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Global Economics & Market Strategy

Malaysia: RON95 Fuel Subsidies Needed to be Reduced in Stages

- **We viewed that the RON95 fuel subsidy rationalisation must be implemented on a gradual and measured approach, in consideration of (1) the retail price of RON95 would have substantial impact on inflation, (2) to contain dampening impact on consumer spending.**

- **Our quantitative analysis suggests a RON95 price float to lift headline inflation by 3.05% ppt. Higher inflation dampens real wages, whereby every 1% reduction in real wages will drag private consumption by around 0.3%. Nonetheless, Malaysia may see fiscal savings of MYR1.9 bn in operating expenditure for every 10-cent increase in RON95 retail price. For MYR, our model suggests that the fiscal account balance has the highest beta on USD-MYR.**

- **Further out, we opine that RON95 petrol subsidy rationalisation might be delayed to end-2024, at the earliest. We expect more details on the RON95 petrol subsidy rationalisation to be released during the tabling of Budget 2025, which is scheduled on 18 October.**

Economist

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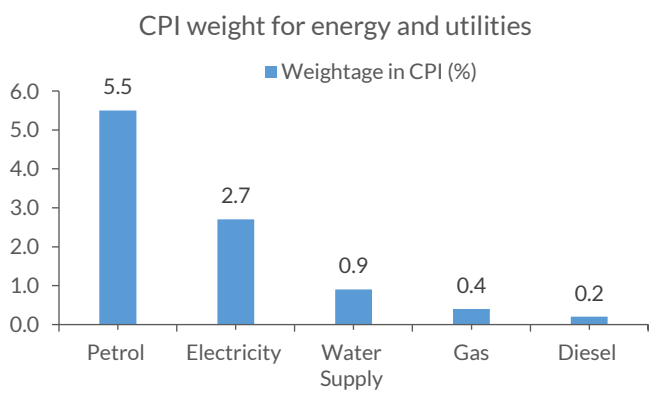
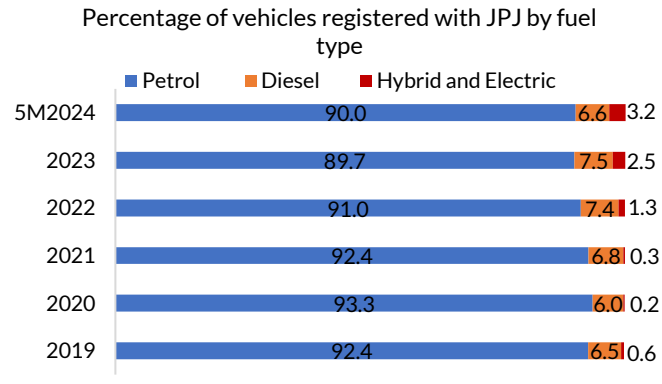
Figure 1: Petrol has greater weightage than diesel in CPI basket



Source: Macrobond, RHB Economics & Market Strategy.

Figure 2: Most of Malaysia's motor vehicles consume petrol as their primary fuel choice



Source: data.gov.my, RHB Economics & Market Strategy.

RON95 petrol subsidy rationalisation might be delayed to end-2024

We assess the impact of RON95 petrol subsidy rationalisation on economy via a few key aspects which include (1) inflation, (2) consumer spending, (3) fiscal and lastly (4) MYR. We viewed that the RON95 fuel subsidy rationalisation must be implemented on a gradual and measured approach, in consideration of (1) the retail price of RON95 would have substantial impact on inflation, (2) to contain dampening impact on consumer spending. The phased reduction in RON95 subsidy would be positive for government fiscal position and MYR, given that 70% of the subsidy expenditure is allocated to fuel component.

