Crude oil was on track for its biggest one-day drop since the 1991 Gulf War. It came after Saudi Arabia threatened to swamp the oil market by increasing its output and offered crude deep discounts to win new customers. As a result, oil prices fell with Brent hitting US$35 a barrel, while West Texas Intermediate plummeted to US$33.00 a barrel (Chart 1).

- The plunge in oil prices rattled the global stock markets (Table 1). At the same time, it hastened the rush into government bonds as investors sought safety. In a rush to find safe-haven assets, the 10-year US Treasury yield dropped to a record low of 0.5% – the sharpest rally for US sovereign debt in more than a decade. Prospects for the 10-year yield to dip into the negative region just like the government bonds in Europe and Japan are on the table. The 30-year US Treasury yield fell below 1%, taking the entire US yield curve below that level for the first time (Chart 2).

- Meanwhile, Malaysia's 10-year MGS yield has been trading near its all-time low of 2.76%. At the same time, the 30-year MGS yield came in at 3.52% (Chart 3) Besides, the equities market reported a net foreign loss of RM1.2 billion in the week prior, bringing the YTD loss to RM3.3 billion (Chart 4).

- It now appears that the global economy is heading into a very serious situation. The year 2020 first started with the coronavirus scare which is still impacting the global economy. Global supply chains and shipping are impacted severely, thus hurting the manufacturing sector which is already in recession as a result of the trade war tension between the US and China. Both exports and imports are impacted.

- Besides, the virus has affected tourism and tourism-related business activities and other services activities indirectly, thus weighing on global services. And now, crude prices are falling. It is also the first time ever the 10-year US yields dipped below 0.5%. Collapsing oil prices are not good for the global economy and certainly not for the US and Malaysian economy. Added with the collapse in yields and a huge selloff in the equity markets, these events heighten the potential risk for a global recession in 2020.

B. Similar to the 2008-2009 financial crisis

- What we are witnessing in today's oil price direction is somewhat similar to the 2008-2009 global financial crisis where in part, it could be attributed to panic selling. However, this time around the economic impact from the drop in oil prices was due to the Russians' reluctance to join Opec members. Such move will not only have serious economic implications, but also geopolitical consequences, especially in the Gulf area.

- The decline in oil prices could see several net oil-exporting countries managing, to some extent, by initially running substantial and higher fiscal deficits. The challenge on these economies will emerge when their GDP growth continues to face downside risk compared to the rest of the world. More so, if spot crude oil prices fall well below their fiscal and external breakeven prices (Tables 2 & 3) as it will heighten the challenge on their fiscal and current account positions. In particular, major oil producers with currency pegs to the US dollar or other tightly managed exchange rate arrangements like Iran, Iraq, Nigeria, Saudi Arabia, the GCC countries and Venezuela.

- Monetary policies will also be constrained in commodity-exporting countries, especially those with more flexible exchange rates. As the currencies of these countries depreciate fast, it will add inflationary pressure. At the same time, it limits the room for monetary policy easing in response to addressing a slower growth. What could happen is a divergence in monetary policies. The global monetary policy is now on an easing trend to address the coronavirus impact. However, such monetary easing may not take place globally, should the oil prices continue to drop, especially in commodity-exporting countries.

- Meanwhile, the impact of the drop in oil prices on global GDP should be assessed based on supply and demand. Estimates showed that for every 10% drop in oil prices as a result of supply shocks, it will raise the global GDP by 0.1% to 0.2%. Meanwhile, if the drop in oil prices is due to weaker demand, it will lower the global GDP by 0.2%–0.3%. Hence if the current weak oil price is due to higher supply (50%) and weaker demand (50%), the net impact on the global GDP is a slight drop of 0.1% from our base-case projection of 1.8%–2.3% from 2.8%–3.0% previously, prior to the coronavirus impact.

- Furthermore, financial strain will emerge as a result of the drop in oil prices, particularly in countries with foreign currency exposures. Although the share of major oil-exporting countries in relation to the global economy is small, around 15% of global GDP based on purchasing power parity. The negative spillovers on those countries with close trade and/or financial links can be impactful. It can weigh down the already weakening global confidence as a result of the virus impact and hence global economic activities.

C. Strain on Malaysia's fiscal deficit

- The domestic economic reliance on oil revenue leaves the economy vulnerable to global commodity markets. Contribution of oil revenue to total revenue is projected at 20.7% (Chart 5) based on Budget 2020. The projected oil price i.e. Brent per barrel was US$62 per barrel. On that account, the fiscal deficit/GDP is expected to drop to 3.2% in 2020 from 3.4% in 2019.

