

MALAYSIA'S FISCAL & PENSION SYSTEMS ARE OUT OF SYNC – RISKS ARE ELEVATED & REFORMS NEEDED. But is there a political will to pre-empt the projected problems?



"We do not want to end up like Greece... Malaysia could go bankrupt in 2019 with total debts amounting to RM1,158 billion," Minister in the PM's Dept, Idris Jala, 27 May 2010.

NEWS UPDATE

- The administration of PM Najib projected 2012f budget deficit at 4.7% GDP but the IMF expected this could not be met and it projected 5.1%.
- **Due to the supplementary budget approved in June 2012, with an additional RM13.8 billion or 1.5% GDP of spending, it appears that Malaysia's deficit could exceed 6%.**

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Fiscal & pension system status and issues

- **IMF: Malaysia's general government debt 57.5% and overall balance -5.1% vs GDP for 2012f;** fiscal situation not yet at critical stage on trend projections
- **IMF: Federal government non-oil primary balance averages -11.2% vs GDP (range -9.2 to -14.5%), 2007-2012f;** reflects heavy reliance of about 40% revenues from oil & gas (payouts from Petronas)
- **Fiscal risk is heightened and Malaysia vulnerable to growth and other economic shocks; contingent liabilities not well accounted**
- **Malaysia's pension system has not seen reform in over 50 years**
 - 70% use up EPF lump sum within 10 years of retirement vs 17-20 years life expectancy in retirement
 - Uncertainties of adequacy at SOCSO; civil service pension liabilities and possible social and health insurance needs add to fiscal concerns

EDITORIAL

While the rest of the world looks on, a fiscal crisis is roiling key countries in the Eurozone. Bond yields recently rose to unprecedented levels as investors grew leery of holding the debt issued by these governments. Bouts of fear are relieved by periods of hope of rescues via more stimulus packages. In the meantime, the fundamentals remain largely unchanged since the Global Financial Crisis hit. For this, developed country policy makers prescribed quantitative easing with bank (and banker bonus) bailouts but limited immediate retrenchments and reforms. In this period of renewed uncertainty, the problems lie with uncompetitive economies that enjoyed booms in cheap credit, housing and fiscal spending; all of which had failed to generate sufficient economic returns, leaving them with piles of public debt that investors are less willing to fund.

In the run up to the Asian Financial Crisis, hot money and high credit growth boosted (poor) corporate investments. This was resolved with currency crashes, austerity, corporate wipe outs, political change and reform – notably in Indonesia, Thailand and South Korea. In Malaysia, novel policies of capital controls and an exchange rate peg seemed to contain pressure for serious political-economic change. This pain avoidance is akin to recent USA and Eurozone policy. Post-crisis, Malaysia adopted another similar policy: as investment and employment growth in the private sector has lagged, public sector (add in statutory authorities and GLCs) employment growth and salaries have been gaining on the private sector's. Bottom line: multi-year budget deficits, ballooning public debt and public sector excesses are worrying indicators. Furthermore, small and open economies such as Malaysia are not expected to have the luxury of extending unsustainable policies too far into the future.

In Malaysia's fiscal and pension systems, there are warning signs of risks and need for reforms. The gloomy outlook is that pre-emptive change is unlikely. Such concerns seem too distant for the public to understand or appreciate. The world over, politicians pander to populism and we lack statesmen willing to educate the public and steer through reforms over the heads of interest groups. So, it is a muddle through with hopes for the best: will time, and economic pick-up elsewhere, heal everything?

Malaysia's fiscal history tells an interesting story of a country that had once led its peers in achievement rankings. Post-Asian Financial Crisis, Malaysia became a laggard on many economic and financial indicators, including in its fiscal deficit, despite enjoying revenues

from oil and gas. As foreign and domestic private investments have been anaemic, public spending has been boosted. But judging by fiscal revenue outcomes, these returns have been somewhat disappointing. 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. Indeed, Malaysia has even come to rely on Petronas for some 40% of its fiscal revenue. Reuters' "Special Report: Petronas chafes at its role as Malaysia's piggy bank," 2 Jul 2012, is worth a read. Khor Reports' study# on management and management structure changes at Petronas and its new strategy for marginal field exploration and development (via a bonanza of service contracts for newbie Malaysian oil services players and eschewing the traditional risk-sharing model) points to potential for greater uncertainty for the national oil company. The troubling fiscal policy of reliance on such payouts may be compounded by greater risk at Petronas. Thus, it is "risk plus" all around. The Petronas-fiscal situation bears much closer scrutiny.

In the pensions sector, Malaysia had a lead with its Employees' Provident Fund (EPF); an innovation in its day, it is a defined contribution fund (you get what you put in plus investment returns) and it was hoped that retirees would not be a burden on the state. Despite reasonable returns, heavy pre-retirement withdrawals result in a RM50,000 typical balance at age 55; and 70% of use up their lump sum within 10 years of retirement vs. 17-20 years of retirement life. Other components in the pension system include a defined benefit pension scheme for civil servants, and a social insurance scheme for lower-income employees. With a clutch of state-run pension funds dominant (and more being set up), political-economists worry about their role as market makers and movers in the local securities markets. And what about civil service pension liabilities? The sector has not seen reform in over 50 years. Time for a review and rethink?



Khor Yu Leng

"Petronas – new directions and challenges," 1 Feb 2011, Khor Reports, Malaysia Briefings, Issue 001. Topics covered: new governance, new strategy implementation, proposed special fund & Sudan challenge.

