From the Desk of the Chief Economist

BANK ISLAM

National Budget 2022 Preview

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ECONOMIC RESEARCH

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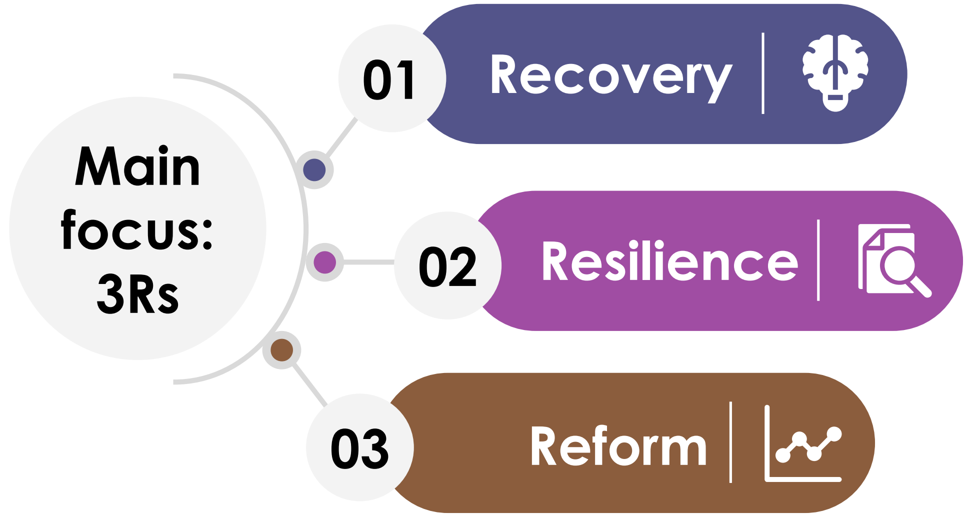
BUDGET 2022



- ✓ The national budget for 2022 which is to be tabled on 29 October 2021 will see Malaysia's pathway to a betterment condition, focusing on the 3Rs of speeding up recovery, strengthening economic resilience, as well as catalyzing reform.
- ✓ As such, Budget 2022 is expected to remain expansionary to support the government's wider and longer term reform efforts under the 12th Malaysia Plan (12MP).
- ✓ 2022 would be a critical year for Malaysia to jumpstart not just from an economic recovery perspective but also to cover the recovery of industries, livelihoods, as well as jobs particularly, to those who are affected the most by the pandemic.
- ✓ Therefore, financial institutions will play a vital role moving forward through the lens of the said 3Rs by supporting business continuity when the economy reopens at a larger scale.

LARGER ALLOCATION FOR DEVELOPMENT EXPENDITURE

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Federal Government Budgetary Position

RM billion	2015	2016	2017	2018	2019	2020	2021E	2022F
Revenue	219.1	212.4	220.4	232.9	264.4	225.1	234.1	257.5
%chg	-0.7%	-3.0%	3.8%	5.7%	13.5%	-14.9%	4.0%	10.0%
Operating Expenditure	217.0	210.2	217.7	231.0	263.3	224.6	234.7	249.1
%chg	-1.2%	-3.1%	3.6%	6.1%	14.0%	-14.7%	4.5%	6.1%
Current Balance	**2.1**	**2.2**	**2.7**	**1.9**	**1.1**	**0.5**	**-0.7**	**8.4**
%chg	101.8%	7.5%	20.6%	-29.1%	-44.2%	-55.7%	-238.2%	-1383.2%
Gross Development Expenditure	40.8	42.0	44.9	56.1	54.2	51.4	67.5	74.3
%chg	3.2%	3.0%	6.9%	25.0%	-3.4%	-5.2%	31.4%	10.0%
Less: Loan Recoveries	1.5	1.3	1.9	0.8	1.6	1.3	1.6	1.6
Net Development Expenditure	**39.3**	**40.6**	**43.0**	**55.3**	**52.6**	**50.1**	**65.9**	**72.7**
%chg	2.2%	3.5%	5.9%	28.5%	-4.9%	-4.7%	31.5%	10.2%
Covid-19 Fund	**-**	**-**	**-**	**-**	**-**	**38.0**	**30.0**	**30.0**
%chg	-	-	-	-	-	-	-0.2	0.0
Overall Balance	**-37.2**	**-38.4**	**-40.3**	**-53.4**	**-51.5**	**-87.6**	**-96.6**	**-94.2**
% of GDP	**-3.2%**	**-3.1%**	**-2.9%**	**-3.7%**	**-3.4%**	**-6.2%**	**-6.5%**	**-6.0%**

Sources: CEIC, Bank Islam

- ✓ Drawing from the 12MP, the National Budget 2022 would be an expansionary budget to support the country's recovery after experiencing a series of lockdowns that have curtailed economic activities. Following this, we anticipate that Operating Expenditure (OE) to increase to RM249.1 billion in 2022 (2021E: RM234.7 billion).
- ✓ Apart from that, the allocation for Development Expenditure (DE) is also anticipated to be larger (2022F: RM74.3 billion vs. 2021E: RM67.5 billion) in tandem with the12MP announcement which amounted RM400.0 billion as we believe the government would continue to implement the planned mega projects to spur the economic growth.
- ✓ Meanwhile, the fiscal deficits to GDP ratio is slated to narrow gradually to 6.0% in 2022 from an estimated 6.5% in 2021 as the nominal GDP is projected to be higher in 2022. Thus far, the Ministry of Finance (MOF) forecasted that fiscal deficits target to be at 3.0%-3.5% of GDP by the end of 2025 under the 12MP.
- ✓ As such, the government will have to increase the revenue or broaden the revenue base to offset the higher OE and DE and to achieve the fiscal target.

