From the Desk of the
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GOVERNMENT LIKELY TO PROCEED WITH RON95 SUBSIDY CUTS AMID FALLING OIL PRICES

- Subsidies have long been an essential fiscal policy tool for the Malaysian economy, contributing to economic growth and providing critical support to disadvantaged groups, thereby improving their standard of living. However, the inefficient allocation of subsidies to ineligible groups can significantly increase government expenditure, potentially leading to unsustainable fiscal pressures over time.

- A clear example is the petrol subsidy, which disproportionately benefits higher-income households, especially those in the T20 income bracket. In fact, this group receives over 50% of the benefits from petrol-related subsidies, raising questions about the fairness and effectiveness of the current subsidy framework. These concerns are compounded by the volatility of global oil prices—when prices rise, the cost of RON95 fuel climbs accordingly, forcing the government to bear a larger subsidy burden. This, in turn, puts additional pressure on public finances and deepens fiscal imbalances.

- Back in 2022, fuel subsidies surged to RM52.0 billion when global crude oil prices hit USD100 per barrel as a result of a combination of post-pandemic demand recovery and reduced global oil supply, particularly due to geopolitical tensions between Russia and Ukraine. The RM52.0 billion in fuel subsidies accounted for 74% of total subsidies for the year. Specifically, the average subsidy per litre for RON95 and diesel amounted to RM1.34 and RM1.29, respectively. In total, the country's subsidy spending for 2022 hit an all-time high of RM70.3 billion, encompassing RM58 billion in subsidies for operating expenditure and RM12.3 billion allocated for the COVID-19 fund. Consequently, the fiscal deficit for 2022 remained high and ended at 5.5%, raising concerns about the sustainability of such spending.