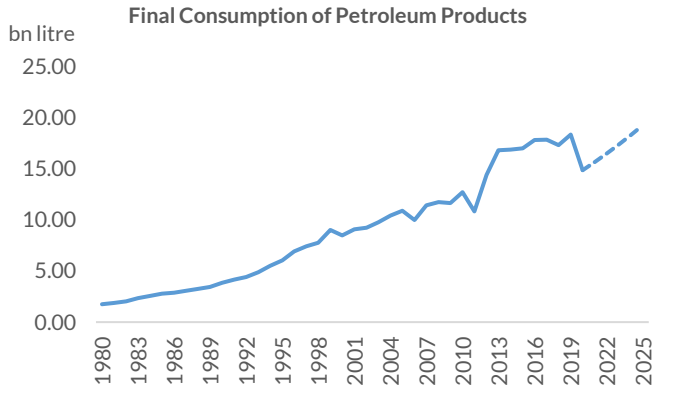
Further out, we opined that RON95 petrol subsidy rationalisation might be delayed to end-2024, at the earliest. In our opinion, the Government might assess the lagged impact of diesel prices adjustments and other fiscal measures i.e. revision in services tax and utilities tariffs on the inflation trajectory and the economy, prior to the implementation of RON95 petrol subsidy rationalisation. We expect more details on the RON95 petrol subsidy rationalisation to be released during the tabling of Budget 2025, which is scheduled on 18 October. At the time of writing, there is no policy paper has been drafted yet to rationalise the subsidy on RON95 fuel.

Figure 3: Regression suggests that RON 95 prices has the highest beta in influencing Malaysia's fuel CPI

Dependent Variable: Fuel Inflation (%YoY)				
Regression Statistics				
Multiple R	0.9998			
R Square	0.9996			
Adjusted R Square	0.9995			
Standard Error	0.3515			
Observations	69			
	Coeff	*Std Error*	*t Stat*	*P-value*
Intercept	-0.17	0.05	-3.56	0.00
RON 95(YoY%)	0.85	0.01	67.14	0.00
Diesel (YoY%)	0.04	0.01	3.00	0.00
RON97(YoY%)	0.08	0.00	44.22	0.00

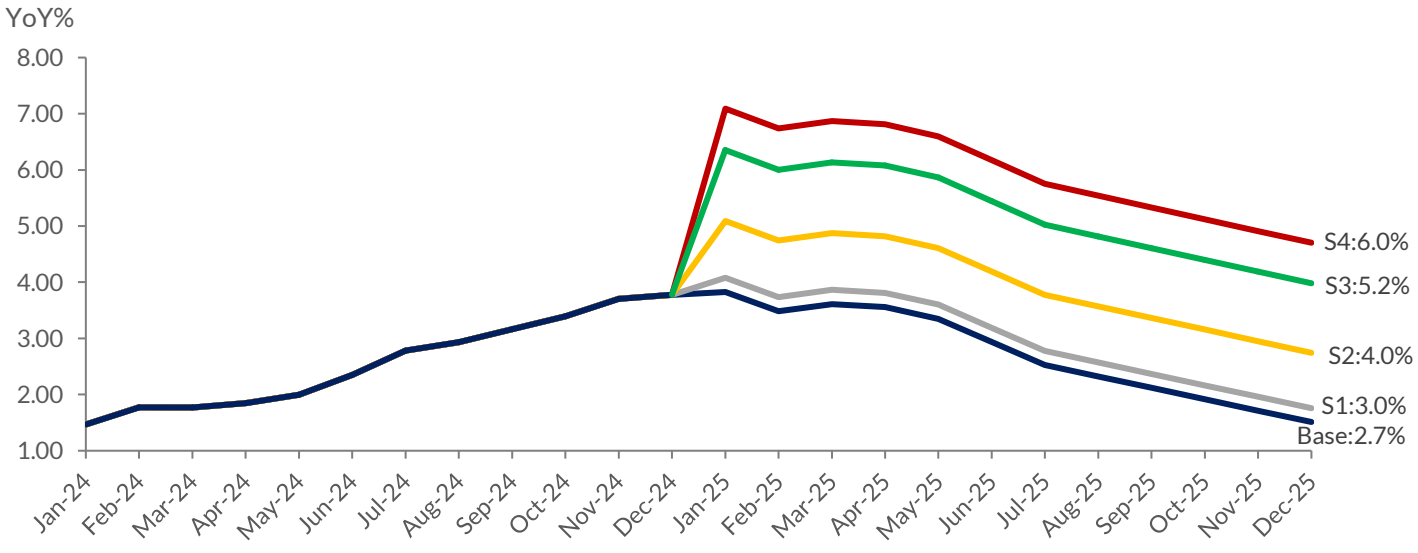
Source: RHB Economics & Market Strategy. The regression model assumes the impact of diesel prices changes on every diesel-powered vehicle.