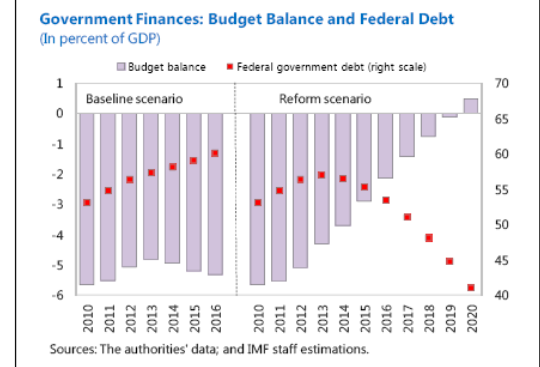
BACKGROUND

The fiscal situation & need for reform – what the IMF says

<p>2012 deficit target will be hard to achieve with growth slowdown; IMF expects 5.1% deficit vs budget target deficit 4.7%; federal govt debt to rise above 55% GDP</p> <p>But this has been superseded with extra spending in the June supplementary budget; likely to push the deficit over 6%</p> <p>Authorities target 3% deficit by 2015, to ensure debt-to-GDP does not exceed 55%</p> <p>IMF says Malaysia now has limited room for fiscal stimulus in a downturn; need for structural and fiscal reform</p> <p>Debt-GDP ratio expected to increase, medium-term. Instead, IMF suggests reform with 42% target.</p> <p>Broaden tax base, reduce subsidies, rationalize opex and devex</p>	<p>THE IMF SAYS.....</p> <p><i>The deficit target envisaged in the 2012 budget will be difficult to achieve in light of the projected growth slowdown. In the staff's view, the authorities should abide by their budget expenditure ceiling but allow automatic stabilizers to operate on the revenue side. Under these assumptions, the federal government's budget deficit is projected by staff at 5.1 percent of GDP, against the budget target of 4.7 percent, implying marginal consolidation over 2011. While federal government debt would rise above 55 percent of GDP, this more modest fiscal adjustment would help cushion the downturn. Keeping to the budget target would add a significant drag on growth. Efforts, however, should be made to better target budgeted expenditures to the most needy, as well as to rationalize subsidies and channel the realized savings to items with high fiscal multipliers.</i></p> <p><i>The authorities were confident of meeting the 2012 deficit target even if growth is lower than expected. Given conservative revenue assumptions, they remain optimistic that federal government debt can be kept below 55 percent of GDP in 2012 and over the medium term, based on a deficit path targeting a 3 percent of GDP deficit by 2015. Nevertheless, they would view a temporary rise in federal government debt above this threshold as acceptable to support growth under exceptional circumstances if downside risks to growth materialize. Otherwise, they will ensure that the debt-to- GDP ratio does not exceed 55 percent.</i></p> <p><i>In the event of a severe downturn, there is only limited room for countercyclical fiscal stimulus. Given Malaysia's still high fiscal deficit and federal government debt, any limited discretionary measures would need to be accompanied by credible medium-term</i></p>	<p><i>fiscal consolidation plans to ensure debt can return to a declining path over the medium term. Fiscal measures should aim at supporting low-income households and in areas with high multipliers, and could be augmented with guarantees and credit lines to small and medium enterprises to support employment and incomes.</i></p> <p><i>Structural measures need to be accompanied by fiscal reforms. Efforts should concentrate on increasing fiscal space to allow room for countercyclical fiscal policies, putting federal government debt on a declining trajectory, and removing distortions in the tax and subsidy system. Broadening the tax base through the proposed goods and services tax would help reduce reliance on procyclical oil-related revenues. Resource allocation would be improved by the streamlining of subsidies and wasteful tax incentives, and replacing them with targeted assistance to the needy.</i></p> <p><i>To achieve the authorities' projected deficit path and generate sufficient fiscal space, consolidation needs to be faster than under the staff's baseline. Committing to a medium term anchor accompanied by well-articulated revenue and expenditure measures, while allowing room for automatic stabilizers to operate and some discretionary spending to counter cyclical downturns, would help cement credibility. The staff's medium-term illustrative reform scenario envisages a reduction in federal government debt to the pre-crisis level of 42 percent of GDP as a benchmark. This is consistent with the authorities' fiscal deficit path, and could be achieved by broadening the tax base, reducing subsidies and rationalizing both operating and development expenditure</i></p>
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Improve fiscal transparency & prepare a comprehensive fiscal risk assessment

The formulation of fiscal policies would be enhanced by further improvements to fiscal transparency. Malaysia's fiscal transparency is supported most importantly by a comprehensive legal framework that governs public finances and the budget process. In some areas, further efforts to increase transparency in line with the 2011 fiscal ROSC are recommended, including: expanding the coverage of the budget to include pension funds and all autonomous entities; gradually moving from discretionary to rules-based tax incentives; reporting comprehensively on public-private partnerships with a focus on fiscal risks; including in the budget clear information on new revenue and expenditure initiatives, contingent liabilities and quasi-fiscal activities; and preparing a comprehensive fiscal risk assessment.