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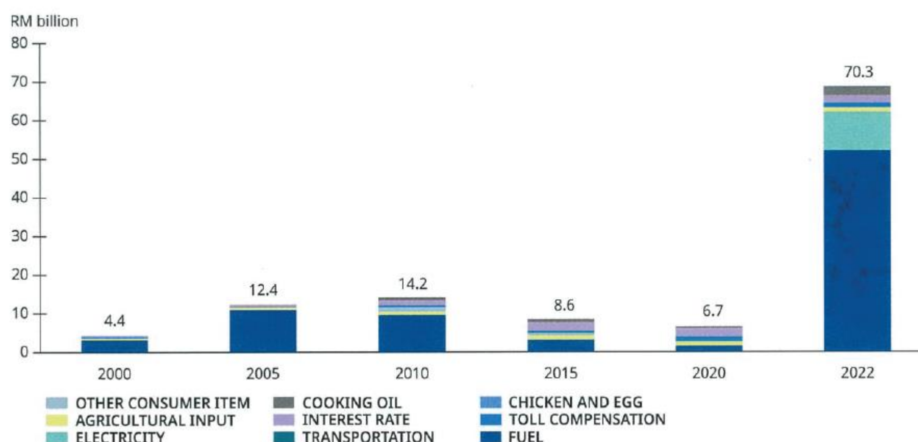
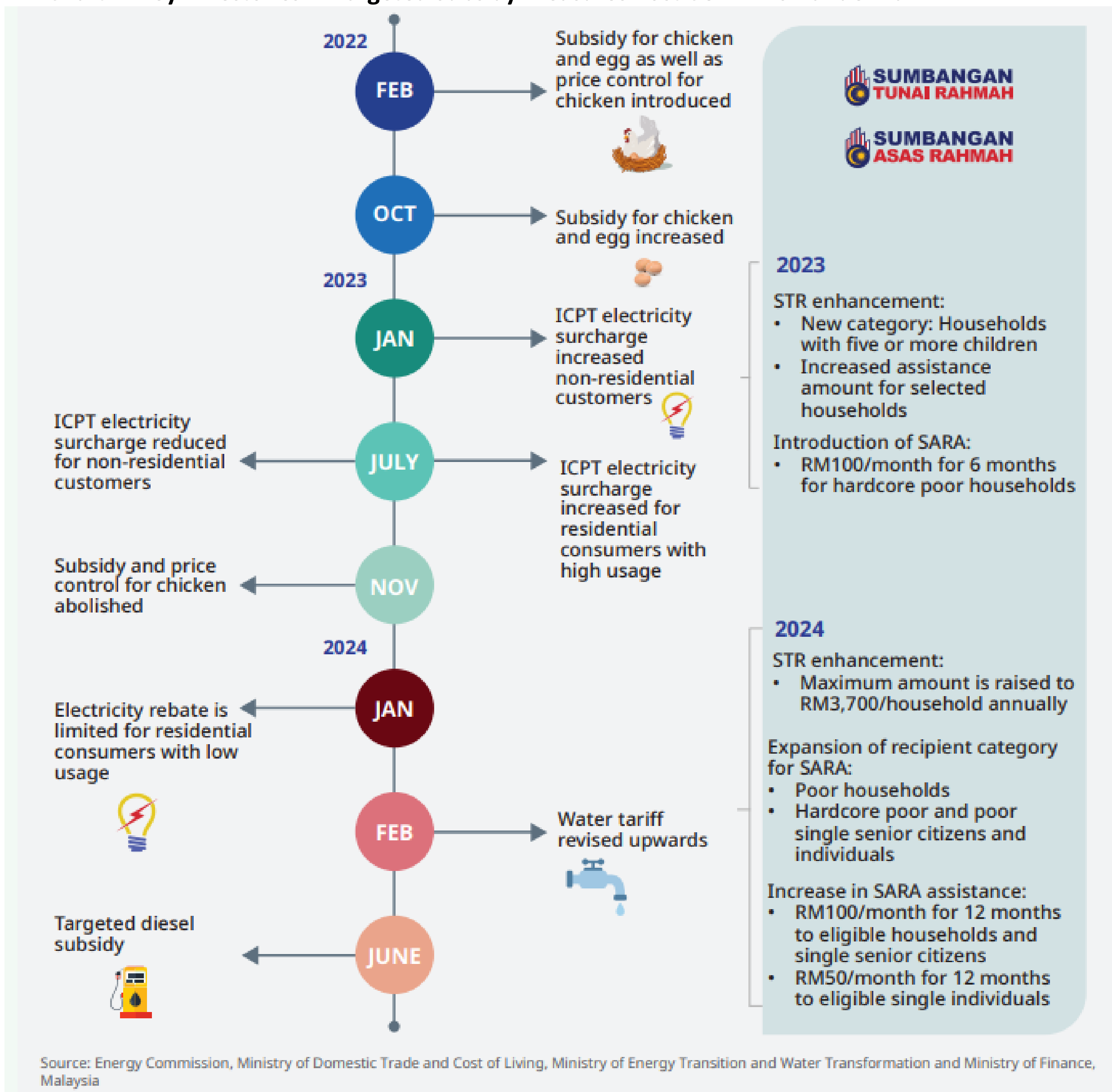
Chart 1: Trend of Subsidy Outlays, 2000-2022



Sources: MOF; Note: Total subsidies exclude wage subsidy program under the COVID-19 Fund

- Amid mounting fiscal pressures from broad-based subsidy programs, the government has begun transitioning towards a more targeted approach to ensure more sustainable public spending. This shift involves realigning key policies to better direct subsidies toward those who genuinely need them. In the post-COVID-19 period, a series of strategic, phased measures were introduced—starting with adjustments to the electricity tariff surcharge, followed by the removal of subsidies and price controls on chicken, revisions to water tariffs, and the retargeting of diesel subsidies. These steps were carefully implemented to avoid major disruptions to economic growth and to keep inflationary pressures in check.

Chart 2: Key Milestones in Targeted Subsidy Measures Post COVID-19 Pandemic



Sources: MOF

- Despite the long-term benefits of subsidy rationalization, public concerns have persisted—particularly around the fear that reducing fuel subsidies could trigger price hikes in food and essential services. These concerns came into sharper focus when, on 10th June 2024, the government took its first major step by removing diesel subsidies in Peninsular Malaysia. Diesel prices were allowed to float in tandem with global oil price movements, while the subsidized rate of RM2.15 per litre was maintained for Sabah, Sarawak, and Labuan. This policy shift marked a crucial milestone in Malaysia's broader fiscal reform agenda, helping the government save approximately RM600 million per month. Importantly, the move had only a modest effect on consumer prices—headline inflation averaged just 1.8% YoY in 2024, down from 2.5% in 2023. This muted impact was largely due to the effective rollout of the Subsidized Diesel Control System (SKDS) 2.0, which provided fleet cards to eligible logistics vehicles, cushioning downstream price pressures on goods and services. The program demonstrated that well-targeted subsidies could reduce fiscal strain without significantly burdening the public.

