**Cover Story: The rising subsidy bill quandary and its implications**

MALAYSIA registered an inflation rate of 2.5% in 2021, versus -1.2% in 2020. The two biggest contributors to the rise in prices — according to the **Department of Statistics Malaysia** — were the ceiling price set for RON95 petrol in the country at RM2.05 effective from February last year, and the increase in chicken prices above their 2020 average.

When the prices of certain goods increase, the government's solution has always been to impose price controls on those goods to ease the burden of consumers, and to grant subsidies to ease cost pressures on producers.

The 2022 Economic Report estimated the expenditure for subsidies and social assistance in 2022 (excluding measures announced during the tabling of the budget) at RM17.35 billion, up from RM16.7 billion in 2021.

Fuel has long been a subsidised commodity in Malaysia, but it was only early this month — the first time since 2008 — that the government agreed to subsidise poultry players.

While these measures would help alleviate cost burdens for the rakyat and keep inflation in check, they would further strain government coffers. The Edge takes a closer look at the subsidies granted for fuel and to the poultry industry, and weighs in on their implications.

<u>Tricky balance with fuel prices</u>
Crude oil prices have been climbing sharply in recent weeks. Since last December, Brent crude has gained 32% to US$91.38 per barrel last Friday evening — similar to levels last seen in 2014, right before prices came crashing down.

Analysts are now predicting that crude oil prices will continue to trend higher, surpassing US$100 per barrel. Two main events have resulted in a steep rise in crude oil, the first being increased demand on global economic rebound while supply comes in short of the demand.

The second is the geopolitical tension between Russia and Ukraine. Russia is the second-largest oil producer and an important supplier of natural gas.

"Any material escalation of conflict between Russia and Ukraine that disrupts global supply of oil and gas would lift energy prices," said Moody's Analytics in a report recently.

While crude oil prices have risen dramatically, consumers in Malaysia have continued to enjoy retail fuel prices that have remained unchanged for 11 months now. Since February 2021, the price of RON95 and diesel has been capped at RM2.05 per litre and RM2.15 per litre respectively, as the government reiterated its commitment to reduce the cost of living, following a year turned upside down by the Covid-19 pandemic.

Only the price of unleaded RON97 has risen in line with global crude oil prices.

For 2021, crude oil prices hovered at US$51.80 per barrel and US$85 per barrel, averaging US$70 per barrel.

At the rate crude oil prices are currently rising, it is a given that the government will be subsidising more than the budgeted amount for retail fuel if RON95 and diesel are kept at prevailing prices.

Notably, there are no official numbers on how much exactly the government subsidies for fuel each year.

The RM17.35 billion "subsidy and social assistance" estimated for 2022, includes cash handouts, a cooking oil stabilisation scheme, education assistance and scholarships, interest rate subsidies, electricity subsidies, paddy plantation subsidies, flour subsidies, LPG subsidies as well as farmer, fisherman and livestock incentives.

Economists contacted by The Edge estimate the government's fuel subsidy bill at between RM12 billion and RM18.5 billion this year, based on their average forecast of Brent crude prices.

United Overseas Bank (M) Bhd's (UOB) senior economist Julia Goh believes fuel subsidies could come up to RM18.5 billion this year, assuming the Brent crude average of US$90 per barrel and the ringgit averages at RM4.25 against the greenback.

CGS-CIMB Research economist Ahmad Nazmi Idrus believes that, with the assumption that Brent crude averages at US$80 per barrel this year, the fuel subsidy should come in around RM14.2 billion compared to RM7.8 billion, when Brent crude averaged at US$70 per barrel in 2021.

The Ministry of Finance itself budgeted for crude oil price to average at US$67 per barrel in 2022 at the unveiling of Budget 2022.

Nonetheless, rising crude oil prices will also mean an increase in the government's oil-related revenue, given that the country benefits from its oil exports.

But would the rise in federal government revenue be enough to compensate for the fuel subsidy it needs to fork out?