Figure 4: We assumed continued expansion in consumption of petroleum products



Source: Energy Commission Malaysia. RHB Economics & Market Strategy. In-house estimation from 2022-2025

Figure 5: RON95 retail price vs headline inflation scenario analysis



*Source: RHB Economics & Market Strategy. *Based on the unsubsidised RON95 petrol price of RM3.30/litre as at 19 June versus the current retail price of RM2.05/litre*

RON95 price float is estimated to lift the headline inflation by 3.05% ppt

On inflation front, we think the direct impact of headline inflation would substantial given (1) larger consumer base relative to diesel-powered vehicles; (2) significant weightage in CPI basket at 5.5% (versus diesel at 0.2%). For instance, petrol powered vehicles make up around 90% of the vehicles registered with the Road Transport Department (JPJ) while diesel powered car constitute around 7% of the vehicles. The direct impact that we manage to quantify (as discussed in the following paragraph) is the upside on inflation, resulting from increased expenses incurred for the purchase of oil or oil-based products.

Based on our estimate (Figure 3), the direct contribution of every 1% increase in RON95 retail price would have 0.05% upside in headline inflation. Our quantitative analysis in Figure 3 suggests that RON 95 has the highest beta (coefficient: 0.85) in influencing Malaysia's fuel CPI, with RON 97 (coefficient: 0.08) following suit. The high coefficient seen for RON95 also suggests that: (1) most of Malaysia's motor vehicles, with the coefficient suggesting as high as >80%, consume RON 95 as their primary fuel choice, which indicates that (2) RON 95 price rationalisation will have a material influence on headline CPI as compared to diesel.

Based on our calculation, the price float of RON95 petrol might have potential upside on inflation by 3.05% ppt (based on the unsubsidised RON95 petrol price of RM3.30/litre as at 19 June versus the current retail price of RM2.05/litre). In terms of MYR, every 10-cent increase in RON95 retail prices would have 0.3% ppt upside in average annual inflation. We view that the retargeting of the RON95 subsidy rationalisation might take form in a more gradual approach and we have built a simple inflation model based on few scenarios with different RON95 retail price. Our base case inflation forecast for 2025 is 2.7% YoY. Assuming the retail prices of RON95 is adjusted upwards by 10 cents, the 0.25% ppt upside in headline inflation would lift our headline inflation projection to 3.0% YoY as per our S1 scenario. In the same vein, 50 cent increase would result in 1.25% ppt upside with the annual headline inflation at 4.0% YoY; MYR 1 increase would result in 2.5% ppt upside with annual inflation potentially reach 5.2% YoY.

We are cognisant of the indirect impacts of increased RON95 retail prices, which could potentially affect other components of the CPI. This depends on the scale and speed of the pass-through to prices of other non-commodity consumer goods and services. The impact of higher fuel prices might be reflected in higher business costs, which include costs of raw materials, transportation, logistics and utilities. Industries with relatively higher reliance on transportation and logistics are more sensitive to fuel price changes, i.e. manufacturing, retail and logistics. In longer term, businesses might opt to pass the costs to consumers via higher prices for goods and services, which in turn would contribute to further inflationary pressure. The strength of the indirect impact might be affected by (1) the extent to which rise in costs impacts profit margins, (2) underlying demand conditions and (3) structure of the market for the products.

