

The Malaysian Budget 2001

Setting the pace for the new millennium

October 20, 2000

Preface

With a fresh electoral mandate until November 2004 and no UMNO elections until 2003, *Barisan Nasional* has to deliver a robust economy after the Asian economic crisis and its lingering effects that continue to this day.

With two consecutive years of growth peaking at the current year's 7.5 percent, this target seems to have been partially achieved. Nevertheless, the indications are that 2001 will see a slowdown in gross domestic product (GDP) growth figures. Domestic consumption, which soared in 1999 (from a low base), is showing early signs of consolidation. The sales of big-ticket items like houses and cars are leading indicators of a more tepid consumer sentiment this year.

In the wake of further market turbulence as well as the impending slowdown of our main export markets to Europe and the United States, it seems likely as well that our manufacturing sector will be negatively impacted. On the brighter side, higher oil prices have provided the government coffers with a much-needed shot in the arm.

Here's what the government has been hinting:

Prime Minister Datuk Seri Dr Mahathir Mohamad said: "... there will be a slight surplus in the 2001 Budget, It's a good Budget ... we always think about the people."

Ministry of Finance advisor Datuk Mustapa Mohamed said: "... we can expect the Budget 2001 to be supportive of growth ... inflation on average is barely 1.5 percent month-on-month, the country continues to enjoy full employment while bank lending has picked up consistently for six consecutive months."

What will Budget 2001 hold? At this stage, the answer is still anybody's guess. Typically, speculation on the expected changes in the forthcoming Budget on October 27 is running rife. To put things in perspective, zoomFinance has assembled a team of expert panelists to navigate these murky waters and to provide insights into what we can expect.

THE PANELISTS



Teoh Su Yin [TSY] (Pesaka Jardine Fleming Sdn Bhd)
Teoh Su Yin is a Director and Head of Research of Pesaka Jardine Fleming Sdn Bhd. She has been with the company for more than six years. She currently covers the real estate, infrastructure, plantations and conglomerate sectors.



Gan Kim Khoon [GKK] (Arab-Malaysian Securities Sdn Bhd)
Gan Kim Khoon is currently the General Manager, Investment Research of Arab-Malaysian Securities Sdn Bhd, a member of the Arab-Malaysian Banking Group. He has overall responsibility for the equity research products of Arab-Malaysian Securities. Prior to joining Arab-Malaysian Securities in April 2000, Gan was a Senior Vice-President at SG Securities (Malaysia) Sdn Bhd. His earlier stints were with HSBC Securities (Malaysia) Sdn Bhd and the Standard Chartered Bank.



Dr Chin Yoong Kheong [CYK] (KPMG Consulting)
Dr Chin Yoong Kheong is the partner in charge of KPMG Consulting. Prior to this, he was with the firm's audit and tax practices. He is currently the lead partner for e-business for KPMG in the region. Chin is also the author of "*Malaysian Taxation*" and "*Malaysian Taxation Practice*." Whilst in the tax practice, Chin was a member of the Taxation Committee of the Malaysian International Chamber of Commerce and Industry (MICCI).



Kumar Tharmalingam [KT]
(The International Real Estate Federation, FIABCI)
Kumar Tharmalingam is the current President of the Malaysian chapter of FIABCI. He brings with him over 25 years of experience in the property sector. He began his career in Britain with Gerald Eve & Co and returned to Malaysia where he practiced as a valuer and estate agent. He was the Managing Director of Debenham, Tewson, Tharmalingam & Aziz from 1980 to 1986. He was an Executive Director of Taiping Consolidated Bhd and is currently the Executive Vice-President of privately owned waste management company - Chain Cycle Sdn Bhd.



Dr. Veerinderjeet Singh [VS] (Arthur Andersen & Co)
Dr. Veerinderjeet Singh is an Executive Director at Arthur Andersen & Co and has extensive experience in tax matters both as an academic as well as at the professional level. He has served with the Malaysian Inland Revenue Department, worked in international accounting firms as well as held the positions of Associate Professor in Taxation and Head of the Department of Accounting at the Faculty of Economics & Administration at the University of Malaya.