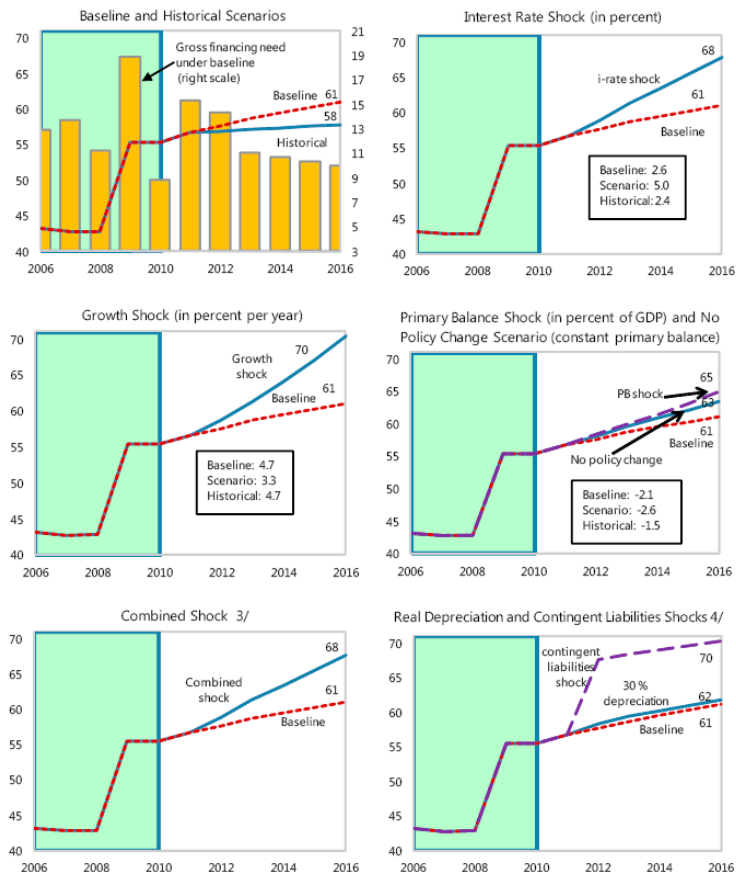
Note: Under the IMF's Reform Scenario, "Further budget consolidation efforts are needed to put the debt to GDP ratio on a declining trajectory over the medium term through clearly articulated revenue and expenditure measures, including a phased reduction of subsidies, broadening of the tax base, and more targeted and efficient social spending..." However, this scenario seems unrelated to any policy plan by the current administration. The possibility of implementing the deep reforms needed to achieve the IMF's Reform Scenario was not assessed. Source: Excerpts from IMF (2012)

IMF baseline scenario and bound tests

IMF Baseline scenario: debt is expected to rise steadily relative to GDP over the next five years, reaching about 61 percent of GDP by 2016.

IMF Bound tests: debt path is highly vulnerable to growth and interest rate shocks. E.g. a decline in real GDP growth of about 1.5%-age points relative to the baseline would increase the debt to GDP ratio to above 70 % in 2016

Figure I.2. Malaysia: Public Debt Sustainability: Bound Tests 1/ 2/ (Public debt, in percent of GDP)



Sources: International Monetary Fund, country desk data; and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
 2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
 3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
 4/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2010, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Source: Excerpts from IMF (2012)

The pensions system & key issues – Prof Asher says

Population ageing is some way off, so there is time for necessary adjustments

Life expectancy at age 60 is 17-20 years

Malaysia lacks a unified pension structure. EPF is the dominant scheme with 12.3 million members; 5.8 million are active, representing 50% of the labour force

Contributions are 23% of wages (half that for 55-75 year olds) or 4.5% of GDP; contributions net of the high withdrawals is 1.5% of GDP.

Average balance is RM30,000 or 1.2x per capita income

Demographic & labour market trends

- Demographic trends in Malaysia portend population ageing, but this is some way off, with the number of aged (over 60) projected to exceed those under 15 by 2045. The number of aged is projected to increase from 1.5 million in 2000 (6.6% of the total population) to 3.1 million (9.9%) by 2020, reaching 18.3% and 22.2% in 2040 and 2050.
- In 2005, the life expectancy at age 60 was 17.2 years for males and 19.6 for females. These averages conceal wide variations among ethnic groups. By 2050, life expectancy at birth is projected 78 for males and 83 for females.
- Malaysia total labour force in 2008 was 11 million, with a 79% participation ratio for males and 46% for females. The relatively low participation by females suggests that they are unlikely to accumulate sufficient retirement savings from their labour income.

Current pension system

- Malaysia has several schemes with different designs, each targeted at a specific group of workers and operating independently with some overlaps. The pension system lacks a unified structure.
- There are separate schemes for civil servants (KWAP), armed forces (LTAT), private sector workers (the Employees Provident Fund or EPF), a workman compensation scheme that includes pensions for lower wage earners (SOCSCO), and social assistance and social pension programs administered by the Department of Social welfare. Muslims can also be assisted by Zakat, an Islamic welfare institution, but with limited scope. Malaysia's 2.7 million self-employed (2009) may join the EPF voluntarily, but only 50,000 had done so by end 2008.
- EPF had 12.4 million members at end 2009, of which 5.8 million were active contributors, representing 46% of total members and 50% of the labour force. As foreign workers and civil servants are nearly 20% and 11% of the total, coverage is regarded as approaching universal level.

The EPF is dominant

Table 5.2 Malaysia, Employees Provident Fund – selected indicators, 2006–2009

Indicators	2006	2007	2008	2009
Total Members (million)	11.6	11.69	12.05	12.37
Number of active members (million)	5.29	5.4	5.71	5.79
% change in active members	0.6	2.1	5.7	1.4
As % of labor force	45.8	47.3	49.2	49.9
Number of employers	416,928	428,319	441,820	453,716
Annual Contributions (million, RM)	26,191	28,926 ¹	34,543	33,468
As % of GDP	4.6	4.5	4.7	4.2
Annual withdrawals (million, RM)	15,052	21,309	21,741	24,711
Net contribution as % of GDP	1.9	1.2	1.8	1.1
Withdrawals as a % of contributions	57.5	73.7	62.9	73.8
EPF balances (billion, RM)	290.2	318.3	344.6	375.5
As % of GDP	50.6	49.6	48.1	47.5
Per member(RM)	25017	27228	28598	30356
Per member balance/per capita GDP	1.2	1.2	1.1	1.3
Change in EPF balances (billion, RM)	29.3	28.1	26.3	30.9
As % of GDP	5.6	4.4	3.7	3.9
As % of gross national savings	13.7	11.8	9.7	14.9

EPF = Employees Provident Fund.
Source: Author's calculations based on data from (EPF, various years); and (Bank Negara Annual Report, various years).