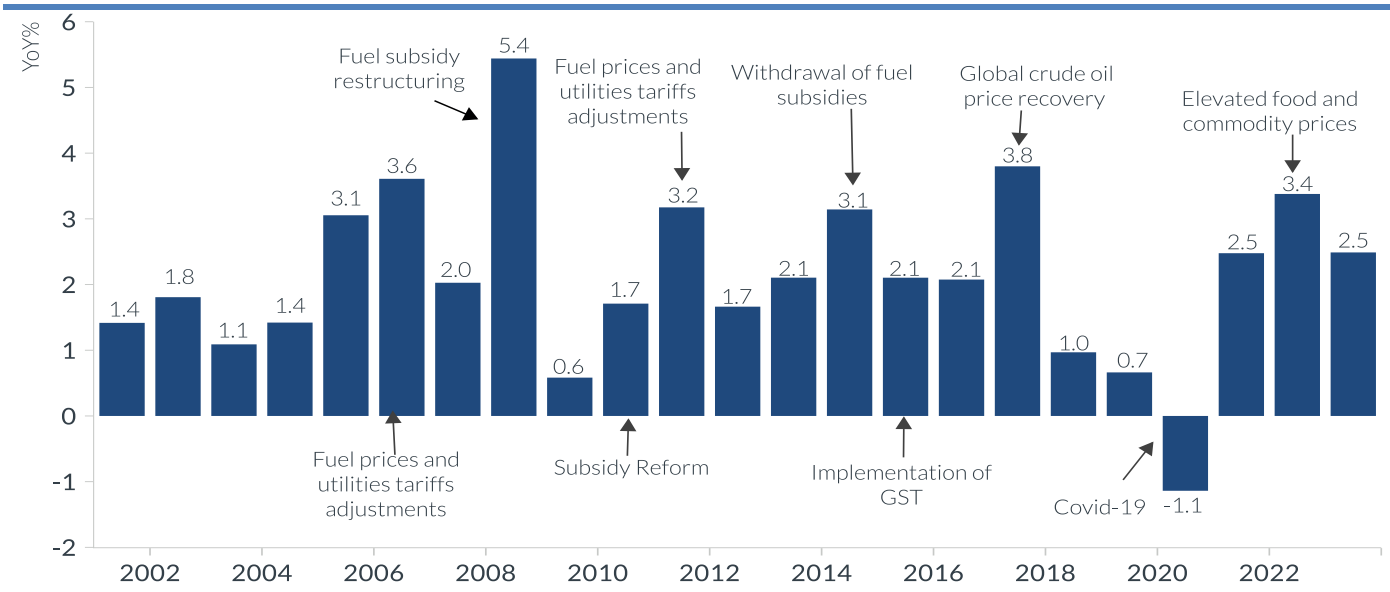
Persistent increase in RON95 fuel prices might lift the inflation expectations among consumers and businesses as well, causing second round impact on the actual inflation. The inflation expectations might affect actual inflation via impact on spending pattern as well as price and wage-setting decisions. If stakeholders expect fuel prices to continue rising, they may adjust their behaviour, such as demanding higher wages or increasing prices, which can contribute to broader inflationary trends. According to a previous research conducted by Bank Negara Malaysia (BNM), household might overestimate the future inflation of frequently-purchased items and necessities, i.e. transportation and food items.

The inflation trajectory and dynamics over the past 20 years (Figure 6) have been primarily driven by supply factors, such as periodic adjustments to administered prices (e.g., domestic fuel prices, utility tariffs, and ceiling prices for staple food items), coupled with supply disruptions of key commodities. The transmission of global commodity price movements to domestic inflation depends on the extent of adjustments to administered prices. To some extent, the existence of subsidies and price controls for administered goods i.e. fuel and staple food items have cushioned or delayed the impact of external shocks on domestic inflation, which mainly transmitted to the economy via changes in fuel and food prices. The removal of the RON95 fuel subsidy and the shift towards market-based prices would imply that changes in global oil prices would have a larger and faster pass-through to domestic inflation. This might increase the variability of prices in the CPI basket, especially for fuel and food.

For reference, we conducted a simple case study on the effect of fuel subsidy adjustments in Indonesia. In September 2022, Indonesia increased its subsidised fuel prices by approximately 30%, with the price of Pertalite (RON 90) rising to IDR 10,000 per litre (from IDR 7,650 per litre) and Solar (Diesel) to IDR 6,800 per litre (from IDR5,150 per litre). As anticipated, the fuel

price hike itself significantly increased transportation inflation, with this component rising by 16% month-over-month compared to 6.7% in August 2022. Surprisingly, the pass-through effect on other key components such as food & beverages, housing & utilities costs, household equipment, and recreation was not significant, possibly due to price stickiness in these selected items.

Figure 6: Domestic policy changes and movement of commodity prices would have substantial impact on headline inflation



Source: Macrobond,RHB Economics & Market Strategy.