MODERATORS:
Rajen Devadason [RD] (RD Book Projects)
Rajen Devadason is an award-winning journalist. As staff writer, of *Malaysian Business* magazine, he won the Malaysian Press Institute's award for best economic journalism in 1992 and the Citibank Pan-Asia business journalism award, which included a stint at New York's

Columbia University and visits to the White House, World Bank and the US Federal Reserve. His first book *Your A-Z Guide to the Stock Market* was published in 1997 and since then he has seen a new book out each year. Devadason holds a Bachelor of Science (Hons) degree in Physics and Computing from King's College, University of London, and is a member of MENSA UK. He currently writes two distinct financial planning columns - a print column for *Malaysian Business* magazine and an online one for zoomFinance - and is overworked as a financial planning trainer-cum-consultant.



Steven K C Poh [SP] (i2Media Sdn Bhd)

Ex-journalist Steven Poh is the CEO of i2Media Sdn Bhd, an integrated marketing communications specialist. He was formerly business correspondent for *Asiaweek* magazine and General Manager/Senior Consultant of a KLSE-listed software development house. He won the 1992 Malaysian Press Institute prize for best magazine writing while still at *Malaysian Business*. Also a former Press Fellow of Wolfson College at the University of Cambridge, Poh graduated with a Bachelor of Science degree in Communications (Journalism) from Southeast Missouri State University. He completed his Master of Science degree in Speech Communication from Southern Illinois University at Carbondale.

Below are excerpts of the discussion ...

zoomFinance - Round Table Forum

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RD: Malaysia is currently enjoying strong GDP figures, with some analysts actually projecting the third quarter GDP growth of 7.5 percent and a seven percent growth for next year. Interest rates continue to remain low; with the base lending rate (BLR) remaining at 6.5 percent while inflation continues to remain a benign four percent - low by any standards. Meanwhile, government expenditure is expected to outpace income - in the region of RM20 billion - marking Malaysia's third consecutive year of deficit spending. Do you expect any of these figures to come in significantly

different?



TSY: For this year, we are looking for an 8.5 percent GDP growth for 2000 and 6.3 percent for 2001. The issue to focus on is that inflationary pressures are very real - with the various hikes in petrol and transport prices. Inflationary pressures are definitely mounting and interest rates should see an upswing. There have been very subtle changes in the banking system. If you check around the banks at the moment, the mortgage war has definitely eased. You don't see the great bargains which were available at the start of the year anymore. So this is already a sign that we have reached the bottom in terms of where interest rates are heading. However, I don't think that they will pick up dramatically. It will be gradual.

VS: This year, we are looking at 7.5 percent, although eight percent is also achievable. Next year it [GDP growth] is going to come down, maybe to 6.5 percent. This is looking at what is happening in the world markets, especially in the U.S. I agree that interest rates seem to have bottomed out and I think it will be on the upswing in the coming year. Inflation will then obviously become a concern. As such, inflation is one area we will have to keep an eye on.

GKK: We are expecting quite strong growth for this year, in the region of 8.9 percent followed by a relatively strong seven percent next year. The growth will come mainly from domestic and external sources. From domestic sources, it will again be spearheaded by the manufacturing sector, which is expected to be the main driver of growth. As for inflation, I would agree with the view that inflation may be creeping up. The government, through various measures, such as introducing more items on the price control list as announced recently, could possibly put a cap on the consumer price index (CPI).

RD: What I would really try to get an answer on is whether we will be looking at a budget deficit or a budget surplus.

CYK: We have registered a very strong growth this year. I don't see anything wrong with running a budget deficit because we need an expansionary policy. The question is not really whether we should be in deficit, but whether an expansionary policy will lead to further inflation. The challenge the government is facing right now is that the growth is not widespread. So at the end of the day whether there is a deficit or not depends how they are going to tackle the various sectors of the economy. However, I would expect a slight deficit.

SP: With the economy still not seen as "settling down" after more than two years of regional financial crisis and with an uncertain global economic outlook, which would be a better end result this time around? A budget surplus or a budget deficit?

GKK: A budget deficit would be a better choice.

RD: A warning sign for the economy on the whole is that loans growth has been weak - at just plus two percent in July. Money supply growth has also been a slow plus 3.7 percent. With the current expansionary monetary



policy to continue and notwithstanding the relatively low interest rate regime that we are already in, do you think an expansionary fiscal policy is still required? If so, what fiscal measures do you think the government can undertake to boost this weak loans growth? And more importantly, why has loans growth been measly?