Source: Excerpt from Asher (2012)

- Since 1996, the standard contribution rate has fluctuated around 23% of wages, with 12% and 11% contributions from the employer and employee respectively. Note that there is no ceiling. During the recent recession, the employee's contribution rate was reduced to 8% but 50% of active members chose to maintain their contribution rate at 11%.
- From 2008, the liability period for contributions was extended from age 55 to 75, but at half the above rates (with flexibility to contribute more voluntarily), to lower the cost of hiring older workers.
- Gross contributions to GDP ratio averaged 4.5%, 2006-2009, but a high level of pre-retirement withdrawals resulted in net contributions averaging only 1.5% of GDP (excludes dividend income). Measured by EPF member balances, the contribution of mandatory savings through the EPF to gross national savings was 12.5% or 4.4% of GDP.
- The average balance is low, averaging 1.2 x per capita incomes. Account 1 (70% of contributions) is for retirement and can only be withdrawn at age 55 years, but part of these savings can be invested in approved investments. This is not popular as only 0.43 million or 7.4% of active contributors have done so, withdrawing RM3.3 billion. Savings in Account 2 (30% of contributions) can be used for housing, education and health needs and for withdrawal at age 50.

Median EPF balance at age 54: RM50,000 or less than 2x per capita income

70% use up EPF lump sum withdrawals within 10 years of retirement

EPF balance was RM375.5 billion in 2009 (47.5% of GDP) and its 27% equity allocation was 10% of the stock market capitalization

Concentration of savings in state-controlled hands is a potentially large political risk

Trust in the EPF is an intangible to be addressed for reforms

A drastic restructuring of the EPF payout phase is needed

- The average balance is RM30,000 or 1.2x per capita income, but 73% of EPF active contributors had balances under RM50,000, constituting less than a quarter of total savings, while the top 12% owned 53% of total savings in 2009.
- Asher cites Othman's estimate of the median EPF balance at age 54: RM50,000 or less than 2x per capita income, in 2009. Skewed wage patterns and differing pre-retirement withdrawals result in 2010 average balance of RM160,000 for males and RM100,000 for females.
- EPF balances grew from RM9.1 billion (17.1% of GDP) in 1980, to RM180.8 billion in 2000 (57.9%) and RM375.5 billion in 2009 (47.5%). The latter is equivalent to 38% of Malaysia's stock market capitalization; and its equity allocation of 27% represents 10% of market capitalization, making the EPF's size a concern for its impact on market prices.
- Looking ahead the EPF's market power will continue to grow, and measured together with other government agencies also investing in the market, including SOCSO, the concentration of savings in state-controlled hands is a potentially large political risk.
- Returns have been relatively high, with nominal and real rate of return of about 5% and 2.8%, 1999-2009.

Table 5.4 Malaysia's Employees Provident Fund: real rate of return to members (%)

Year	Nominal dividend rate	Inflation rate (CPI)	Real rate of dividend
1961-2009	6.51	3.23	3.28
1961-1980	5.94	3.38	2.56
1980-1996	8.10	3.68	4.42
1997-1999 (1)	6.75	3.59	3.15
1999-2009	5.22	2.45	2.77

CPI = consumer price index

1 This period includes the 1997-1998 Asian Financial Crisis.

Notes: The Average Annual Compound Growth Rate is calculated using the formula: $r = ((1+rA)^t(1/i)) - 1$ where, rA = aggregate return over t years, (Annual rates are aggregated by taking their products for t years).

Source: Author's estimate based on data from EPF (various years).

Source: Excerpts from Asher (2012)

Issues in the current pension scheme

- Various schemes operate in isolation without formal linkages to offer management of different risks and during the life cycle. Caters to those with steady employment. Lacks diversification for sources of retirement income.
- Coverage is regarded as broadly complete, with 50% of the labour force with EPF and 12% in the civil service and armed forces, while 20% are foreigners. Thus, perhaps a

gap of 18%. There are some overlaps, principally of SOCSO and the EPF.

- An adequate replacement rate (ratio of retirement to pre-retirement income) is between 66-75%, from all sources of retirement income, including support from children and conversion of housing equity into retirement consumption.
- The EPF scheme does not provide a high level of adequacy for most members. Accumulated balances are used up quickly during retirement, with 70% estimated to exhaust their EPF lump sum withdrawals within 10 years of retirement (research by Othman cited by Asher).
- Moreover, EPF was not designed to address risks of longevity, inflation and survivors' benefits; it should publicize information about replacement rates to encourage better retirement planning and help improve the financial literacy of its members.
- The current EPF withdrawal age of 55 is too low given Malaysia's longevity trends. A drastic restructuring of the EPF payout phase is needed, but the membership is reluctant to increasing the age of full withdrawal or to agree to phased withdrawals or annuities. Attempts to introduce deferred annuities have not succeeded for financial market limitations and longevity uncertainty.