NEW GOVVIES ISSUANCE IS LIKELY TO BE HIGHER NEXT YEAR

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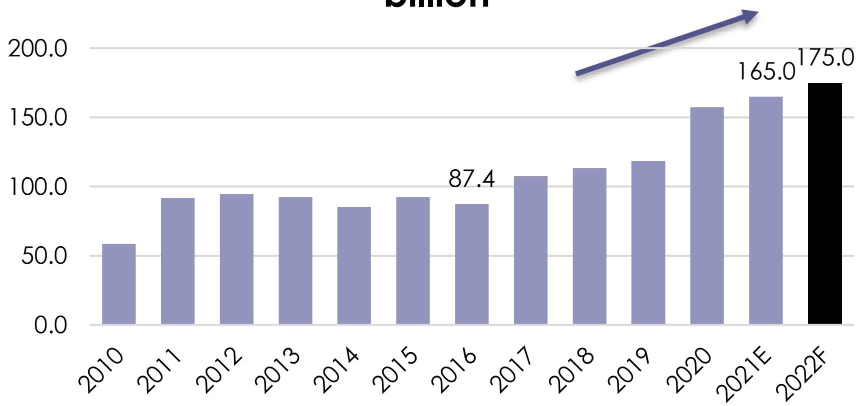
Total Issuance for MGS and GII, RM billion

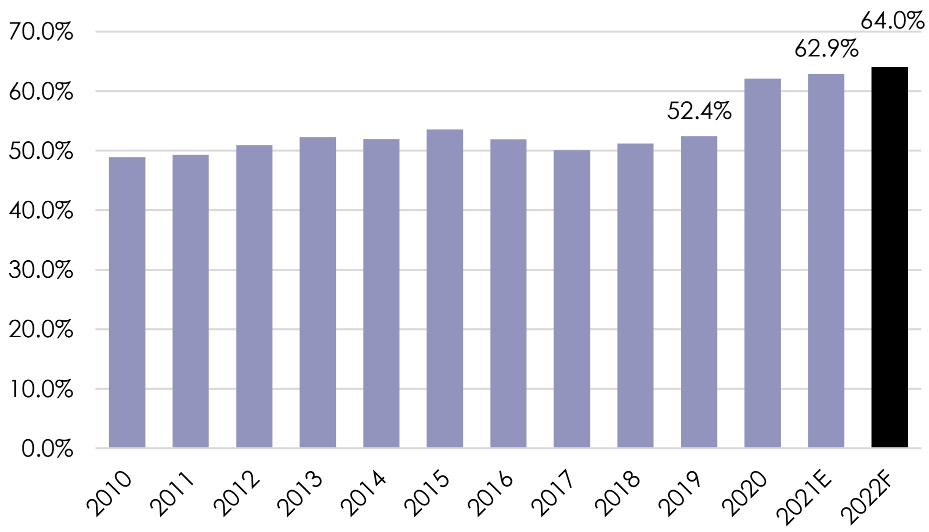


Sources: CEIC, Bank Islam
* Data as at 26 October 2021

- ✓ As at the 26 October 2021, the total issuance of MGS and GII stood at RM138.4 billion (10M2020: RM141.6 billion).
- ✓ Following the large DE allocation during the tabling of 12MP, the new issuance of local govvies (MGS and GII) is expected to increase to RM175.0 billion in next year from estimated RM165.0 billion in 2021 in order to rejuvenate the economy after the Covid-19 crisis.

- ✓ Apart from that, the statutory debt limit is set to be raised from current level of 60.0% to 65.0% that allow flexibility in the fiscal room to accelerate the economic recovery.
- ✓ According to our estimation, the additional 5 percentage points (ppts) in the statutory debt limit would provide an additional of RM117.0 billion to prescribe fiscal stimulus.
- ✓ Therefore, the federal government debt to GDP ratio is projected to increase to 64.0% in 2022 (2021E: 62.9%).
- ✓ All in all, the government will have to balance the need for supporting the economic recovery with its fiscal position.

Federal Government Debt to GDP ratio, %



Sources: CEIC, Bank Islam

IS REINTRODUCING GST APPROPRIATE NOW?