- Building on this momentum, the government remains resolute in its commitment to fiscal consolidation, aiming to narrow the fiscal deficit to 3.8% of GDP in 2025, down from 4.1% in 2024—already better than the initial 4.3% target. To support this goal, a targeted subsidy framework for RON95 petrol is set to be introduced by mid-2025. The plan includes a two-tier pricing system that will gradually phase out subsidies for the wealthiest 15% of Malaysians (T15) and foreign nationals, who collectively account for roughly 40% of total petrol subsidy usage. In 2024, total government spending on subsidies, incentives, and financial aid surpassed RM70 billion—well above the RM58 billion initially allocated in Budget 2024. Much of this overrun stemmed from additional allocations for petroleum products, including RON95, diesel, and liquefied petroleum gas (LPG). With RON95 alone costing the government nearly RM20 billion, better targeting and reduction of subsidy leakages could yield potential savings exceeding RM8 billion annually. Despite the rationalization, the government has assured the public that 85% of citizens will continue to enjoy subsidized RON95 petrol, with the continued support expected to cost around RM12 billion—underscoring its commitment to both fiscal discipline and social protection.

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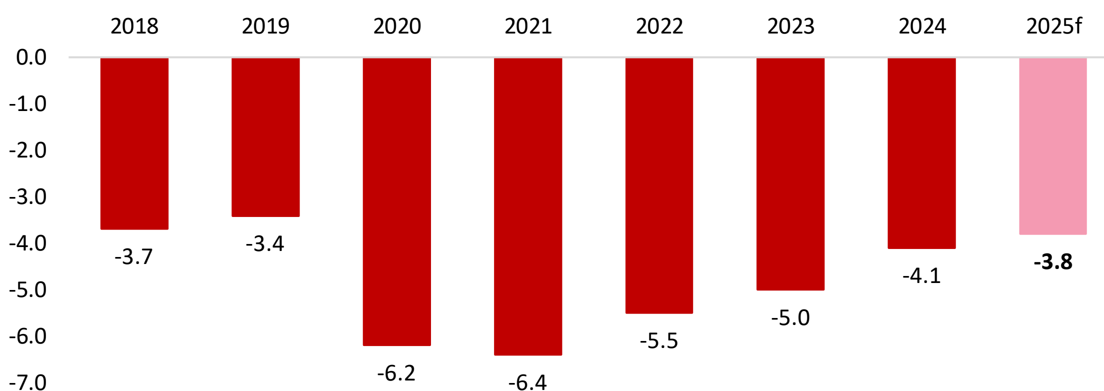
Chart 3: Malaysia's Fiscal Deficit, % of GDP



Sources: MOF

- While some observers argue that the current global environment—marked by escalating trade tensions and tariff hikes—makes this an inopportune time for subsidy cuts, we take a more constructive view. Malaysia, as a highly open economy, is indeed vulnerable to global headwinds, but the recent decline in global oil prices presents a strategic window for subsidy rationalization. With lower oil prices, the floating market price of RON95 would remain relatively manageable, minimizing the shock to consumers and making the transition to a targeted subsidy system less disruptive. Admittedly, falling oil prices also imply weaker petroleum-related revenues, which could weigh on the government's fiscal position. However, Malaysia has been gradually reducing its reliance on oil-related income, and the fiscal cost of untargeted subsidies continues to outweigh the risks of temporary revenue softness. With over RM70 billion spent on subsidies in 2024—far exceeding the Budget 2024 allocation of RM58 billion—the urgency to optimize spending is clear.