RON95 Rationalisation May Impact Consumer Spending

As the most widely consumed fuel in Malaysia, the price of RON95 fuel can impact Malaysia's economy via (1) direct impact on consumer spending, (2) inflationary pressure and (3) potential upsides on business costs. We recognise that there would be some dampening effect on consumer spending amid lower disposable income. In a scenario where inflation rises faster than disposable incomes, consumers may be less inclined to spend as the purchasing power of disposable income is eroded by high inflation. To recap, we have published a thematic report focused on consumer spending in Malaysia where we have employed a few analyses to determine the long run and short run determinants of private consumption in Malaysia. In the long run, current income and expectations of future income played a positive role in determining private consumption. Meanwhile, the impulse response analysis shows that the impact of changes in income on private consumption are positive and statistically significant, with lagged impact of six months after the shock.

Figure 7: Higher fuel price might affect private consumption via erosion on real wages growth

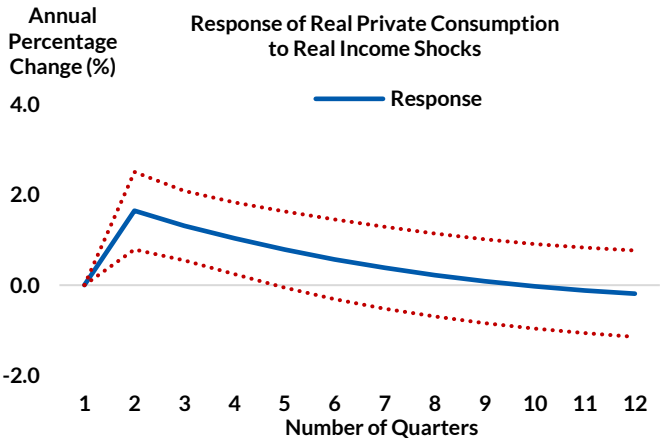
Dependent Variable: Private Consumption (%YoY)

Regression Statistics	
Multiple R	0.8412
R Square	0.7076
Adjusted R Square	0.6838
Standard Error	3.1101
Observations	41

	Coeff	*Std Error*	*t Stat*	*P-value*
Intercept	2.73	0.76	3.60	0.00
Real Wage YoY % (Services)	0.29	0.09	3.33	0.00
IP YoY %	0.77	0.10	7.85	0.00
FDI Outflows YoY % (t-4)	-0.04	0.02	-2.32	0.03

Source: CEIC, RHB Economics & Market Strategy.

Figure 8: …and consumer spending is positively related to real income shocks

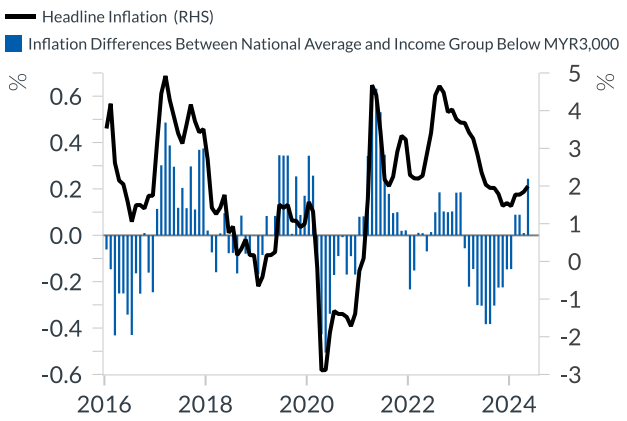


Source: CEIC, RHB Economics & Market Strategy.

Our regression analysis (Figure 7) shows that for every 1% reduction in real wages, the potential downside on the private consumption is around 0.3%. We have used the wages in services sector as the proxy for wage for Malaysia in our model due to (1) limitation in data for national average wage; (2) our assumption of the overall household income is drive by services sector income. As highlighted in our previous report, services sector played a major role in driving the overall income. As a major and growing component of Malaysian economy, the services sector accounting for nearly 57% of gross domestic products and 60% of national employment. The mean wages in the services sector over the past 5 years (2018-2023) is at 2.7% with the latest wage growth at 3.3% (as at 1Q24). As discussed earlier, higher RON95 price would lead to upside in the inflation with the headline inflation could potentially surge to 6.0% YoY (in the event of RON95 price float). With the current wage growth level, the free float of RON95 petrol price would imply negative real wage growth. Note that private consumption accounts for the lion's share of Malaysia's GDP at around 60%, suggesting that any delta to consumer spending has a relatively high beta to overall GDP growth.