- Meanwhile, following the outbreak of the coronavirus, the PH government unveiled an additional RM20 billion stimulus package in a move to support the affected industries and the economic growth from sliding. As a result, the fiscal deficit/GDP was revised upwards to 3.4% for 2020.

- However, the new challenge is the sharp drop in the oil prices. With the average Brent price per barrel for the first two months at US$60 per barrel, the oil price will have to average around US$64 per barrel for the remaining months of 2020 to US$62 per barrel.

- Now with the drop in oil price to US$35 per barrel, it heightens the risk on the ability to meet the new fiscal deficit/GDP of 3.4%. With a US$27 per barrel fall from the PH government's target of US$62, it should reduce the oil revenue by RM8.1 billion. It is based on the view that for every US$1 per barrel drop in oil price, it will reduce the oil revenue by RM300 million. Thus, the oil revenue should drop from the Budget 2020's projection of RM50.6 billion to RM42.5 billion (Chart 6).

- Assuming the total revenue drops to RM236.4 billion primarily due to lower oil revenue contribution and with no changes on total expenditure which is RM296.2 billion, the fiscal deficit/GDP for 2020 should reach 3.8% from the new projection of 3.4% as a result of the fiscal stimulus package (Chart 7).

- However, if the drop in oil price results in the easing of fuel subsidy estimated at RM6 billion, that should provide comfort on the fiscal deficit position. The drop in revenue due to the loss in oil revenue, added with lower expenditure as a result of no fuel subsidy, would result in a slightly higher fiscal deficit of around 3.6% of GDP from the current 3.4% of the GDP projection (Chart 7).

- Meanwhile, the risk for oil prices to go below US$30 per barrel remains high. Possibilities for oil prices to drop to as low as US$20–US$25 cannot be ruled out. Should oil prices reel to such low levels, the additional loss in oil revenue will be around RM11.1–RM12.6 billion and will add strong upwards pressure on the fiscal deficit/GDP, surpassing 4% levels.

- While global central banks are still on a monetary easing pathway, such easing flexibility could soften in the case of Bank Negara. The central bank has reduced in total 50bps from the start of 2020 to bring the OPR to 2.50%. There is now a challenge on the monetary policy. With the ringgit being on a more flexible exchange rate, any further easing of the policy rate could add pressure to the ringgit to weaken against the USD. In part because the ringgit is vulnerable to the movement of oil prices. Besides, a cheaper ringgit due to weaker oil prices compounded with any further monetary easing could pose potential inflationary pressure driven by higher import cost. Any potential rate cuts can be instituted modestly only if the global central banks continue to cut rates aggressively. Bank Negara need to look at alternative mechanism like reducing the SRR and inject the addition fund into the Special Investment Fund to support SME businesses.

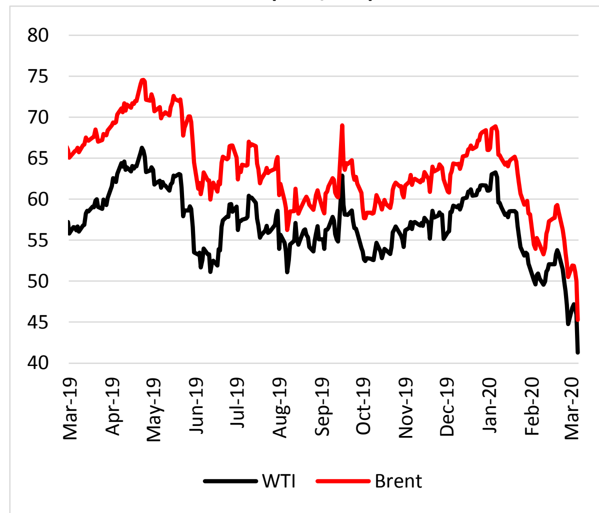
- With limited fiscal and monetary flexibility, added with ongoing external headwinds and domestic challenges, our base-case GDP growth projection for 2020 is between 2.5% and 3.0% with an upside of 3.8%. To support domestic economic activities, it is important to revive both the consumer and business confidence, and address the tough job market by expediting policy implementation apart from having consistent policies. There is also a need for better engagement between the policymakers and businesses prior to instituting the policies. The oil price impact on the GDP is about 0.02% for every 1% change in price.

- Meanwhile, lower oil prices will help soften potential inflationary pressure with an impact around 0.07% for a 1% change in oil price. With transport costs accounting for around 15% of the CPI basket, any reduction in fuel prices will have a big impact, especially to the lower-income groups, as they represent a bigger percentage of spending compared with those with high income. Savings from lower fuel pump prices could see consumers loosen their belts, particularly the B40 group and M40. As a result, consumer spending may improve modestly in this challenging economic environment, benefitting the retail segment of the businesses like fast-moving consumer goods and vehicles.