Source: Khor Reports summary from Asher (2012)

The pensions system – a data brief

- Five (5) key schemes in a non-unified pension system
- Nearly 80% of the Malaysian labour force (ex-foreigners) covered
- RM451 billion of balances, representing 59% of GDP
- 18-27% of assets allocated to equities, with close to RM130 billion in this asset class; equivalent to 13% of the Malaysia stock market capitalization

Malaysia's pension system – key components	Type of pension fund	No. of members			Contribution rate, % salary		Balances		Equity allocation			Data
		total members, million	active members, million	no. active, % labour force	Employer	Employee	RM billion	% GDP	% assets	RM billion	% mkt cap#	
Employees Provident Fund (EPF)[1]	Defined contribution	12.4	5.8	50	12	11	375.5	47.5	27.1	101.8	10.3	2009
Civil service pension scheme (KWAP)	Defined benefit[2]	1.75	1.24	11	60.0	9.0	26.3*	16.2*	1.6*	2008, 2009
		0.51 million pensioners (41% of civil servants), with pension costs RM8.4 billion or 1.2% of gross national income in 2008; Since 1991, a Retirement Fund set up with RM500 million initial allocation, sources of income are a) federal govt provides 5% of annual emoluments budget, b) lower levels of govt provide 17.5% of salaries of pensionable employees, c) investment income from accumulated balances. But actuarial studies not available, to ascertain if contributions plus investment income sufficient to meet future pension liabilities. This could represent a fiscal risk.										
Armed forces fund (LTAT)	Defined contribution[3]				15	10	7.2	1.1	18.3*	8.9*	0.9*	2008
Social Security Organization (SOC SO) [4]	Defined contribution with social insurance principles	n/a	5.7*	50*			8.3	1.3	20.5*	1.7*	0.2*	2008
	Employment injury scheme				0.5	0.5						
	Invalidity pension scheme				1.75	0						
Social pensions	Defined benefit[2]	Department of Social Welfare provides social pensions to those above 60 years of age who are destitute, not able bodied and have no next of kind. Monthly pension is RM 300/month vs 2009 poverty line of RM720/month. In 2009, fewer than 40,000 recipients with each receiving RM1900/year (less than the legislated amount).										

Notes: [1]Please read text for details on EPF scheme. [2] Defined benefit pension schemes are broadly financed from the annual government budget.
[3] Serving members of the other ranks in the Armed Forces are required to contribute and for officers, participation is voluntary and contributions are minimum of RM25 with a maximum of RM750 monthly. Disability and survivors' benefit features if event occur during service. Full withdrawal age is 50 years. Provision for housing purchase once during service. LTAT Group reports "Securities Held-for-trading" at RM6.3 billion for 2008 out of total assets of RM48.7 billion and "Securities at cost" of RM 2.6 billion, thus total equity allocation (excluding unquoted securities) is about RM8.9 billion or 18.3% of total assets, in-line with the other pension funds.
[4] Overlaps with EPF. Covers workers earning less than RM3,000/month but remain covered if salaries exceed this limit. Covers spouse's pension if death occurs while individual in service prior to reaching age of 55.
Malaysia stock market capitalization was RM990.3 billion at end December 2009. *Additional data research by Khor Reports, data from company annual reports.
Source: Khor Reports summary from Asher (2012) plus additional research by Khor Reports on equity allocations and SOC SO data.

ANALYSIS BY KHOR REPORTS

Malaysia's fiscal & pension issues

Malaysia's fiscal system shows a weakening trend and declining relative performance

On simple trajectory, worry that debt-GDP could blow out to 100% by the end of the decade

Change in budget accounting method recommended by experts – contingent liabilities not accounted for

Fiscal risks are heightened and IMF reports that Malaysia has limited fiscal room over the medium term

Heavy reliance on fiscal revenue from oil & gas sources (Petronas) means that non-oil balances are worse than -10% for 2010-2012f

Overall negative balance even at times of high oil prices a concern

Weakening fiscal trend

Malaysia's government finance has seen a weakening long-term trend with overall budgetary deficits above 5% of GDP recently, ballooning to 7% in 2009, causing public debt to expand to over 55% of GDP. It may even exceed 6% in 2012. Malaysia appears to have the biggest overall budget deficit among key neighbours (see details of comparison on the next page); about 3 to 4% even during the economic 'good times' before the Global Financial Crisis. On this measure of fiscal strength and flexibility, Malaysia's position has deteriorated and it is now ranked at the bottom of this group. Malaysia's relative decline in fiscal strength ranking is notable, mid-1990s to the present.

Malaysia's public debt – worries that it could blow out to 100% of GDP by 2020?

The elevated 55% debt level of Malaysia combined with a continued deficit, points to a troubling trajectory for public debt. This needs to be arrested. For instance, a simple extrapolation results in a debt-to-GDP of near 100% in 8 years ($57.5 + 5 \times 8 = 97.5$). This does not account for many off-balance-sheet contingencies including public-sector pension funding needs and a myriad of government guarantees. Risks also rise with escalating healthcare and education costs, additional pre-electoral cash payouts and more big and costly new projects.

Account for contingent liabilities

Is a change in budgeting method needed? Yes, as there are contingent liabilities which create fiscal risk - a crucial issue. But these risks are hard to quantify at present. For instance, accrued pension liabilities are not reflected in Malaysia's government expenditure due to the cash budget methodology currently used. The accounting method can be changed to more accurately reflect public expenditure and receipts, plus assets and liabilities (currently absent).

Fiscal risks & the need for reform

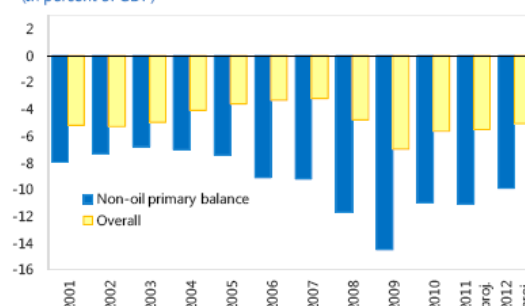
While Malaysia's current fiscal situation is

manageable (on paper), there are fiscal risks. The IMF (2012) says that Malaysia has "limited fiscal room over the medium term." This means that the country is vulnerable to a growth slowdown and other economic shocks. Thus, the questions on debt sustainability. Tail-risks also exist with off-balance sheet contingent liability risks. While reform is spoken of, there seems little appetite and impetus for the substantive changes the IMF envisages.

Is the deficit worse than it appears? Yes.