CYK: When we talk about loans growth, we must understand that it is a question of supply and demand. When the economy is on the upswing and things are going very well, and you have that level of confidence, bankers do not mind lending. But when you are on the downswing, suddenly you have a huge lack of confidence. At the end of the day, when this happens, we have a situation where the bankers only tend to lend money to those who have collaterals, secured and really do not need to borrow.

RD: Are you saying that they are only prepared to lend to those who do not need it?

CYK: Precisely! Those who really need the funds do not have access to it and this is where the government needs to do something. However, it is not an easy task. Fundamentally, what is important is how the government is going to revive the level of confidence.

RD: The government is well aware of the problems of getting the private sector to do something for the national good. As I said earlier, I think a lot of our bankers are still caught in a time warp. They are totally locked in the whole idea of securitized lending and there seems to be a tremendous lack of acumen in terms of being able to look at a business plan and decide it can make money. What's likely to make the bankers change their mind set here?

GKK: I think there is very little left for the government to do. If we were to look at what they [the government] did last year, they set a target of eight percent [for bankers' loan portfolio] and raised it to 10 percent. Last year's budget had an incentive for banks, whereby if they achieved a loan growth exceeding eight percent, interest income on anything that is above that level is exempted from tax. But all of these were never totally implemented. With the exception of a few banks (Hong Leong Bank Bhd and Public Bank Bhd), which managed to achieve this target, most were unable to do so. So even with this directive from the various government agencies, we do not see banks aggressively lending out there. In terms of micro measures, there are actually very little left to do. What the government could do is to have a very accommodative monetary policy and basically let the interest rates stay low. You may see inter-bank rates going up, but not the BLR. And this is a bad squeeze on the banks' margins. Right now, if you were to look closely at how the BLR is calculated, it is pegged to the intervention rate. Currently, there is still a very large disparity between the intervention rate of 5.5 percent and the three-month KLIBOR at 3.3 percent. Based on the intervention rate, the BLR is still 6.8 percent. So even if interest rates on the whole rise and we do expect the KLIBOR to rise to as high as five percent by the end of next year, it may still not translate into a change in the intervention rate set by Bank Negara. Which means that the BLR could stay low. So even if it did increase, it would not increase as substantial as the increase in the three-month KLIBOR.

RD: In light of the impending rate hikes, is it fair to say that for the coming year bank stocks will lose some of their shine?

GKK: I think that one of the other objectives is to prod the banks to grow their loans book to compensate for the decrease in net interest margins. The argument is that if you grow your loans book aggressively, say in excess of 10 percent, you could actually mitigate the squeeze in net interest margin that you would face from the rising interest rate scenario.



TSY: I think you have to be very realistic because the carrot and stick approach has not worked in the past and we have to realize that the demand for credit is still weak with the exception of residential properties. So for banks to go out and increase their loans book at a time when there is weak demand seems unlikely. And don't forget that non-performing loans (NPLs) will still be on the back of their minds. Remember that the Corporate Debt Restructuring Committee (CDRC) is still managing over RM40 billion worth of debt which is not classified as NPLs under Bank Negara and they need a healthy market because the debt workout is mainly via a debt-for-equity swap. If you don't see that coming through, you will see a reversal of NPLs into the system. The thing to bear in mind is that loans growth is important but realistically for a banker, NPLs are still on the back of their minds.

RD: In terms of a reversal back into the system, are you then saying that if the equity market does not perform accordingly and they [CDRC] cannot carry through with the swap, they will be forced to send those NPLs back?

TSY: There is a time limit as to how long a debt takes to be resolved by CDRC. If you look at it, I believe that for the end of June 2000, it is about RM15 billion of debt still under workout.

RD: Does anyone have any idea what proportion of that RM40 billion is property related? What would you like to see happen to correct this situation?