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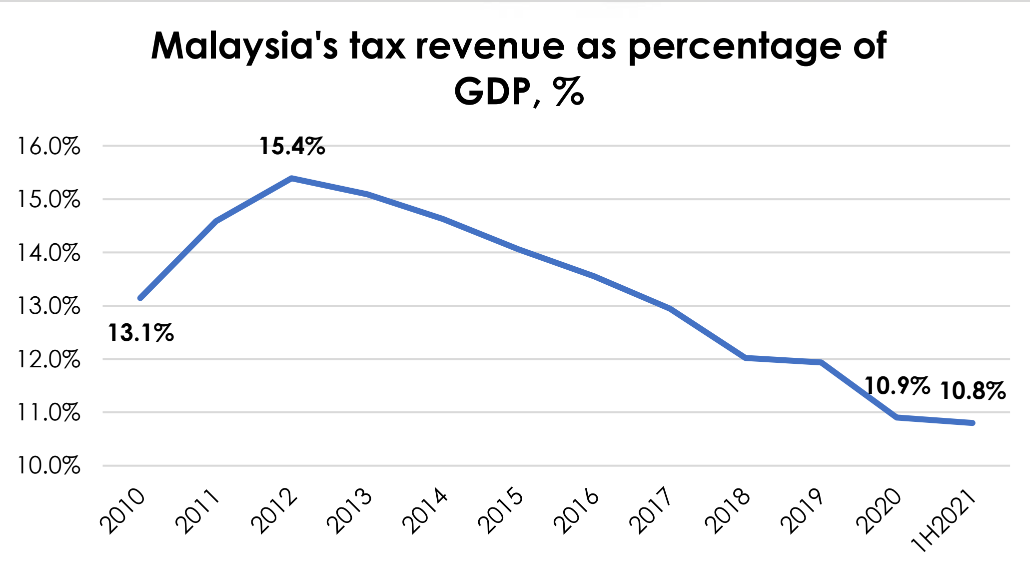
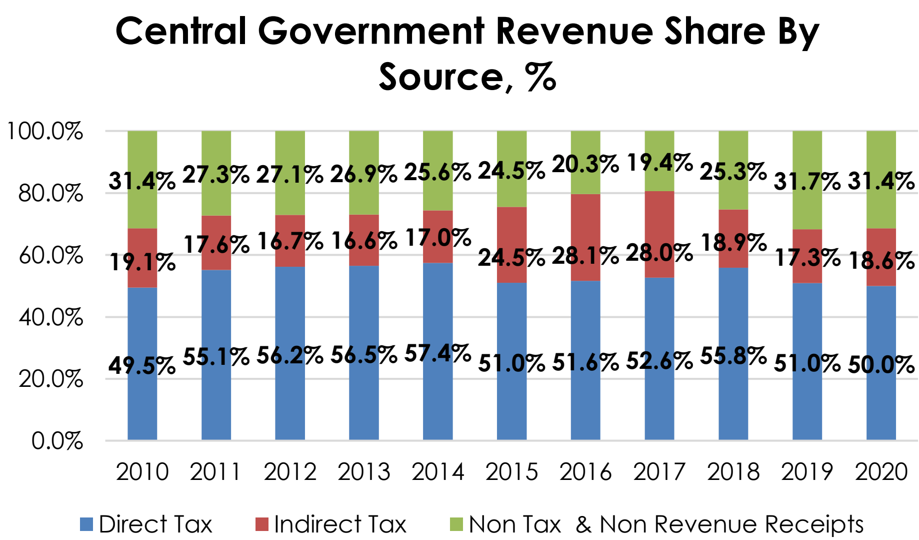


Sources: MOF, Bank Negara Malaysia, CEIC



Sources: CEIC, Bank Islam

- ✓ Malaysia's tax revenue as a percentage of GDP has been on the decline from 15.4% in 2012 to 10.8% in 1H2021.
- ✓ Apart from that, the contribution of indirect taxation towards Malaysia's central government revenue has been below 20.0% since 2018, coinciding with the implementation of Sales and Services Tax (SST) in lieu of the Goods and Services Tax (GST).
- ✓ Therefore, a question beckons if GST would be appropriate to make up the government's coffers given the high development expenditure from 2021 to 2025 as outlined under the 12MP.
- ✓ Notwithstanding this, the reintroduction of GST in the Budget 2022 may not be appropriate as businesses are still recovering from the pandemic.
- ✓ With that in mind, the government should rather focus more on the effectiveness of the taxation system via an increase in tax compliance through measures such as the Tax Identification Number mentioned in the MOF's pre-budget 2022 statement.
- ✓ On a broader scale, the implementation of the Medium-Term Revenue Strategy (MTRS) to ensure that tax collection is continually managed and sustainably increased in line with GDP growth appears to be a measure that is dynamic.
- ✓ This seems logical as the economic growth continues to recover and later normalise, profitability can be sustained well. As such, tax brackets can be gradually adjusted higher.