Malaysia's fiscal policy is heavily reliant on oil and gas income to supplement taxes and other revenues, contributing about 40%. If we factor out this income (from a non-renewable resource with big price fluctuations), Malaysia is experiencing a very high government overall budget deficit to GDP ratio. According to the IMF, Malaysia's deficit (excluding oil income) as a percentage of GDP was about 7 to 8% in 2001-2005. It deteriorated further in the face of higher oil prices the next two years, and ballooned to 12 to 15% in the crisis years. It remains worse than 10% in 2010-2012f. Moreover, Malaysia is widely expected to become a net oil importer. This bodes ill for oil income and the budget deficit.

Central Government Overall and Non-Oil Primary Balance (In percent of GDP)



Source: Excerpt from IMF (2012)

Comparing Malaysia's fiscal performance

The table and charts below present broad data, reported by the countries and compiled by the ADB. As accounting methods do differ, analytically, they are not strictly comparable. However, each country's trends do have some relevance for comparison. For instance, during the 1993-1997 boom period,

"We do not want to end up like Greece ... Malaysia could go bankrupt in 2019 with total debts amounting to RM1,158 billion," Minister in the Prime Minister's Department, Idris Jala, 27 May 2010

Key fiscal reforms: broaden tax base, reduce subsidies, rationalize spending; improve fiscal transparency

Malaysia's fiscal position appears comfortable with surpluses. It was ranked near the top of the group of countries that Bank Negara Malaysia typically presents for comparison in its Annual Reports (graph and table below). However, in the 2002-2007 economic and commodity boom, Malaysia's fiscal position appears weaker than all the others and it also did not improve as fast as Philippines and Thailand.

Debt level pushing over 55%

A 2010 statement by Idris Jala (see text quote on the left), highlights the potential problem that Malaysia faces in its public finances. Malaysia had a yawning budget deficit of RM47.4bn or 7.0% of GDP in 2009 (vs. RM5.0bn or 1.7% of GDP in 1998) which pushed the debt level to RM362.4bn or 53.3% of GDP as at end-2009 (RM103.1bn or 35.1% of GDP in 1998).

In comparison, the ADB reported that average rich countries debt grew from 83.3% of GDP in 2008 to almost 100% in 2010. Developing economies saw smaller growth from 35.7% to 37.8% in two years, but these countries also have lower debt tolerance than rich ones. Malaysia's current debt level of over 55% places it in uncomfortable territory and without a strong positive outlook for improvement.

Key fiscal reforms

Recommendations for reforms by various economists, including the IMF are to:

- Broaden the tax base, reduce subsidies, and rationalize operational expenditure and development expenditure.
- Improve fiscal transparency & prepare a comprehensive fiscal risk assessment.

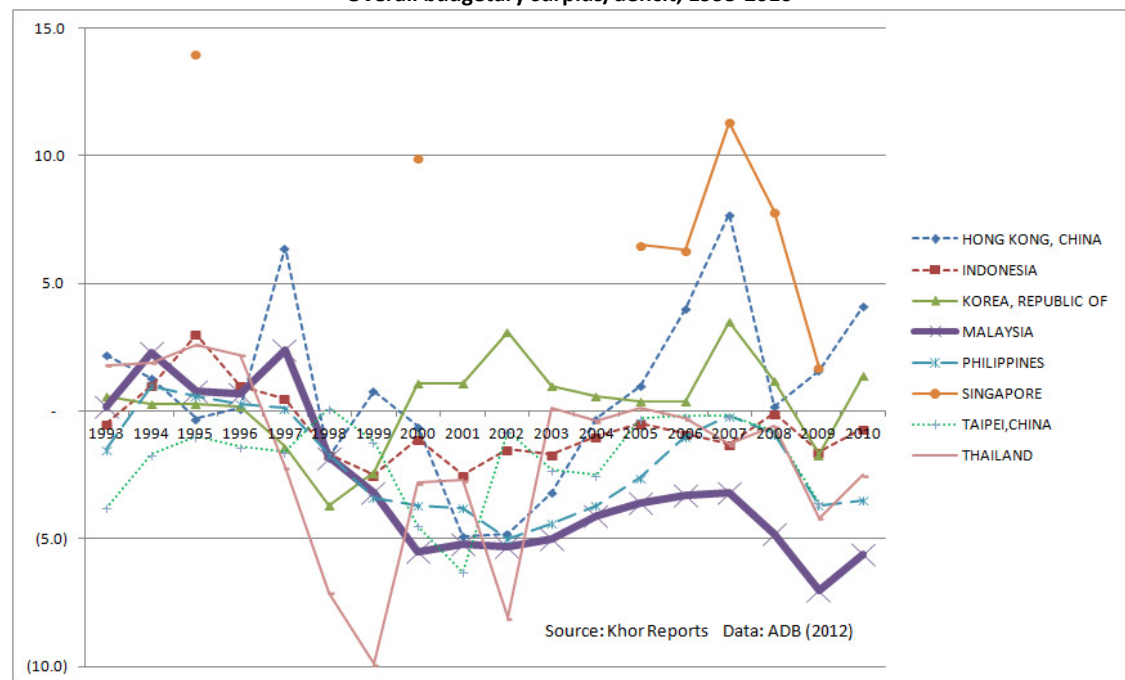
1993-2010, Malaysia had the biggest overall budget deficit annual average of 2.8%.

Malaysia tops its comparative group* for deficits; cumulative change of -51.2% vs -20.9% group average ex-Singapore.

During 2003-2007 economic boom, average deficit 3.8%. Recent average 5.8%, for 2008-2010.

On this measure of fiscal strength and flexibility, Malaysia's current weak position is a notable contrast to its pre-Asian Financial Crisis performance.