- Shocks from the oil price tend to have a bigger impact on the long-term interest rates, influencing around 18% of the movement and 11% on real effective exchange rate. Meanwhile, the impact on short-term interest rates (3 months T-BILLS) is about 4% while money supply (M1) is around 8% and real GDP about 5%. Besides, weaker oil prices will spark uncertainties in the market as investors and fund managers will be selling down O&G stocks amid worries that these counters are overvalued following growing investor interest in the last few years.

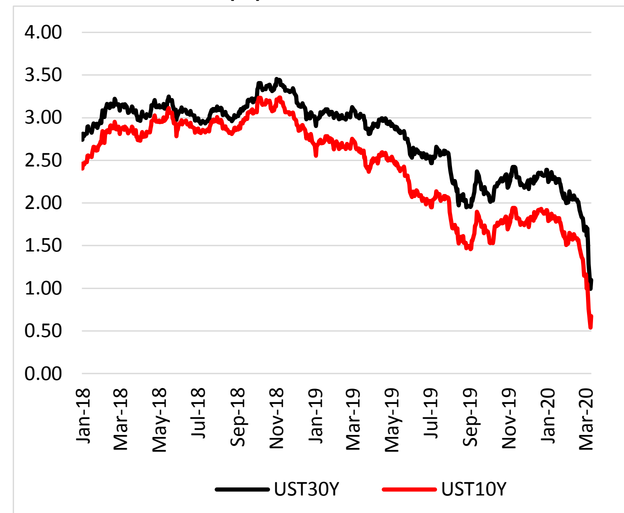
- Meanwhile, the aviation industry, which sees about 40% of its operating cost weighed by fuel expenses, is expected to benefit from lower oil prices. Cheap oil price will somewhat help mitigate the negative coronavirus impact, which is seen to be hurting the tourism and its related business activities. The positive impact on the operating costs of the aviation industry as a result of lower oil prices will only be seen in the next quarter. Also, integrated oil companies with refining operations should benefit from cheaper oil.

Chart 1: Brent and WTI (US$/bbl)



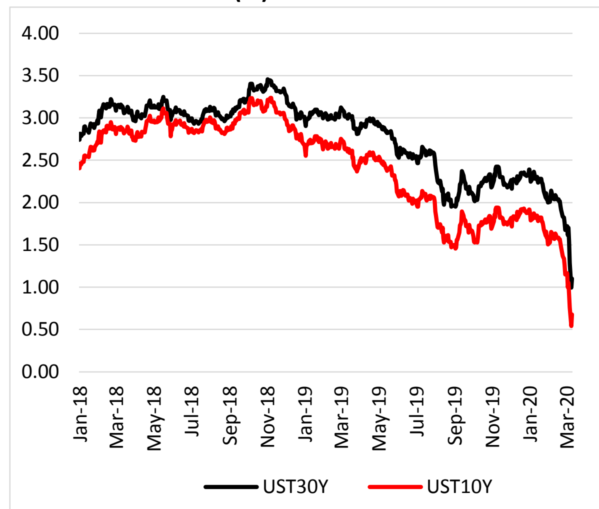
Source: Bloomberg/AmBank Research

Chart 3: UST Yields (%)



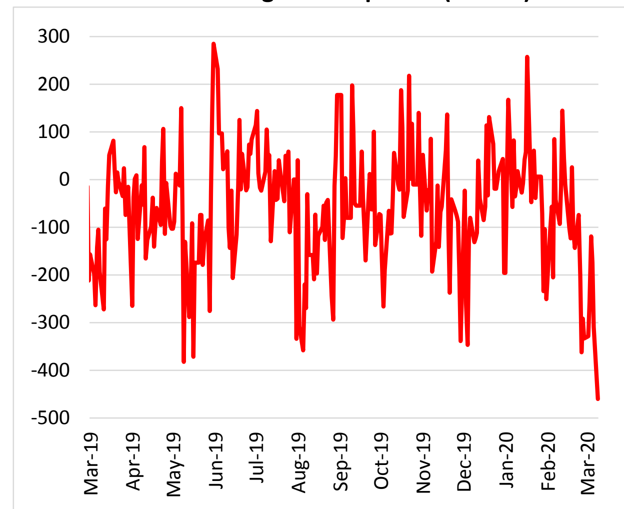
Source: Bloomberg/AmBank Research

Chart 3: MGS Yields (%)



Source: Bloomberg/AmBank Research

Chart 4: KLCI Net Foreign Participation (RM'bil)