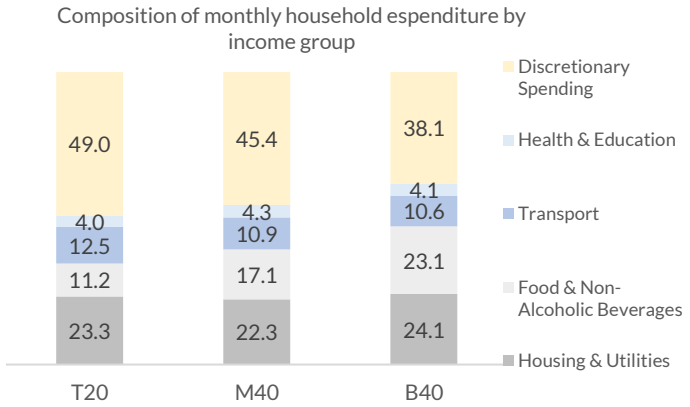
Higher-income groups would feel a greater direct impact from RON95 price adjustments due to their higher share of transportation costs in the household budget. The overall impact across income quantiles however depends on the extent of the indirect impact, such as potential price pass-through to food and other consumer goods and services. Household income plays a crucial role in shaping expenditure patterns: lower-income groups allocate a larger portion of their spending to food, housing, and utilities, and less to transport, healthcare, education, and discretionary expenses compared to higher-income groups. The spending patterns of lower-income groups, who allocate a higher proportion of their income to necessities, make them particularly susceptible to price changes. For example, during periods of high inflation, those earning less than MYR3,000 tend to experience inflation rates higher than the national average. At an aggregate level, the impact on consumer spending is moderated by (1) continued social assistance provision to lower-income groups and (2) varying impacts across income groups, with the higher-income group showing relatively inelastic demand. In aggregate consumer expenditure, the T20 contributes the most at 42.3%, followed by the M40 at 39.9%, and the B40 group at 17.8%.

Figure 9: Lower income group would relatively vulnerable to high inflation



Source: Macrobond, RHB Economics & Market Strategy.

Figure 10: Higher income group experience higher share of transport costs in household budget



Source: CEIC, RHB Economics & Market Strategy. Discretionary spending includes clothing & footwear, furnishing & household equipment, information & communication, recreation, restaurants & hotels, insurance & financial services and personal care & miscellaneous goods and services.

RON95 fuel subsidy rationalisation is positive for fiscal and MYR

On fiscal front, free float of RON95 petrol could generate a potential saving of MYR24.1 bn in fuel subsidies. The government might see additional savings of MYR1.9bn in operating expenditure for every 10-cent increase in RON95 retail price. Our analysis is predicted on a few key assumptions, i.e. (1) the unsubsidised RON95 retail price at MYR3.30 per litre (as at 19 June 2024), (2) the subsidy per litre is estimated by the price differences between unsubsidised RON95 retail price versus current retail price of MYR2.05 per litre, (3) the RON95 consumption is projected at 19.3 bn litre. The phasing out of fuel subsidies might require some support measures in the initial stage, i.e., a cash transfer mechanism coupled with periodic review of the impact to avoid a sharp increase in inflation and burdens on vulnerable goods. In other words, this also implies there could be a higher allocation of social assistance.

We think the path to reduce the fiscal deficit to below 3% of GDP at this juncture is not an easy one, amid (1) declining revenue collection where government revenue accounts for only 15% of GDP by 2024 versus 21% of GDP in 2012; (2) ballooning operating expenditure (OE) where the OE would account for 99% of central government revenue by 2024; (3) elevated government debt, projected at 64% of GDP by 2024, close to statutory limit of 65% of GDP. The OE rationalisation remains challenging due to the significant portion of rigid operating expenditure (emoluments, pension expenditure and debt services charges), where the aforementioned components account for 59% of the total OE. Other than the aforementioned, the allocated expenditure for subsidies and social assistance in 2024 is projected to account for around 15% of the OE.

