

Subsidy cuts: What are Najib's options?

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Prime Minister Najib Abdul Razak could face questions over his commitment to economic reform after his government dodged a cut in fuel subsidies, threatening to put finances in peril and test the patience of investors seeking change.

The decision on Wednesday to avoid a subsidy cut is likely to be regarded as the latest in a series of U-turns by Najib's two-year old government which has tried to woo investment by pledging to overhaul the economy while trying to keep voters happy.

The government had warned that high energy prices would force a review of subsidies but shied away from making cuts, saying it would hold fuel prices steady for now because of the needs of the people.

Deputy Finance Minister Donald Lim was quoted yesterday as saying Malaysia would review fuel prices if the price of oil hit US\$110-US\$120 per barrel.

Following are some questions and answers on the economic and political implications of a rollback in subsidies, which are expected to double to almost RM21 billion this year because of high energy prices.

How serious is Najib about cutting subsidies?

In a recent speech, Najib likened Malaysia's fuel subsidies to "opium" but he appears wary of upsetting voters with steep price increases. The next general election is due by mid-2013.

Since taking office in 2009 he has raised the price of the widely used RON95 gasoline blend incrementally from RM1.75 per litre to RM1.90.

That is still below the RM2.10 target that a government body tasked with studying subsidies had recommended he achieve this year.

He has also twice delayed the implementation of a goods and services tax (GST) and softened his stance on the overhaul of a controversial affirmative action policy favouring the country's majority Malays.

Analysts say Najib may be willing to initiate these changes but only after he secures a strong mandate at the next general election.

How long can the government hold off on subsidy cuts?

Najib needs to cut subsidies and widen the tax base to continue trimming the government's fiscal deficit which hit a 20-year high of 7 percent of gross domestic product in 2009. The deficit was at 5.6 percent in 2010 and is officially targeted to be 5.4 percent this year.

Najib said this month that fuel subsidies in 2011, which make up the bulk of the total subsidy bill, have been revised upwards from RM11 billion to RM18 billion due to high global crude prices.

The additional RM7 billion spending would push up the budget deficit to 6.3 percent of GDP in 2011 unless subsidies are cut, Bank of America Merrill Lynch said in a research note on May 20.

Global crude oil prices are set to rise to a possible high of US\$140 by the end of 2012 as inventories and Opec spare capacity run out, according to Goldman Sachs.

But some analysts say Malaysia may have some room to delay price increases as it is a net oil exporter and would gain from strong crude markets.

Increasing tax revenues and the recent divestment of state holdings in government-linked firms could provide the government with some room to undertake only a modest fuel price rise, said Bank of America Merrill Lynch.

What is at stake?

Najib's predecessor Abdullah Ahmad Badawi saw his approval rating plummet from a high of 91 percent to less than 50 percent after doubling the price of gasoline from RM1.35 in 2003 to RM2.70 in 2008, according to independent opinion polling outfit the Merdeka Center.

Abdullah later cut prices seven times but voter anger over rising prices and his lacklustre administration led to record losses for the government in a 2008 general election and forced him into early retirement the following year.

Najib has been more cautious, preceding each of his three fuel price increases with measures to mitigate the impact on the poor such as higher salaries for low-ranking civil servants.

The opposition, which made major inroads in Sarawak state election last month, has pledged to reduce fuel prices if it wins the next general election.

The opposition has also criticised the government for failing to adopt a tougher stance on independent power producers whom they say should bear the brunt of any subsidy cut.

Independent power producers received RM19 billion worth of subsidised gas from national oil firm Petronas in 2009, according to media reports.

What are Najib's options?

His first option is to bite the bullet and raise gasoline retail prices along with electricity tariffs. The impact on food and transport could push inflation beyond an official target of 2.5-3.5 percent this year.

But the government could try to cushion the blow for low income groups. Possible measures include rebates, increasing a cost of living allowances in the public sector and raising civil servants' salaries.

Najib can expect a political backlash in such a scenario, which could dissuade him from holding snap general elections.

A second option is to make smaller gasoline price increases of between 5 to 10 sen along with an electricity tariff increase focused mainly on industrial users.

Najib would still need to manage voter unhappiness in this situation, which could influence the timing of the next general election. But he could still call for snap polls, as he banks on growing support from majority Malays and healthy economic growth.

A third option would be to hold off on any subsidy cuts until after the next general election. Such a move could indicate that national polls are imminent although there has been no indication of that.

- Reuters