Source: Bloomberg/AmBank Research

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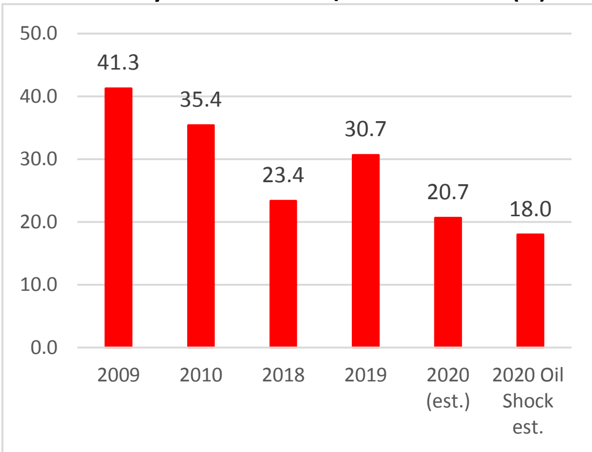
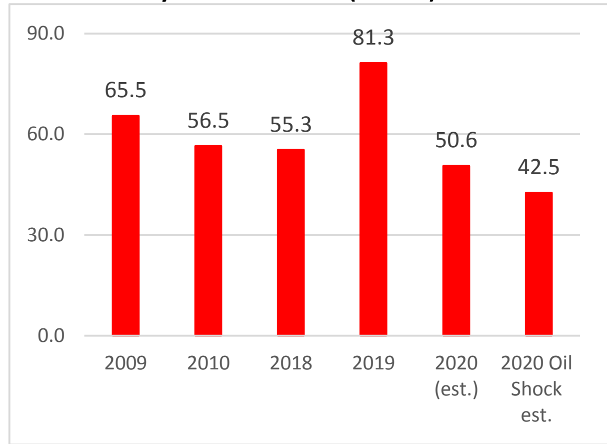
Chart 5: Malaysia Oil Revenue/Total Revenue (%)



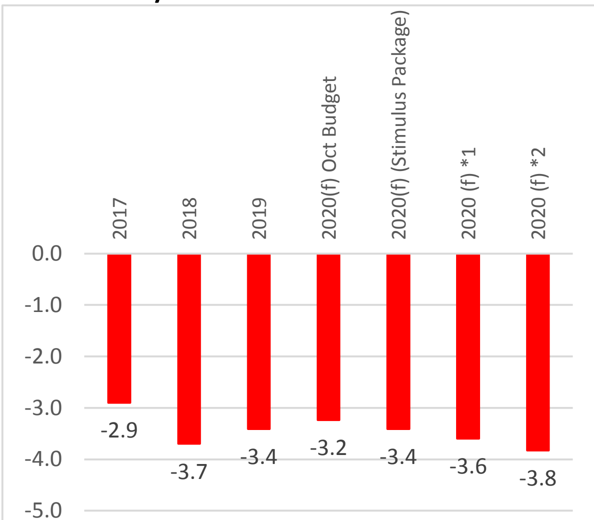
Source: MoF/AmBank Research; Note *2019 includes one-off Petronas dividend (11.4%); 2020 Oil shock estimate at US$35/bbl*

Chart 6: Malaysia Oil Revenue (RM'bil)



Source: MoF/AmBank Research; Note *2019 includes one-off Petronas dividend (RM30bil); 2020 Oil shock est. at US$35/bbl*

Chart 7: Malaysia Fiscal Deficit % GDP



Source: MoF/AmBank Research; Note: *1 = Assuming revenue loss & savings from fuel subsidy; *2 = Assuming only revenue losses

Table 1: Fiscal Breakeven Oil Price (US$/bbl)

Equity Market	YTD Changes (%)
Dow Jones	-16.4
S&P500	-15.0
UK	-20.9
EU	-21.0
Japan	-16.7
Australia	-13.8
India	-14.1
China	-3.5
Hong Kong	-11.2
Singapore	-13.7
Thailand	-20.5
Indonesia	-18.5
Philippines	-19.2
Malaysia	-10.4
Vietnam	-13.1

Source: IMF/AmBank Research

Table 2: Fiscal Breakeven Oil Price (US$/bbl)

Countries	Fiscal Breakeven Oil Price (US$/bbl)
Algeria	92.3
Bahrain	93.0
Iran	124.4
Iraq	59.0
Kuwait	49.7
Libya	79.0
Oman	85.9
Qatar	45.4
Saudi Arabia	78.3
UAE	68.0

Source: IMF/AmBank Research

Table 3: External (Current Account) Breakeven Oil Price (US$/bbl)

Countries	External (Current Account) Breakeven Oil Price (US$/bbl)
Algeria	75.0
Bahrain	77.8
Iran	52.4
Iraq	59.4
Kuwait	49.6
Libya	67.7
Oman	69.6
Qatar	51.2
Saudi Arabia	58.1
UAE	42.4

Source:IMF/ AmBank Research

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