Government Finance, percent of GDP at current market prices, Overall budgetary surplus/deficit, 1993-2010



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.

Government Finance percent of GDP at current market prices, Overall budgetary surplus/deficit																		
	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
HONG KONG, CHINA	2.2	1.3	(0.3)	0.1	6.4	(1.8)	0.8	(0.6)	(4.9)	(4.8)	(3.2)	(0.3)	1.0	4.0	7.7	0.2	1.6	4.1
INDONESIA	(0.5)	1.0	3.0	1.0	0.5	(1.7)	(2.5)	(1.1)	(2.5)	(1.5)	(1.7)	(1.0)	(0.5)	(0.9)	(1.3)	(0.1)	(1.6)	(0.7)
KOREA, REPUBLIC OF	0.6	0.3	0.3	0.2	(1.4)	(3.7)	(2.4)	1.1	1.1	3.1	1.0	0.6	0.4	0.4	3.5	1.2	(1.7)	1.4
MALAYSIA	0.2	2.3	0.8	0.7	2.4	(1.8)	(3.2)	(5.5)	(5.2)	(5.3)	(5.0)	(4.1)	(3.6)	(3.3)	(3.2)	(4.8)	(7.0)	(5.6)
PHILIPPINES	(1.5)	1.0	0.6	0.3	0.1	(1.7)	(3.4)	(3.7)	(3.8)	(5.0)	(4.4)	(3.7)	(2.6)	(1.0)	(0.2)	(0.9)	(3.7)	(3.5)
SINGAPORE			14.0					9.9					6.5	6.3	11.3	7.8	1.7	
TAIPEI, CHINA	(3.8)	(1.7)	(1.0)	(1.4)	(1.6)	0.1	(1.2)	(4.5)	(6.3)	(0.8)	(2.3)	(2.5)	(0.3)	(0.2)	(0.2)	(0.8)	(3.6)	
THAILAND	1.8	1.9	2.6	2.2	(2.2)	(7.1)	(9.9)	(2.8)	(2.7)	(8.1)	0.1	(0.4)	0.1	(0.3)	(1.3)	(0.6)	(4.2)	(2.5)

Khor Reports data summary and analysis prepared August 2012. Data: Asian Development Bank, Key Indicators for Asia and the Pacific, last updated through SDBS on 30 July 2011, www.adb.org/statistics.

<p>In the pensions system, a reconstruction is required</p> <p>Recommended reforms: linkage of formal pension schemes and social pensions / social assistance; reduce over-concentration of assets with the EPF; civil service pension reform; address aging issues</p> <p>A mix of parametric and systemic reforms of individual schemes, particularly the EPF</p> <p>Boost fiduciary responsibility</p>	<p>Pension reforms – a reconstruction needed</p> <p>In the analysis and recommendations (as in the background piece above) on the pension systems, we draw heavily from Asher (2012).</p> <p>The key reform areas:</p> <ol style="list-style-type: none"> 1. Link the formal pension schemes and social pensions /social assistance 2. Reduce the overconcentration of pension assets managed by the EPF 3. Civil service pension reform – shift toward defined contribution for newly appointed officials (they may even join the EPF) 4. Address aging issues – increasing feminization (women live longer) and a larger proportion of old-old; need for integration of health care financing with pension financing and addressing the need for long term care. <p>Asher concludes that “the reconstruction of Malaysia’s pension system would require a mix of parametric and systemic reforms of individual schemes, particularly the EPF. Such reforms will be facilitated by complementary reforms in labor markets, fiscal systems, and in governance and management of pension schemes. There is a strong case for a shift in mindset of the policymakers in Malaysia from welfare</p>	<p>orientation to professionalism and to system-wide perspective in reconstructing the pension system; and in permitting fiduciary responsibility to members of provident and pension funds to play a greater role.”</p>
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DATA & FACTS

Malaysia – info & statistics

Key economic & financial indicators, 2007-2012f:

Table 1. Malaysia: Selected Economic and Financial Indicators, 2007–12

Nominal GDP (2010): US\$238 billion
 Main export (percent of total): electrical & electronic products (39%), commodities (23%)
 GDP per capita (2010): US\$8,423
 Population (2010): 28.3 million
 Unemployment rate (2010): 3.3 percent