THE GOVERNMENT HAS BEEN REDUCING SUBSIDIES SINCE 2012

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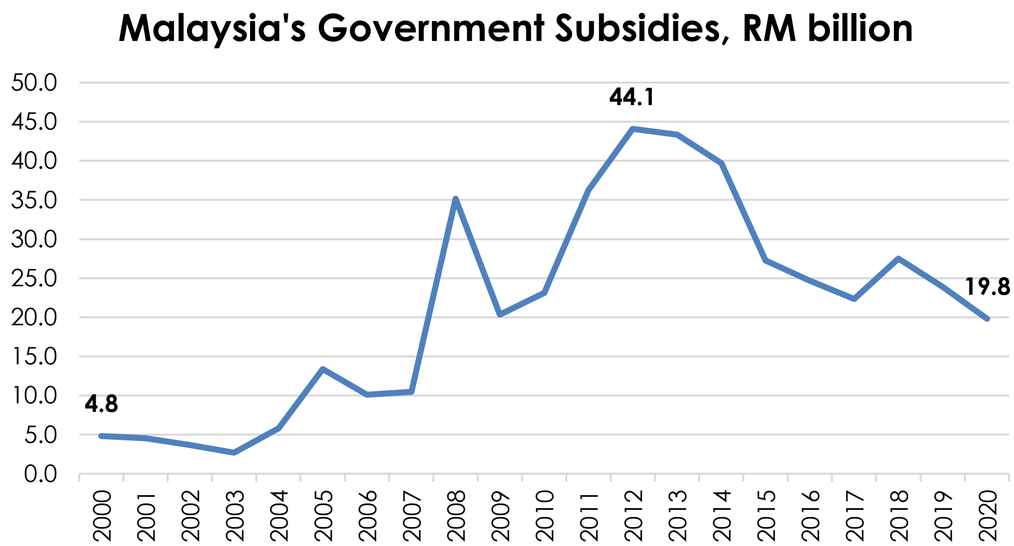
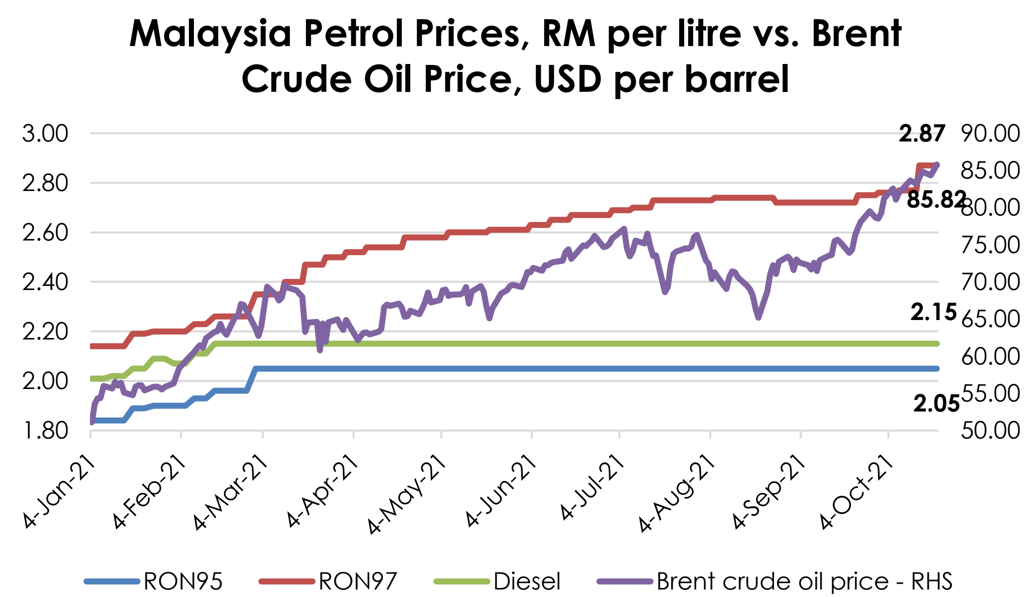
- ✓ Understanding the need for the country to manage its expenditures optimally while nurturing growth, the removal subsidies seems to be an ideal alternative to minimise government expenditure.
- ✓ At the same time, we observed that Malaysia's total government subsidies have been on a downward trend from RM44.1 billion in 2012 to RM19.8 billion in 2020.
- ✓ Therefore, it can be said that the government has been playing its role in subsidy rationalization over the past few years and room for further subsidy cuts may be limited especially in light of the economy which is still in recovery mode.
- ✓ Perhaps a measurable amount of subsidies could be taken away by the government in order to free up some space to spend on other matters to strike a delicate balancing act.
- ✓ With oil prices rising, subsidies given by the government for pump prices could be revisited.
- ✓ Currently, the price ceiling for RON95 and Diesel at RM2.05 per litre and RM2.15 per litre respectively was implemented on 27 February this year when Brent crude oil price was at USD66.13 per barrel based on the closing price on 26 February. As at 25 October, Brent crude price has surged by 30.0% since then, indicating that the government has absorbed a lot from the rise in oil price via subsidies.





Source: CEIC

KEY AREAS TO LOOK AT FOR BUDGET 2022 ACCORDING TO MARKET OBSERVERS

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- ✓ Since Budget 2022 is set to be expansionary in order to support the recovery of the economy, many industries that were hit badly by the pandemic have expressed their wish lists for the upcoming federal budget.
- ✓ Below are among of the identified key areas in which market observers are anticipating the proposed initiatives by the government to be tabled in the parliament on 29 October.

01 Small and Medium Enterprises (SMEs)

02 Property

03 Energy

04 Tourism

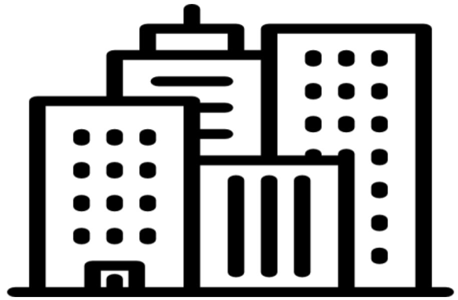
05 Construction

06 Telecommunications

Source: Various media

KEY AREAS TO LOOK AT FOR BUDGET 2022

SMEs



1 Tax incentive for SMEs

- To reduce SME tax to 10.0% from 17.0%.
- To reduce corporate tax to 15.0% for the first RM500k taxable income in 2021 and 2022.

2 Stop mass audit tax

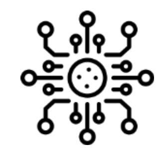
- Urged a halt to mass audit tax operations for suspected tax evasion from 2019 to 2023 to allow SMEs to reprieve and turn around in 2022 and 2023.

3 Wage Subsidy Programme (WSP)

- To extend the RM600 wage subsidy until June 2022 for all sectors that are deemed non-essential or not allowed to operate until phases 3 and 4 of NRP.

4 Human Resource Development Fund (HRDF)

- A waiver on the HRDF levy until June 2022.
- To reduce the levy to 0.5% until June 2023.



5 SME Digitalisation

- Human capital in information technology (IT), specifically talent from overseas is needed to transform SMEs into digitalisation.

Sources: The Star, The Edge Markets, Free Malaysia Today

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PROPERTY

1 Real Property Gain Tax (RPGT)

- Properties held for more than 5 years should be exempted from RPGT.
- Houses below RM300k to be exempted from stamp duty.

2 Home Ownership Campaign (HOC)

- Extension of HOC until 2022.
- Properties worth RM1.0 million to get full duty stamp exemption.
- Properties worth more than RM1.0 million to get duty stamp, capped at only 1.0%.

3 First-time home buyers incentives

- One-off grant of RM10k from the government for first-time home buyers, especially to those in the B40 group.
- To implement Developer Interest Bearing Scheme, whereby there is no need to service loan repayment during the project's construction period.

4 Malaysia My Second Home (MM2H)

- To ease MM2H requirements to spur foreign purchase property and at the same time, not jeopardise the local purchasers interest.