According to the Associated Chinese Chamber of Commerce and Industry of Malaysia's Socio-economic Research Centre (SERC) executive director Lee Heng Guie, a crude oil price average of US$95 per barrel in January 2022 will add extra revenue of RM10.2 billion.

"Assuming the subsidy of between 70 sen and 85 sen per litre for RON95, the estimated fuel subsidy for RON95 could reach RM12 billion, based on 14.4 billion litres. The fuel subsidy bill would be larger if we add diesel [in the calculation], which is estimated at RM6.5 billion.

"Overall, it is a net revenue loss of RM1.8 billion," Lee explains.

Subsidising fuel is only part of the picture. With rising global oil prices, there is no doubt food has also risen in price and subsidies for essential food items such as flour, cooking oil and eggs will similarly rise.

That said, with the tight fiscal situation and rising crude oil prices, would the government be compelled to lift the ceiling price on fuel to provide some relief to Putrajaya's coffers, which are already strained by Covid-19 relief measures and spending?

UOB's Goh says a rise of 20 sen in RON95 prices from the current RM2.05 could result in an estimated savings of RM3 billion to RM4 billion in fuel subsidies. RON95 was last at the RM2.20 level in 2018.

Raising fuel prices is not as simple as it seems, though. A 20 sen rise could result in a 0.7%-to-1% increase in full-year headline inflation, say economists.
Goh explains: "This is just the direct impact of higher fuel prices. There are also indirect effects, as higher fuel prices exacerbate business costs on top of other input prices as well as higher electricity surcharge for commercial and industrial users. This could spark a wider pass-through of costs to consumers. Inflation expectations are likely to rise further and price pressures stay elevated.

"As such, the government needs to understand the wider repercussions of allowing higher fuel prices to feed into inflation expectations at this juncture of the economic recovery."

Fuel accounts for 8.5% of the Consumer Price Index, whereas transport accounts for 14.6%.

Many would remember the reality of the fuel subsidy cut undertaken by the government in 2008 when fuel prices were raised sharply, with RON97 increasing 78 sen per litre to RM2.70 and diesel rising RM1 per litre to RM2.58. Meanwhile, RON92 — now discontinued — climbed 74 sen per litre to RM2.62.

The sharp rise in fuel prices back then was seen as the main culprit that caused inflation to surge to 7.7% year-on-year in June 2008. Prices of goods also rose in tandem.

Two months after that, owing to public outcry, the government gradually revised retail fuel prices. By December 2008, RON97 petrol had dropped to RM1.80 per litre, and both RON92 and diesel cost RM1.70 per litre.

Given the fragile economic recovery, coupled with an unstable political situation in the country, the present government is likely to have even less room to manoeuvre this time around.

Meanwhile, SERC's Lee says a rational move would be for the government to consider reducing fuel subsidy in stages to allow for a gradual increase in pump price, but the current cost increases for businesses and high inflation pressure on consumers could have probably restrained the government from adjusting the fuel prices at this juncture.

"It is politically sensitive to tinker with fuel, gas and electricity, as they are some of the most sensitive prices for households and businesses during the uneven state of economic and business conditions post the reopening of the economy.

"Price sensitivity around fuel is not just about the absolute level of fuel prices but also the direction and rate of change, and expectations about whether increases will be short-lived or more permanent.
"Sustained increases in fuel costs would depress consumers' sentiment about their finances, heighten anxiety about the ensuing impact on cost of living and exacerbate concerns about the strength of economic recovery. There were widespread expectations that prices would continue to rise," says Lee, adding that it would be inappropriate at this juncture to float the RON95 prices.

Nazmi says that while the pressure on the fiscal budget has certainly increased, with global oil prices trending higher, he believe the government can still continue to keep RON95 at current levels as long as there is a net positive gain from fuel prices in the form of petroleum income tax, royalties and export duty.