- While political considerations are an undeniable factor, particularly with the possibility of a general election (state election: Sabah – 2025; Sarawak, Melaka & Johor - 2027 and GE16) on the horizon, we believe the proposed RON95 subsidy rationalization is still likely to proceed by mid-2025. The government has repeatedly reaffirmed its commitment to this timeline. Prime Minister Datuk Seri Anwar Ibrahim and Finance Minister II Datuk Seri Amir Hamzah have both stressed the need for a more equitable and fiscally sustainable subsidy system and have reassured the public that the majority—85% of citizens—will continue to receive subsidized fuel. The new framework is specifically targeted at excluding only the T15 and foreigners, who currently account for approximately 40% of total petrol subsidy consumption. As such, the impact on the average Malaysian household is expected to be minimal, helping to mitigate potential backlash.

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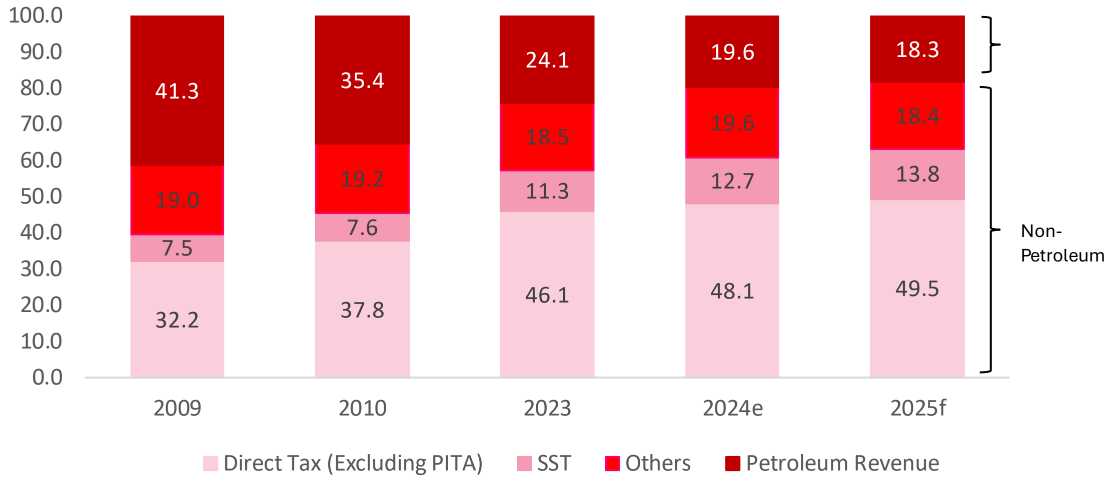
- Nevertheless, the looming election remains a wildcard. Historically, subsidy policies in Malaysia have been politically sensitive, and there is a risk that the government may delay or reverse course in an effort to preserve electoral support. The political temptation to maintain broad-based subsidies—especially amid rising living costs—could intensify as the election nears. That said, we maintain our base case that the RON95 subsidy rationalization will go ahead as scheduled, given the clear policy signaling, ongoing implementation of supporting mechanisms like targeted cash transfers, and the broader fiscal imperative. Still, the election dynamic introduces an element of uncertainty that warrants close monitoring in the months ahead.

Chart 4: Petroleum-Related and Non-Petroleum Revenue (% of Total Revenue)



Sources: MOF

- Brent oil price has remained under pressure, plunging as much as 6.5% in a single day to close at USD65.58/barrel on April 4, marking its lowest level since August 2021. The sharp decline was distressed by the Organization of the Petroleum Exporting Countries (OPEC+) decision to increase output in May 2025, alongside concern sparked by US President Donald Trump's sweeping tariff announcement earlier in the week. Brent crude prices dropped further to a four-year low of USD62.82/barrel on April 8, following China's announcement of retaliatory tariffs, which could escalate the trade war and threaten to weaken energy demand. Growing concerns over a gloomy economic outlook, fueled by rising trade tensions and retaliatory measures from affected countries, have led to expectations of reduced oil demand, reinforcing a bearish outlook for the global oil market.