5 Act 829 or Covid-19 Act 2020

- To extend the coverage and scope of Act 829 or Temporary Measures for Reducing the Impact of Coronavirus Disease 2019 (Covid-19) Act 2020 to protect all parties who are unable to fulfil their obligations due to the effect of the pandemic.

Sources: The Edge Markets, theSundaily, New Straits Times

KEY AREAS TO LOOK AT FOR BUDGET 2022

ENERGY

1 Electrical Vehicle (EV) initiative

- Electro mobility (e-mobility) enhancement by government to be in line with 12MP's plan which aspires to become a low-carbon nation, thus promoting green technology usage.

2 Renewable Energy (RE)

- To set up a floor price for solar tariffs that is economically viable to generate greater investment interest for the long term.
- To reassess RE quota allocation under the power generation plan by increasing about 8.0GW and 20.0GW by 2025 and 2035 respectively.

TOURISM

1 SST incentive

- To extend SST exemption until December 2022 to attract foreign tourists travel to Malaysia.
- To increase the annual SST threshold value for hotel industry from RM500k to RM1.5 million.

2 Business Digitalisation

- An adequate allocation from the government to invest in business digitalisation, particularly in digital marketing to ensure tourism products are easily accessible.

Sources: theSundaily, The Star, Malay Mail

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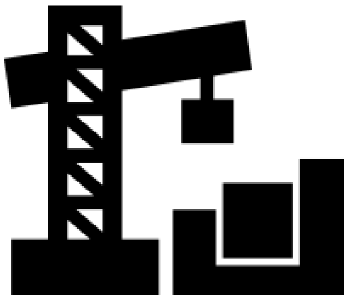
CONSTRUCTION



1 Fund Allocation for Sabah and Sarawak Development

- Allocation of funds to less developed states such as Sabah and Sarawak is anticipated for the upcoming budget to upgrade water, electricity, road, healthcare and educational facilities.
- This is in line with 12MP's target in narrowing the gap between states.

2 Technology Adoption in the Construction Sector

- Allocation needed for Construction 4.0 Transformation Programme which mirrors government's direction to drive the implementation of digital economy and Industrial Revolution 4.0 in the construction sector.

TELECOMMUNICATIONS

1 Tax Breaks for 5G-Enabled Devices

- The incentive will allow people to obtain latest technology device following to 5G implementation by end of 2021.
- To strengthen 4G network by terminating 3G network stages prior to 5G transition under National Digital Network (JENDELA) plan.

Sources: The Star, Focus Malaysia, Business Today

MAIN TAKEAWAYS FROM THE POSSIBLE MEASURES LIKELY BEING TABLED IN BUDGET 2022

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- ✓ Budget 2022 marks the second year of the 12MP (2021 – 2025). Thus, the immediate prioritisation is to craft a swift economic recovery plan which translates into higher generating growth, enhancing economic resilience, revitalizing private investment, more job creations, as well as reskilling and upskilling of manpower.
- ✓ Since the economy is gradually opening with the country about to enter the third year of the Covid-19 outbreak, the recovery is vital at the current juncture since not all businesses can recover quickly.
- ✓ Therefore, Budget 2022 will reflect the government's determination to revive the country's economy with an effort to restore foreign investors' confidence in making Malaysia as the main investment destination.
- ✓ Rounding up what market observers are expecting for Budget 2022 with regard to investment, it seems that reinvestment allowances and tax incentives may still remain prevalent as the country needs to continue attracting foreign investments.
- ✓ Taking this into consideration, the possibility of GST to make a comeback in the coming years cannot be ruled out as the government may need to gradually narrow the gap between revenue and expenditure.

Possible Measures With Regard To Investment Promotion For Budget 2022

Investment Promotion in relation to EV

- The goal is to be in line with National Investment Aspirations (NIA) that focuses on both of long-term sustainability, as well as environmental, social and governance (ESG) elements.
- To include incentives that stimulates demand side of EV and strengthen further existing incentive for manufacturing of EV components.

Expansion of Reinvestment Allowance (RA)

- RA incentives to be made available for all sectors since it is eligible for companies in the manufacturing and selected agricultural sectors previously.
- Removal of the 15-year cap to encourage businesses to continue investing, growing and modernising their operations.
- Rubber industry to get RA incentives as well, especially for the ESG purposes which could pave the way for Malaysia as the global rubber glove innovation centre.

To Review and Revamp the Promotion of Investment Act 1986 (PIA)

- This is in view of slight changes has been made under the said act.
- To encourage multinational corporations (MNCs) to continue investing in Malaysia by offering customised tax incentives that is in line with their needs
- In return, higher-level technology can be exchanged with Malaysia thus, enabling the nation to acquire higher technical skill sets needed.

 Source: Various media

IMPACT-CREDIT RATINGS AND CURRENCY

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Malaysia's Sovereign Credit Ratings

Rating Agency	Credit Rating	Rating Outlook
Fitch Ratings (18 July 2021)	BBB+	✓ Affirmed stable rating outlook. ✓ Malaysia's rating balances between prospects for strong and broad-based medium-term growth, as well as persistent current account surpluses with a highly diversified export base, against high public debt, a low government revenue base and lingering political uncertainty.
S&P Global Ratings (22 June 2021)	A-	✓ The outlook on long-term ratings remains negative. ✓ Worsening domestic Covid-19 situation has exacerbated the enduring pressures on Malaysia's fiscal and debt settings. ✓ Downward ratings pressure could also build if political stability in Malaysia deteriorates, or if the country's external position weakens.
Moody's Ratings (3 June 2021)	A3	✓ Retained table rating outlook. ✓ Supported by the country's diversified, competitive and moderately large economy, ample natural resources, together with strong medium-term growth prospects.