A fowl problem

A subsidy of 60 sen per kg of broiler and five sen per egg will be provided to poultry players between Feb 5 and June 4, which is during the implementation of the Keluarga Malaysia Maximum Price Control Scheme (SHMKM), and involving an allocation of RM528.5 million.

The poultry industry was last granted subsidies in 2008, and that too was due to rising commodity costs. It is understood that the industry was granted subsidies this time around because producers are struggling to cope with rising production costs as well as to compensate them during the imposition of the SHMKM, which does not allow them to raise prices.

Production costs for chicken and eggs have shot up a considerable 30% since October 2020 — owing to a global increase in the price of corn and soybean, which are imported from Argentina and Brazil, and which make up 75% of feed costs.

A check on Bloomberg shows that corn traded on the Chicago Board of Trade has increased 39% y-o-y to US$6.47 per bushel whereas soybean meal prices have increased by 26% to US$452.6 per tonne in the same period.

Should the price of corn and soybean meal continue to spike, a question that arises is whether the subsidies announced by the government would be extended to cushion the impact on producers.

When it comes to implementing short-term measures such as subsidies and price controls, having a good exit strategy is key, says Khazanah Research Institute (KRI) deputy director of research Dr Sarena Che Omar.

“What we don’t want is that global prices of feed [decline], but we are still stuck paying subsidies 10 to 20 years from now and have even forgotten why we did it in the first place. Sounds familiar? That is the paddy and rice industry.

“Conversely, if prices [were] to shoot up higher, [by] the time it takes to decide on a new ceiling price and subsidy, producers would have been negatively impacted. This market inefficiency will kill the industry. So, in this case, perhaps [it will be good to state] a clause that the prices of subsidies will be reviewed if the global feed prices rise above a certain amount within six months. All of this should be stated in fine print,” she tells The Edge.

A poultry industry veteran, who spoke to The Edge on the condition of anonymity, says that while subsidies will help alleviate the burden of poultry players to some extent, they are not a definitive solution to the problems the industry is facing.

“To my knowledge, the process to apply for the subsidies has not been announced, but bear in mind that is going to be a very tedious process, as there are thousands of poultry players in the country. When this is the case, another question that arises is how do you monitor this, to ensure that only genuine claims for subsidies are made?” he says.

“If you want to really make the subsidy process more efficient and achieve the goal of tackling the problem at hand, it is best to just subsidise the importers of corn and soy bean meal. There are fewer than 10 companies doing this; so, the government would just need to subsidise them, instead of thousands of poultry companies. That way, you tackle the problem from the tip of the pyramid rather than the base, as you have fewer people to monitor.”

“At this stage of nascent economic recovery, there is still a need for some subsidies, especially for essential goods. A move towards subsidy rationalisation and targeted subsidies is reasonable but has to be gradual and timed appropriately to prevent an inflation shock that could compound the burden on consumers and businesses.

“The government needs to understand the wider repercussions of reducing some subsidies that could feed into inflation expectations and threaten the economic recovery,” she says.

KRI’s Sarena believes subsidies are an acceptable short-term, stop-gap measure to manage prices for consumers.

“But that is where it can be a double-edged sword, because if we are stuck with this short-term solution for longer periods, it becomes a long-term burden to the government and taxpayers, and tends to kill the industry’s competitiveness,” she says.

Sunway University economics professor Dr Yeah Kim Leng concurs. He cautions that if maintained over a long period of time, subsidies can distort market signals and result in a misallocation of resources.

“The subsidies should just be stop-gap measures to shield the industries and consumers from price spikes, thereby allowing them sufficient time to plan ahead and adjust their spending behaviour and production activities to the new realities of higher food and fuel prices,” he says.

“Instead of subsidising consumption or keeping zombie firms afloat, the resources could be better used to expand infrastructure and other development projects that enhance the country’s growth capacity. If not expended as subsidies, these resources could be retained as fiscal buffers that enhance the country’s economic resilience.”

https://www.theedgemarkets.com/article/cover-story-rising-subsidy-bill-quandary-and-its-implications