KT: Less than half. I believe that banking is really a people business. Having worked in both the Bank of Commerce for three years and MBf Finance for three years, I know both the financial institutions had diverse attitudes to lending. With the mergers, the human element has been overlooked. We are looking at a major loss of jobs, in the region of 30 percent, which could translate into approximately 10,000 bank employees seeing a voluntary separation scheme (VSS) being served on them in the next year or so. None of the bankers would want to lend because when the time comes to be assessed on a performance basis, then all the NPLs that you lent out will have been taken into account. So bankers are saying why should they bother. They will just lend for housing and share financing. Someone mentioned earlier that Hong Leong Bank and Public Bank did achieve their loans growth target. These are banks that have traditionally been on the fringes of the banking sector, in the sense that they have been lone rangers in going into areas that other banks have not gone into, for example into shipping as well as financing exports and imports. So they have recovered by not depending on the traditional sources of lending. It is not that the banks are not lending, but that they are internally frozen.

RD: Specifically, as far as the property sector goes, how do you see current lending to the sector and what can be or should be done in the coming Budget?



KT: Current lending for the residential sector is very active, although it is non-existent outside of it. I think with the restructuring of real estate is happening through CDRC. We will be seeing a lot of ICULS coming into the market over the next year. Out of the RM40 billion, about RM8 billion [or 20 percent] of that is in property. They [CDRC] are able to sell about 50 percent of their tenders and they are quite comfortable with that, although they are only selling the prime lots. The remainder is being dumped into a new company that they have purchased - TTDI. This means that they are going to be in this business for a long time. To avoid the time limit, they have set up this company so they can rotate those properties into the newly acquired company. Danaharta bought its NPLs at roughly 73 percent of the value of the assets. They are selling it about 53 percent of the price they bought them at. To date, they have lost about RM3.8 billion. So even though the NPLs have been taken out from the banks, but there has been almost a 47 percent loss in the value of NPLs on resale. Whatever it is, there are 1.9 million houses in the country of which 400,000 are *kampung* houses. We have housed 12 million people. We are building 120,000 additional units a year, which is higher than Hong Kong or Singapore. In 10 years, we will have done over a million houses. Supply will then equal demand. The residential market is already reaching the saturation level on the lower end.

RD: In the midst of the recession, Singapore took the bold step of opening up its banking sector, which is now in very good shape. We still have some level of capital controls, but if the Budget does not do something, do you think frustrated businessmen will start looking at other ways to bring money back in?

VS: One should be given a certain time frame for all this to work out, and I think that if it does not work out, obviously the government has to do something. I think the mergers are moving along, but as has been pointed out, a very real concern is what happens to the employees. It is correct that the banking sector is a little lethargic and I have always held the view that if our banks were to open up to foreign participation, it will be a good thing. Obviously we need to see the 10 banking groups formed before we think of strategic partnerships and allowing people to come in. This is a good strategy. The concern remains that the merger process is taking quite a bit of time and the banks need to be pushed into it.

TSY: The construction sector is an area the government will use to create more jobs and hence entice the banking system to lend to this sector. We have seen this happen last year. There was a big budget for the infrastructure sector and RM15 billion was supposedly allocated. To my knowledge, not even half of that has been utilized and it comes back to what we have been saying: bankers are not prepared to look at high risk infrastructure jobs.

RD: For how long more can Malaysia maintain its expansionary budget? Note the declining trend in Malaysia's monthly trade surpluses and foreign reserves as well as the increasing amount of government funds being raised

through global and domestic debt markets. The latter is evident by the recent US\$500 million debt issuance from the global bond market as well as the intention to raise another RM5 billion from the domestic bond market via the Infrastructure and Development Bank (IDB).

CYK: It is not possible to have an expansionary budget forever. The biggest limiting factor here would be the size of inflation. Also, the declining trade surpluses and balance of payments is also inevitable as the economy expands and more imports creep up. The most recent crisis was really a financial crisis, which was different from what happened in 1985 where an economic downturn was caused by the collapse of commodity prices. This time around, you have business but no source of financing. In this situation, when there is a recovery, you will import more. To return to a previous point on the property sector, I think that in 1997, just before the crisis started, the government increased property gains taxes to curb speculation. I think the government can remove this now. Secondly, there is the stamp duty. It used to be two percent, but it was hiked up to a maximum four percent. These two hikes increased transaction costs sharply.



VS: If you are looking at the property market trying to get that push to increase transactions, you should cut down the property gains tax to stir up speculation. This could give it some impetus. Currently property gains tax is already waived for low cost housing. It might be extended to other segments.