Sources: Rating Agencies, News

Source: Bloomberg

- ✓ In terms of credit ratings and rating outlook, major credit rating agencies such as Fitch Ratings, S&P Global Ratings and Moody's Ratings kept the outlook on Malaysia unchanged during their last review.
- ✓ The latest reviews by S&P Global Ratings and Moody's rating were carried out in June while Fitch Ratings carried out their review in July, all before the change in Malaysia's leadership and the relaxation of movement restrictions in the country.
- ✓ With that, it may seem that credit rating agencies like Fitch Ratings could remain status quo on Malaysia's sovereign debt ratings in the upcoming review during December. However, the possibility of higher debt of Malaysia's government implicated by the 12MP's projected DE of RM400.0 billion from 2021 to 2025 could pose some risks to the country's fiscal position.
- ✓ Therefore, any downgrade in Malaysia's sovereign debt rating could spark volatility in other areas of the financial markets such as currencies, under which the Ringgit could face downward pressure against the U.S. Dollar.

IMPACT – GOVERNMENT BOND YIELDS

- ✓ As more govvies are expected to be issued in 2022, the yields in government bonds will increase.
- ✓ The reason being is that the higher issuances would mean more supply of bonds which would exert downward pressure on bond prices and subsequently push yields above the current levels.
- ✓ Based on historical data, the 3-Y, 5-Y, and 10-Y MGS yields were higher in some years when there was a sharp increase in govvies issuances. From 2000 to 2019, there were 5 years in which 10-Y MGS yields recorded an annual positive change following the increase in supply of government bonds in the market.
- ✓ The year 2009 saw the highest increase in issuance of govvies at 46.9% year-on-year (y-o-y). As such, 3-Y, 5-Y, and 10-Y MGS yields were all higher by 32.2, 79.4 and 106.8 basis points (bps), respectively. This reflected the post Global Financial Crisis (GFC) 2008 period where the government needed funds to spur economic growth. Henceforth, the similar scenario is likely to repeat as 2022 will be the year of broad-based economic recovery across many sectors.

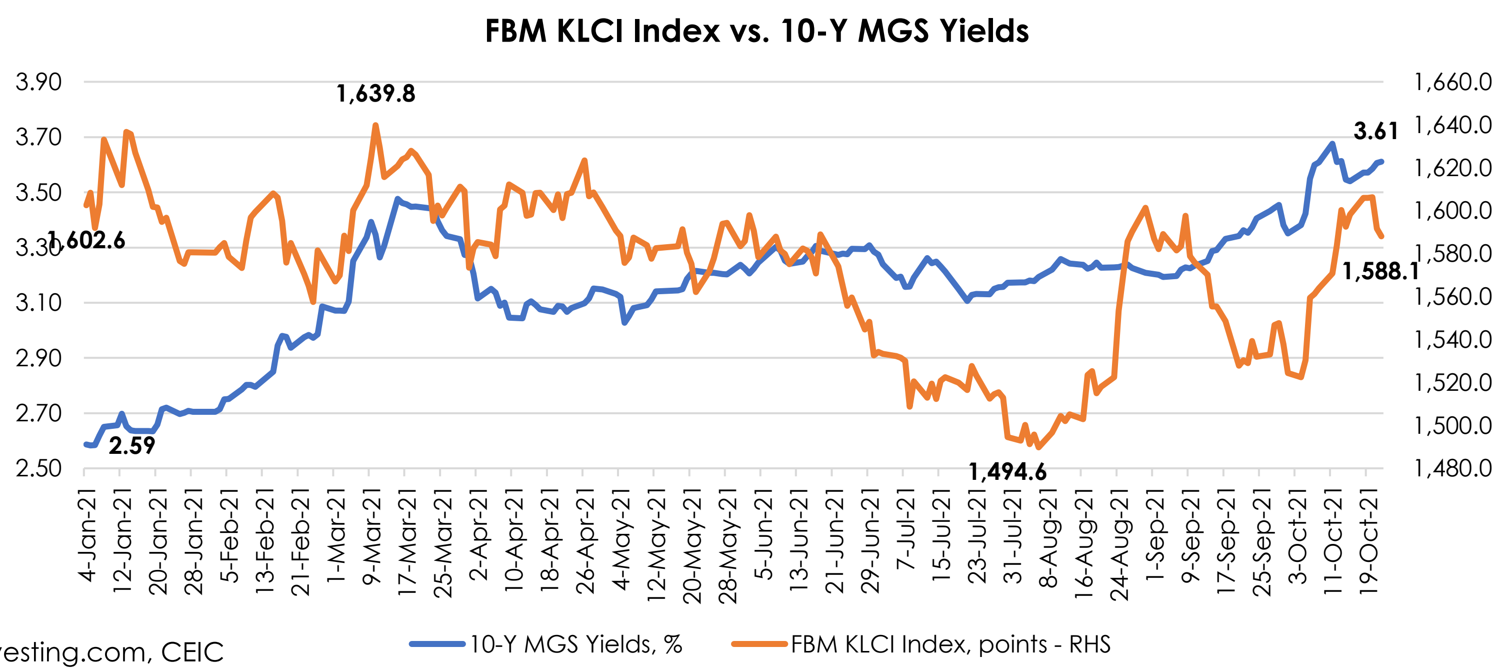
Annual change in 3-Y, 5-Y, and 10-Y MGS Yields in relation to Govvies Issuance and Fiscal Deficit