Fuel subsidy which accounts for around 70% of the subsidy bill highlighting the room for potential adjustment. According to Ministry of Finance (MoF), the federal government has spent a bulk of MYR223.5 bn on subsidies between 2012 and 2022, with 71.6% of the subsidy expenditure allocated to fuel component. The subsidies expenditure surged to MYR55.4 bn in 2022, with fuel subsidies accounted for 81.5% of the total subsidies (MYR45.2 bn) amidst elevated crude oil price at USD100 per barrel. Fuel (which includes RON95, diesel and liquefied petroleum gas) subsidies were paid to fuel suppliers to compensate the differences between the retail price fixed by the officials and true market price. Thus, we opine that the path to rationalise Malaysia's OE is via subsidy retargeting approach while gradually reducing the quantum of subsidies in the years ahead. The rationalisation of other key components, especially emoluments & pension expenditure, debt services charges, and development expenditure needs, would likely take longer.

Figure 11: RON95 retail price vs petrol subsidy scenario analysis

RON95 retail price vs petrol subsidy scenario analysis

RON95 retail price (MYR/litre)	Increment (MYR/litre)	Subsidy per litre (MYR)*	Consumption (bn litre)	Est Subsidy (MYR bn)	Savings (MYR bn)
2.05		1.25	19.3	24.1	
2.15	0.10	1.15	19.3	22.1	1.9
2.25	0.20	1.05	19.3	20.2	3.9
2.55	0.50	0.75	19.3	14.4	9.6
3.05	1.00	0.25	19.3	4.8	19.3
3.30	1.25	0.00	19.3	0.0	24.1

*Source: RHB Economics & Market Strategy. *Based on the unsubsidised RON95 petrol price of RM3.30/litre as at 19 June versus the current retail price of RM2.05/litre*

Our proprietary MYR model suggests that the fiscal account matrices have the highest beta against USD-MYR, in addition to other indicators i.e. public debt, current account balance and US-MY real rates differentials. MYR will benefit from an improved Malaysia-centric interest rate, trade and fiscal matrices while dragged by potentially lower oil prices and higher public debt. The implementation of RON95 fuel subsidy rationalisation with phased adjustment in retail prices would supplement other existing fiscal consolidation measures i.e. revision in services tax and utilities tariffs, which is expected to improve the fiscal position.

In summary, we believe that retargeting subsidies for RON95 is crucial, in line with the government's commitment to fiscal reforms and prudence. Compared to other structural expenditures such as emoluments and pensions, the barrier to rationalise subsidy expenditures may be relatively lower. The subsidy rationalisation would complement other existing measures, such as broadening the tax revenue base and improving tax collection, in achieving the long-term deficit target of

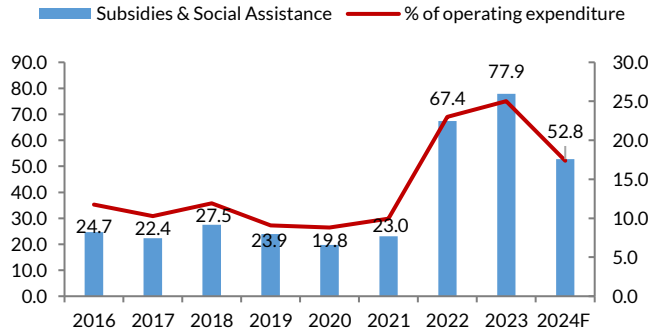
below 3% of GDP. Given its significant impact on inflation trajectory and consumer spending, adjustments to the price and reduction of subsidies for RON95 petrol should be implemented gradually and carefully.

Figure 12: Fuel subsidies surged to 82% of total subsidies in 2022 amid elevated crude oil price

Fuel Type	Year		
	2022 (MYR bn)	2021 (MYR bn)	2020 (MYR bn)
RON 95	23.08	4.47	0.17
Diesel	18.67	2.90	0.29
LPG	3.44	2.65	1.17
Total Fuel Subsidy	**45.18**	**10.02**	**1.63**
Average Brent Oil Price (USD/bbl.)	100.00	70.50	42.20

Source: iGFMAS, RHB Economics & Market Strategy.

Figure 13: Subsidies and social assistance accounts for a significant portion of OE



Source: CEIC, RHB Economics & Market Strategy.