TSY: Taking it a step further, all these measures may be good to spur local sentiment, but if you are talking about attracting foreign investors, you are competing against regional markets where the bureaucracy and regulatory framework are so much more transparent. These are the issues stopping investors from coming in. It is confidence in the country that is needed. The fact that Citibank had such a tough time buying a building in Kuala Lumpur when there was so much excess capacity is definitely discouraging. It is a regulatory problem.

VS: Actually, MITI (Ministry of International Trade and Industry) is reviewing the investment incentives with a view towards whether they can be further improved or more importantly with regards to the transparency issue. If you look at the investment policy, there are certain situations where you can go on a case-by-case basis and get certain incentives and nobody really knows what are the criteria. You need to have consistency and transparency in the policy. We know that FDIs (foreign direct investments) are trickling in, but if you want to give it a push, one possibility we have been talking about is corporate tax rates coming down. At the end of the day, however, it is still perception and how foreigners see it. As for exit levies, they may not be substantial to us, but they are still an issue in the minds of foreign investors.

RD: One of the problems we are currently facing is the spiraling down of FDIs. FDIs approved in the first seven months of the year amounted to only RM4.1 billion, almost half of the RM7.2 billion approved in the corresponding January-July 1999 period. The situation is even more dismal given that FDI flows in 1999 - as depicted by both Malaysian Industrial Development Authority (MIDA) applications and approvals, and actual long-term capital flows - were way below levels recorded before the 1997 crisis. Given the critical importance of FDIs to the domestic economy, do you see the coming

Budget incorporating steps, such as tax incentives or other privileges to lure FDI's back to our shores?



KT: Last week I had a visit from the world president of FIABCI. It was his first visit to Malaysia. All his previous knowledge about Malaysia was from CNN and other global media. After a four-day trip around the country, he told me that what Malaysia really needs to do is to differentiate itself from its neighboring countries. He was impressed that we were still an elected democracy and we do have a different story to tell. He suggested doing something to tell Malaysia's story more

effectively. I have complained about the FIC (Foreign Investment Committee) for many years now because of the way they treat genuine investors. I know of a Middle East investment company that wanted to buy a building on Jalan Raja Chulan and they have been kept waiting for three months. Singapore, for example, has a very simple rule: non-Singaporeans cannot buy any asset in the island republic that is below six storeys. This basically means no landed property, but they can buy offices, commercial, industrial and retail properties without restrictions. The rules are clear and the market is wide open.

RD: In terms of corporate and personal tax rates, what do you think are likely to happen?

VS: I think that it will probably be a good time to reduce corporate tax rates, but we are not looking at a tremendous drop. It is currently at 28 percent, and I think it has been said before that 25 percent is an ideal rate. It would not go down to that level yet, but it may be reduced to 27 percent. If you look at the budgets in the past, there has been a commitment to lower taxes and continuous reform to the tax system, so long as the revenue collection is taken care off. In a situation like this, with the need to attract more FDIs, you are taking a risk in terms of lowering tax rates to increase FDIs. But you then need the other aspects of your policy intact. So the tax issue may be addressed, but there are other factors like transparency that need to be handled in different ways. So I don't think personal tax rates will come down that fast because we have always had a situation where the corporate tax rate is always a little behind. It would be good if we could bring the top personal rate to the corporate rate. But there is always the timing issue, and I think the government will lower the corporate tax rate first before lowering the personal rate.

CYK: I think the figure of 25 percent is the long-term target for the corporate tax rate. The thing about this figure is that many countries have also aimed to reach this target. Incidentally, Singapore has reduced their rate to 25.5 percent. Going back to my point on the expansionary fiscal policy, I think it makes sense to reduce the corporate tax rate down by at least one percent and I would like to see an equalization with the top marginal tax rate of individuals.

RD: Is there any kind of empirical evidence that lowering tax rates will actually increase government revenue?

VS: Previously, when Hong Kong cut its tax rates, it witnessed a sharp increase in revenue, although this was in the context of a booming



economy. If you look at Malaysia, when we reduced corporate income tax in the past, we also saw an increase in revenue. But that was again in the context of a growing economy. So it is a different issue given the scenario we have now.