Year	Annual Change in Yields (Basis Points)			Govvies Issuance	Fiscal	Debt Level as % of
	3-Y MGS	5-Y MGS	10-Y MGS	(RM Billion)	Balance	GDP
2000	-22.2	-40.9	-63.3	18.4	-19.7	35.2%
2001	-95.6	-162.1	-188.4	24.9	-18.4	41.3%
2002	-1.7	-2.6	24.8	19.0	-20.3	43.0%
2003	70.7	112.5	79.2	43.0	-20.9	45.1%
2004	-73.2	-63.5	-11.0	46.6	-19.4	45.7%
2005	49.5	8.2	-50.2	32.3	-18.7	43.8%
2006	11.2	-2.2	-46.0	36.3	-19.1	42.2%
2007	0.5	8.0	36.4	53.2	-20.7	41.5%
2008	-71.7	-78.6	-92.4	61.1	-35.6	41.3%
2009	32.2	79.4	106.8	89.8	-47.4	53.3%
2010	-12.1	-40.4	-24.8	58.7	-43.3	49.6%
2011	-9.5	-16.1	-33.9	91.8	-42.5	50.0%
2012	3.2	1.5	-19.6	94.7	-42.0	51.6%
2013	28.1	42.3	62.5	92.5	-38.6	53.0%
2014	30.5	17.1	1.9	85.3	-37.4	52.7%
2015	-37.3	-36.7	3.9	92.4	-37.2	53.6%
2016	23.5	23.0	4.2	87.4	-38.4	51.9%
2017	-16.4	-13.8	-31.4	107.4	-40.3	50.0%
2018	28.8	21.8	16.6	113.3	-53.4	51.2%
2019	-61.4	-59.9	-76.7	118.6	-51.5	52.4%
2020	-113.0	-106.0	-66.2	157.3	-87.6	62.1%
2021E	76.3	107.2	92.7	165.0	-96.6	62.9%
2022F	12.3	9.4	13.4	175.0	-94.2	64.0%

Sources: CEIC, MOF, Bank Islam

IMPACT – GOVERNMENT BOND YIELDS

- ✓ The higher issuances expected in 2022 serves as an additional ground for government bond yields to rise moving forwards.
- ✓ This is because the equity market expected to improve (seen through higher expected earnings per share (EPS) of the FBM KLCI) especially in sectors that were previously being hit by the pandemic such as tourism and aviation.
- ✓ Henceforth, there is a high likelihood that investors may allocate more weightage in the equity market compared to safe haven assets. As a result, bond yields may start to increase again and limit the upside of bond prices for bond holders.
- ✓ On further scrutiny, the 10-Y MGS yields have been on an upward trend since the start of 2021, reaching 3.61% on 25 October from 2.59% on 4 January, indicating the shift from the bond to the equity market that has shown a positive trajectory amid the gradual reopening of the economy.

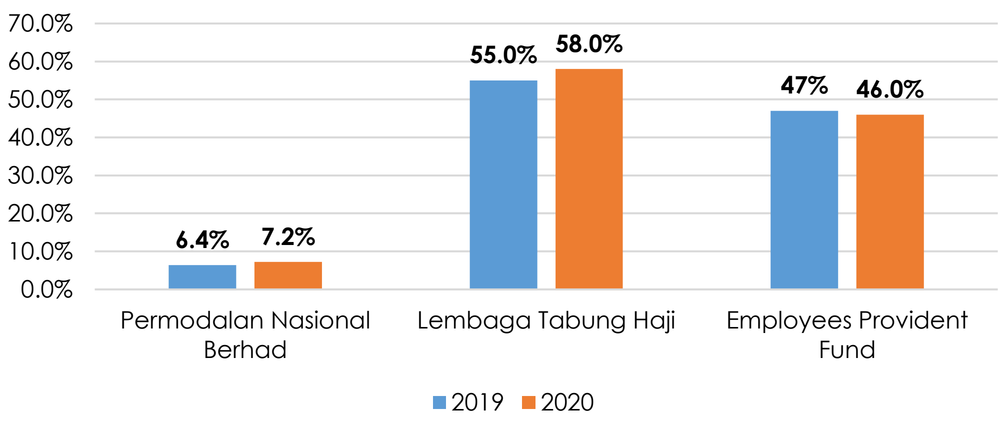


Sources: Investing.com, CEIC

IMPACT – LOCAL INSTITUTIONAL FUNDS HAVE THE APPETITE FOR GOVERNMENT SECURITIES

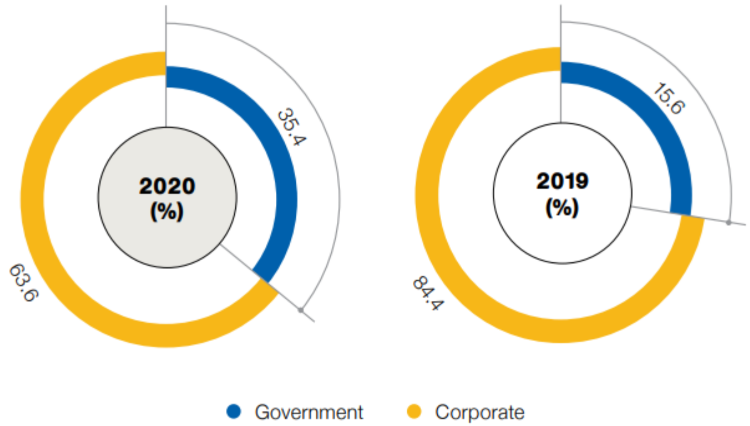
- ✓ In general, assets under management of most local institutional funds have a considerable exposure to the fixed income market.
- ✓ Moreover, the strategic asset allocation mandated for funds such as Lembaga Tabung Haji (LTH) and Permodalan Nasional Berhad (PNB) have increased for fixed income investments from 55.0% and 6.4% in 2019 to 58.0% and 7.2% in 2020 respectively.
- ✓ On further scrutiny, the breakdown of PNB's fixed income allocation shows that the exposure for government bonds has also increased more than double from 15.6% in 2019 to 35.4% in 2020. This signals a stronger appetite for the fund towards government bonds.
- ✓ Meanwhile, local institutional funds such as the Employees Provident Fund (EPF) saw a decline in terms of their exposure towards the fixed income market albeit by a small magnitude whereby the allocation for fixed income investments dropped from 47.0% in 2019 to 46.0% in 2020.
- ✓ All in all, it is worthwhile noting that a high issuance of govvies next year could be absorbed by local institutional funds.