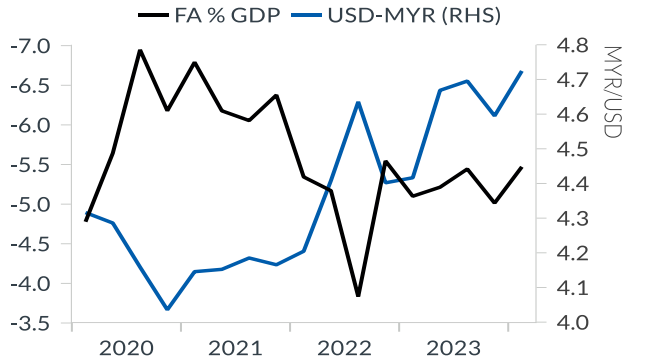
Figure 14: MYR reflects the current and fiscal account balances as well as US-MY real rates

Dependent Variable: USD-MYR	
Regression Statistics	
Multiple R	0.867
R Square	0.751
Adjusted R Square	0.727
Standard Error	0.256
Observations	70

	Coeff	*Std Error*	*t Stat*	*P-value*
Intercept	6.96	0.40	17.38	0.00
Current Account % GDP (-1)	-0.10	0.02	-6.40	0.00
Fiscal Account % GDP (-4)	-0.07	0.04	-1.89	0.05
Public Debt YoY (3QMA) (-2)	-0.04	0.01	-2.81	0.01
KLCI (x100) (-1)	-0.13	0.00	-5.72	0.00
Brent (x100) (-1)	-0.48	0.00	-2.82	0.01
US-MY Real Rates (-4)	0.02	0.03	0.91	0.36

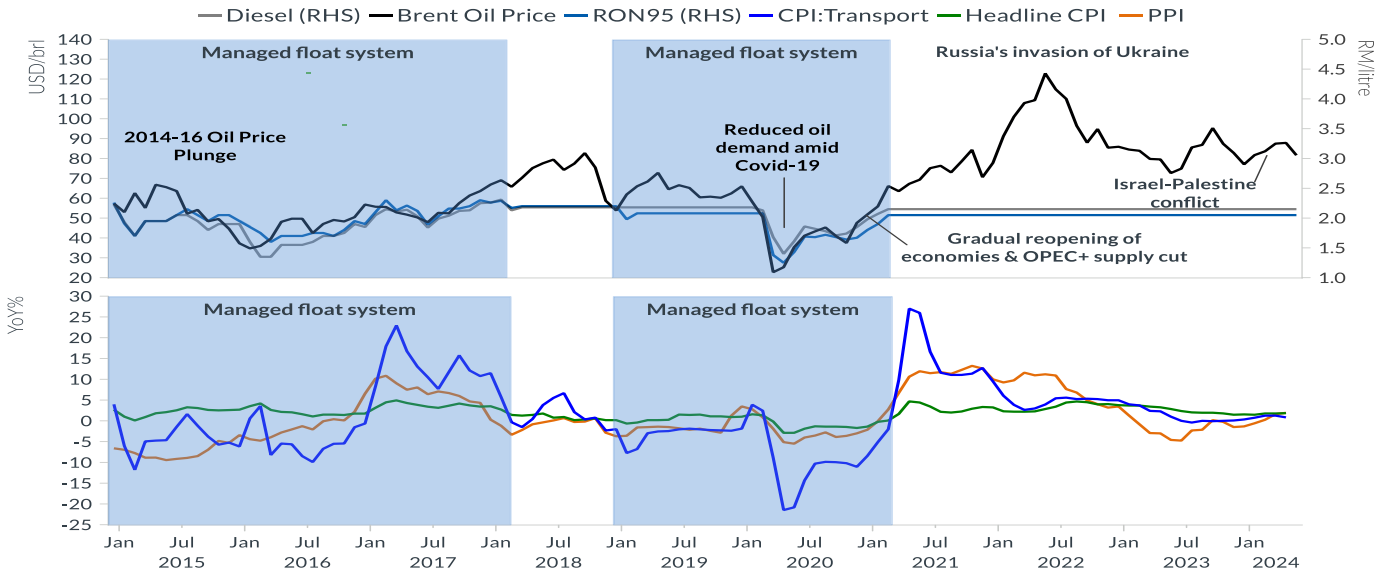
Source: RHB Economics & Market Strategy.

Figure 15: where improved fiscal position is positive for MYR



Source: Macrobond, RHB Economics & Market Strategy.

Figure 16: The existence of fuel subsidy has partially shielded the impact from external oil price shocks on domestic inflation



Source: Macrobond, RHB Economics & Market Strategy.

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