	2007	2008	2009	2010	Proj.	
					2011	2012
Real GDP (percent change)	6.5	4.8	-1.6	7.2	4.7	4.0
Total domestic demand	9.4	5.8	-2.4	12.4	5.9	4.5
Consumption	9.7	9.0	1.3	5.2	6.3	3.8
Private consumption	10.5	8.7	0.7	6.5	6.0	3.7
Gross capital formation	8.4	-2.9	-13.8	38.3	4.8	6.6
GDP deflator	5.0	10.3	-6.9	2.5	2.9	2.7
Saving and investment (in percent of GDP)						
Gross domestic investment	21.6	19.3	14.4	21.4	21.8	21.8
Gross national saving	37.5	37.0	30.9	32.9	33.3	32.6
Fiscal sector (in percent of GDP)						
Federal government overall balance	-3.2	-4.8	-7.0	-5.6	-5.5	-5.1
Revenue	21.8	21.5	23.3	20.8	22.2	21.3
Expenditure and net lending	25.0	26.3	30.3	26.5	27.7	26.4
Federal government non-oil primary balance	-9.2	-11.7	-14.5	-11.0	-11.1	-9.9
Consolidated public sector overall balance 1/	1.5	-5.6	-7.6	-2.1	-8.4	-8.8
General government debt	42.7	42.8	55.4	55.4	56.6	57.5
Inflation and unemployment (period average, in percent)						
CPI inflation	2.0	5.4	0.6	1.7	3.2	2.5
Unemployment rate	3.2	3.3	3.7	3.4	3.2	3.1
Money and credit (end of period, percentage change)						
Broad money (M3) 2/	7.9	10.5	7.7	7.3	11.4	...
Credit to private sector 2/	7.9	12.9	6.2	9.7	9.8	...
Three-month interbank rate (in percent) 3/	3.6	3.4	2.2	3.0	3.2	...
Balance of payments (in billions of U.S. dollars)						
Current account balance	29.8	39.4	31.8	27.4	31.5	31.7
(In percent of GDP)	15.9	17.7	16.5	11.5	11.5	10.8
Trade balance	37.7	51.5	40.2	41.9	47.4	47.8
Exports, f.o.b.	176.3	199.2	157.3	198.8	226.9	241.7
Imports, f.o.b.	138.5	147.6	117.1	157.0	179.6	193.9
Services and income account balance	-3.3	-6.9	-2.8	-7.7	-9.0	-9.2
Capital and financial account balance	-11.3	-35.7	-22.8	-6.2	-19.1	-19.6
Errors and omissions	-5.2	-9.2	-5.1	-11.5	0.0	0.0
Overall balance	13.2	-5.5	3.9	9.7	12.5	12.1
Gross official reserves (US\$ billions)	101.3	91.6	96.8	106.5	119.0	131.1
(In months of following year's imports)	6.8	7.6	6.1	6.0	6.2	6.4
(In percent of short-term debt) 4/	495.4	274.9	362.1	347.0	389.6	436.0
Total external debt (US\$ billions)	56.7	68.2	68.0	73.7	73.3	72.2
(In percent of GDP)	30.3	30.6	35.2	31.0	26.6	24.6
Of which: short-term (in percent of total) 4/	36.1	48.9	39.3	41.7	41.7	41.6
Debt service ratio						
(In percent of exports of goods and services)	3.6	2.8	6.6	2.7	2.7	2.6

Sources: Data provided by the authorities; and Fund staff estimates.

1/ Capital expenditure in the budget includes foreign fixed assets and other items, such as purchase of shares and land, which are excluded from public investment in the national accounts.

2/ As of October 2011.

3/ As of November 2011.

4/ Bv remaining maturity.

IMF reports on the Malaysia Government's Fiscal Policy:

- *The Government is expected to register a better-than-expected lower fiscal deficit of 5.4 percent of GDP in 2011. This is a result of favourable revenue collection due to firm commodity prices and concerted efforts to widen the revenue base. In line with the commitment to further strengthen public finances over the medium term, Malaysia expects to achieve a lower fiscal deficit of 4.7 percent of GDP in 2012.*
- *With regard to debt management, Malaysia has embraced a broader rule to ensure fiscal sustainability. Although legal debt limits vary for domestic and external debt, the Government is fully committed to ensuring a total debt level (domestic and external) not exceeding 55 percent of GDP. Given the increasing uncertainty in the external environment and if growth deteriorates, the authorities view a temporary rise in Federal Government debt level (above the 55 percent to GDP threshold) as acceptable to support aggregate demand.*
- *The authorities are committed to improving their fiscal position while remaining supportive of growth. More importantly, the authorities are mindful that strict adherence to fiscal discipline as well as medium-term fiscal targets will ensure fiscal sustainability and promote macroeconomic stability.*

Source: Excerpts from IMF (2012)

Key medium-term indicators, 2007-2016f:

Table 4. Malaysia: Illustrative Medium-Term Macroeconomic Framework, 2007–16 1/

	2007	2008	2009	2010	Proj.					
					2011	2012	2013	2014	2015	2016
Real sector (percent change)										
Real GDP growth	6.5	4.8	-1.6	7.2	4.7	4.0	4.5	5.0	5.0	5.0
Total domestic demand	9.4	5.8	-2.4	12.4	5.9	4.5	5.6	5.8	5.9	6.0
CPI inflation (period average)	2.0	5.4	0.6	1.7	3.2	2.5	2.5	2.5	2.5	2.5
Saving and investment (in percent of GDP)										
Gross domestic investment	21.6	19.3	14.4	21.4	21.8	21.8	21.9	22.0	22.1	22.2
Private, including stocks	11.9	10.2	3.7	13.1	12.6	11.6	12.7	13.2	13.8	14.3
Public	9.6	9.1	10.7	8.3	9.2	10.2	9.2	8.8	8.3	7.9
Gross national saving	37.5	37.0	30.9	32.9	33.3	32.6	31.9	31.5	31.2	30.8
Private	21.2	26.1	22.0	21.5	25.2	23.3	23.0	22.9	23.0	23.0
Public	16.2	11.0	8.9	11.5	8.1	9.3	9.0	8.6	8.2	7.9
Fiscal sector (in percent of GDP)										
Federal government overall balance	-3.2	-4.8	-7.0	-5.6	-5.5	-5.1	-4.8	-5.0	-5.2	-5.3
Revenue	21.8	21.5	23.3	20.8	22.2	21.3	21.0	20.6	20.2	19.9
Expenditure and net lending	25.0	26.3	30.3	26.5	27.7	26.4	25.8	25.5	25.4	25.2
Federal government non-oil primary balance	-9.2	-11.7	-14.5	-11.0	-11.1	-9.9	-9.1	-8.6	-8.2	-7.3
Consolidated public sector overall balance 2/	1.5	-5.6	-7.6	-2.1	-8.4	-8.8	-7.5	-7.1	-6.7	-6.4
General government debt	42.7	42.8	55.4	55.4	56.6	57.5	58.6	59.5	60.2	61.0
Of which: federal government debt	41.5	41.3	53.3	53.1	54.9	56.4	57.4	58.2	59.1	60.1

Source: Excerpts from IMF (2012)

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Various company reports. As indicated.

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