Percentage of Assets Allocated Under Fixed Income for Local Institutional Funds, %



Sources: Annual Reports of Local Institutional Funds

Permodalan Nasional Berhad's Bond Portfolio Breakdown, %



Source: 2020 Annual Report of Permodalan Nasional Berhad

IMPACT-HIGHER OPR IS EXPECTED NEXT YEAR

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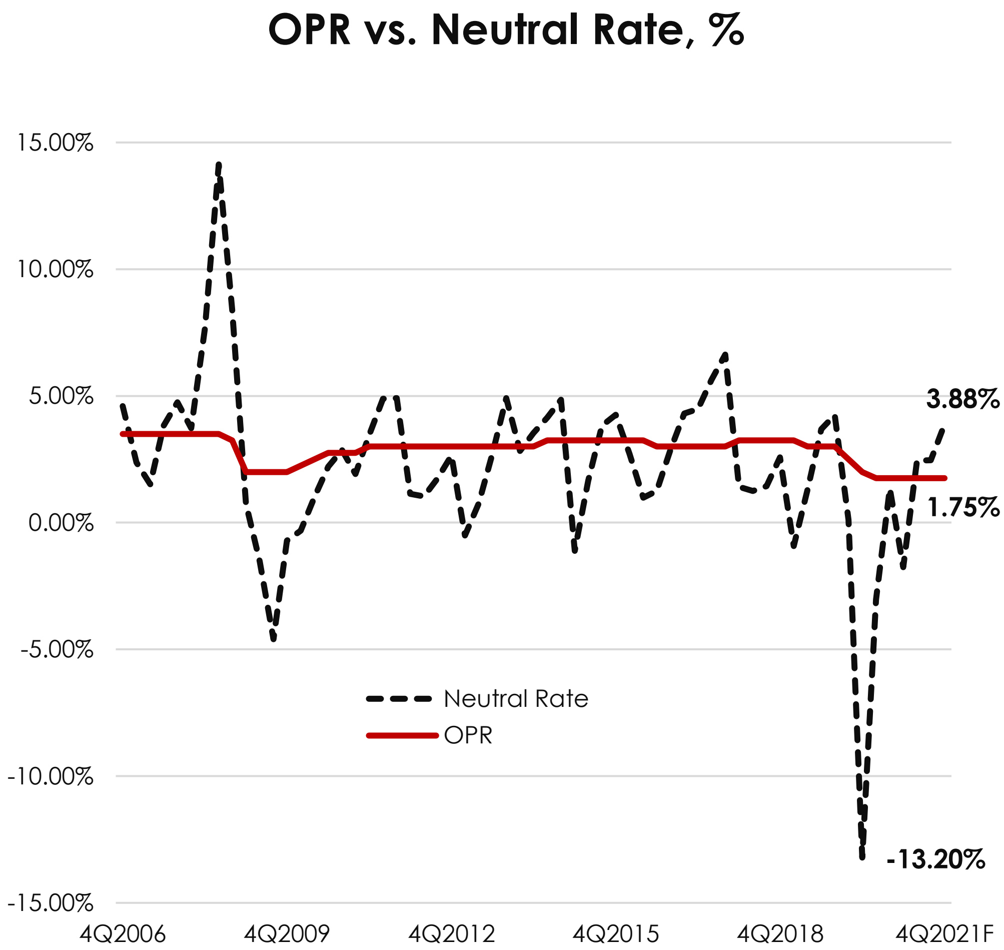

Sources: CEIC, Bank Islam

- ✓ Higher inflation is anticipated amid reopening of economy, comprehensive fiscal measures and improving consumer demand – demand pull inflation.
- ✓ As such, Bank Negara Malaysia (BNM) is expected to increase the Overnight Policy Rate (OPR) in effort to contain the inflationary pressure.
- ✓ Our latest estimates showed that the Taylor's neutral rate (a rate that is neither expansionary nor contractionary) is hovering between 2.50% and 4.00% in 2021.
- ✓ Judging from this, BNM may consider to increase the OPR by 25 basis points to 2.0% next year if the decision is solely on ruled-based monetary policy.
- ✓ It would be premature if the BNM is considering to raise the OPR this year as the economy still on its recovery from the impact of Covid-19 pandemic.
- ✓ But given that fiscal measures are expected to remain largely in place to boost the economy next year, an OPR hike is highly likely in 2H2022 especially if the economy continues to gradually expand post-pandemic.

CONCLUSION

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- ✓ The upcoming Budget 2022 is inevitably an expansionary as the nations needs to emerge after being impacted by the pandemic.
- ✓ Although it may seem worrying that the inability to reintroduce may further strain the government's finances, there are many other methods to promote a more solidified tax revenue base, which includes streamlining the taxation system that facilitates more efficient and transparent tax collections.
- ✓ There is not much point in imposing many types of taxes to widen the government's revenue base if the means to collect taxes are not robust. Moreover, it could also likely lead to the increase in tax evasion and tax avoidance among businesses and individuals.
- ✓ Overall, the government will need to continue playing an important role in reaching an optimal weight of increasing revenues and expanding debt levels as any imbalance in the government's fiscal position could lead to a rating downgrade. A rating downgrade will then cause a trickle down effect to the overall economy whereby foreign investors turn away from Malaysia and seek alternative destinations.

DISCLAIMER

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