Malaysia's fuel subsidy reform: A strategic move towards economic stability and growth

The removal of fuel subsidies in Malaysia need not be inflationary, provided BNM remains committed to maintaining constant underlying inflation

OPINION

by HANS GENBERG

Pic by Muhd Amin Naharul

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THE Malaysian government has implemented a fuel subsidy rationalisation programme by removing subsidies on diesel fuel. While some categories of diesel fuel users will continue to receive a subsidy, for the majority who use fuel as a significant input, its removal implies an increase in production costs.

Macroeconomic Consequences of Subsidy Removal

This note argues that the fuel subsidy rationalisation need not be inflationary and that the savings from the subsidy removal should not be earmarked for any particular expenditure programme.

Understanding these macroeconomic consequences is crucial so that appropriate macroeconomic policies are enacted and misguided criticisms of the subsidy rationalisation programme are avoided.

Inflation

An increase in diesel fuel prices will change the relative prices of goods and services. Diesel-intensive goods and services will rise in price relative to others. For example, transportation services will become more costly and their prices will likely rise relative to banking services. This could happen either through an increase in transportation service prices while banking service prices remain constant, or a decrease in banking service prices while transportation service prices stay the same.

The outcome depends on the monetary policy pursued by Bank Negara Malaysia (BNM) and the fiscal policy of the government. Restrictive policies by BNM and the government could keep transportation costs from increasing while depressing the prices of other goods and services.

However, these policies would come at the cost of a significant slowdown in economic activity.

The most likely and preferable scenario is an increase in transportation service prices without a fall in banking service prices. This is not inflation but a change in relative prices.

To simplify: When fuel prices increase at the pump, the consumer price index (CPI) will rise in the month of the increase. The size of the increase is proportional to the importance of fuel in the CPI basket. After this initial rise, underlying demand pressures that cause all prices to rise more or less in parallel will determine future inflation trends.

These demand pressures can be influenced by economic policies, primarily monetary policy.

The central bank can maintain a low level of inflation by conducting appropriate policies.

The effect of the increase in fuel prices will not be limited to the prices at the pump. Prices of goods using fuel as an input in production will also likely increase over time, leading to a prolonged period of CPI increases above the underlying inflation rate as relative prices adjust.

However, as long as the central bank maintains steady underlying inflation, measured inflation will return to that level.

Thus, the removal of fuel subsidies in Malaysia need not be inflationary, provided BNM remains committed to maintaining constant underlying inflation. The central bank's track record suggests it can prevent temporary shocks from leading to extended high inflation. Over the past twenty years, the average inflation rate in Malaysia has been 2.2%, demonstrating stability by international standards.

When fuel subsidies are removed, measured CPI changes may become more volatile as international oil price fluctuations affect the domestic economy more fully. Nonetheless, BNM can prevent this from causing instability in underlying inflation. Ensuring the public that temporary price level increases will not derail the commitment to low and stable inflation can help anchor inflation expectations.

What to Do with Fuel Subsidy Savings

This question will elicit various suggestions, with many advocating that savings be spent on specific projects. One frequent suggestion is to use the budgetary savings to improve and expand public transport infrastructure, arguing that higher fuel prices increase commuting costs by car, which could be mitigated by better public transport.

Others might argue that the savings should go to public health and education improvements.

While increased spending on public transport, health, and education may be justified, public spending decisions should not be tied to particular revenue sources. Funds are fungible, and decisions on public spending should be based on priorities rather than revenue sources.

Alternatively, the savings from the fuel subsidy rationalisation could be used to limit public borrowing, preventing an increase in public debt.

A reduction in public borrowing would facilitate access to funds for domestic and foreign private sectors to investment in technology and innovation, fostering economic growth and competitiveness in the long term. Such allocation of savings could yield significant economic benefits, complementing the macroeconomic stability achieved through effective monetary policy.

Hans Genberg is a professor of Economics at the Asia School of Business and senior director of Central Banking and Finance Programmes.