CYK: One area we must not forget that the government can do is its ability to expand the reach of taxes. One way to expand the tax base is to increase indirect taxes. These will hit everyone, whether you are in the black economy or not. Some examples include consumption taxes like the sales tax.

RD: The Multimedia Super Corridor (MSC) initiative and the advent of the knowledge economy (k-economy) continue to be the focus of the government to drive Malaysia forward. Recently, tax breaks were announced for venture capitalists. What other incentives can we look forward to in order to encourage the development of information technology in this country?

CYK: I believe the key issue can be addressed via tax incentives. The government has already been very generous, for example, MSC-status companies getting pioneer status for up to 10 years. It does not get any better than that. At the end of the day, it is whether companies want to come in here to participate in the MSC. If one were to look at the success of Silicon Valley, it is actually the talent pool it has. In the shorter term, one of the things we can tackle is to open up our shores to a whole lot more permanent residents. We have to make it easier for expatriates to work and live here.

RD: Do you think the recent KLCI surge has to do with a good budget coming out?

GKK: I think it is the expectation that there could possibly be a cut in the corporate tax rate was one of the reasons. Even if it is only one percentage point, it would still improve the market's EPS (earnings per share). I think the market is also factoring in a cut in the effective personal tax rate. The Prime Minister has already hinted that it will be a "people's budget". This should translate into higher consumption spending and some stocks will benefit from this, such as **Jaya Jusco** or **Courts Mammoth** where people might be enticed to spend more on. Historically, there has always been a pre-Budget rally that happens about two weeks before the Budget Day. Whether it was artificially initiated or on anticipation of good news, it is hard to pinpoint. The question is whether this is sustainable.

TSY: You also have to look at it in the regional context. In the last two weeks, we have seen carnage in regional markets in the TMT (telecommunications, media and technology) sectors. Malaysia is perceived as a safe haven from technology stocks because we are still very much an old economy without much exposure to telcos or dotcoms. So we have seen a small re-rating upwards. The country has really held up pretty well so far. The other reason is that from our analysis, government linked funds have low ratings in the top three stocks compared to the pre-crisis level. I believe there are sufficient forces to keep the index above the 700 level. Also bear in mind that on a regional basis, Malaysia was actually reasonably cheap four weeks ago when it was trading at an 18 percent discount to the region when it is now trading at par. Malaysia is currently trading at 14.3 times 2001 PER.



RD: Who is likely to be the main beneficiary of this Budget?

GKK: The construction sector stands to gain the most. There will be increased allocation for development expenditure of at least 10 percent. Also, most of last year's allocation has still not been spent, so there could be a spillover. Some of the stocks that would gain would be **UEM, IJM, Road Builders, Gamuda** and **MTD Capital**. Some of these will benefit from the revival of projects that were abandoned. Of the five, I think that Gamuda has lagged the market.

TSY: I agree that the construction sector will receive a boost. If anything it will be the smaller cap, Second Board bumiputera contractors who will get the sub-contract projects.

RD: Any other closing comments?

CYK: After the 1987 recession, Malaysia successfully turned itself into a manufacturing center. We must not forget that a lot of the manufacturing boys were attracted here because of relatively inexpensive labor. When we look at FDI numbers, we must realize that a lot of it actually flows out because we buy capital goods. So when we talk about FDIs, we must talk about the net value or the value-add factor. So the Budget needs to focus on bringing the manufacturing sector up the value chain. Looking at the manufacturing cycle, it starts with R&D (research and development). R&D is really a service industry and many incentives have been given here. However, I think this [R&D] has failed because it was too easy to make money without putting in the hard work in R&D. A longer-term focus needs to be on R&D. Another important thing to do is to improve logistics and distribution. When we talk about distribution, Malaysia is very well positioned. We have good facilities and cheap labor. A challenge we are facing here is in the tax policy. I was actually advising a MNC (multinational company) to set up a logistics center in Malaysia. This means they would have turned their Malaysian center into their worldwide distribution center. However, the Treasury wanted to tax the company worldwide. I find it difficult to understand this. It could be the fault of how tax treaties are worded, but Singapore saw this problem back in the mid-eighties and have since declared that it would not tax goods passing through Singapore. So in the end my client went to Singapore.



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