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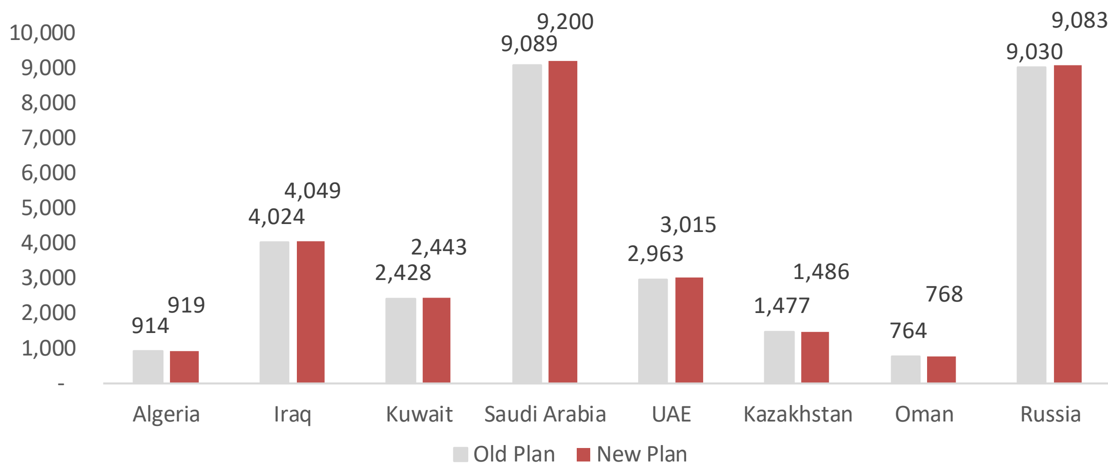
Chart 5: Brent Oil Price, USD/barrel

Sources: Bloomberg

- The situation worsened further following OPEC+'s unexpected decision to hike more production in May 2025, which added to oversupply concerns. The plan agreed by Russia, Saudi Arabia, UAE, Kuwait, Iraq, Algeria, Kazakhstan and Oman, gradually unwinding their recent output cut of 2.2 million barrel per day (bpd), which took effect this month. Additionally, the International Energy Agency (IEA) had already forecasted a supply surplus in the oil market this year, even before these new increases were announced.

Chart 6: OPEC+ Planned Oil Output Increases in May 2025 (thousands of barrels per day)



Sources: OPEC

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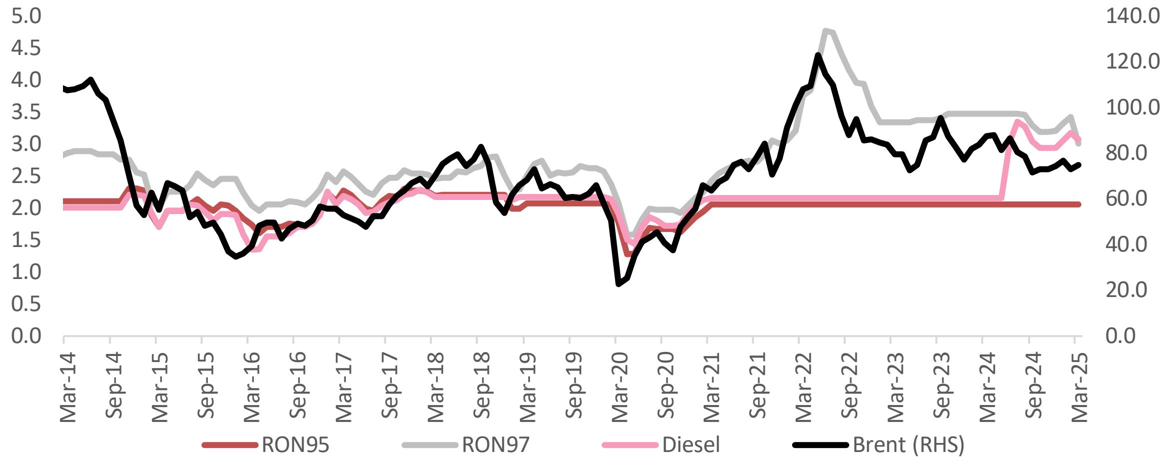
- Besides the lower global oil prices, which would translate into lower unsubsidized RON95 fuel prices, the pressure from subsidy removal is expected to be less significant this time around, as it will apply only to the top 15% (T15) income group and foreigners. Additionally, the implementation of "Ops Kesan" will ensure that no parties take advantage of the subsidy targeting by unreasonably increasing prices, helping to prevent further price hikes.

THE HISTORICAL IMPACT OF FUEL SUBSIDY MECHANISM CHANGES ON THE HEADLINE INFLATION

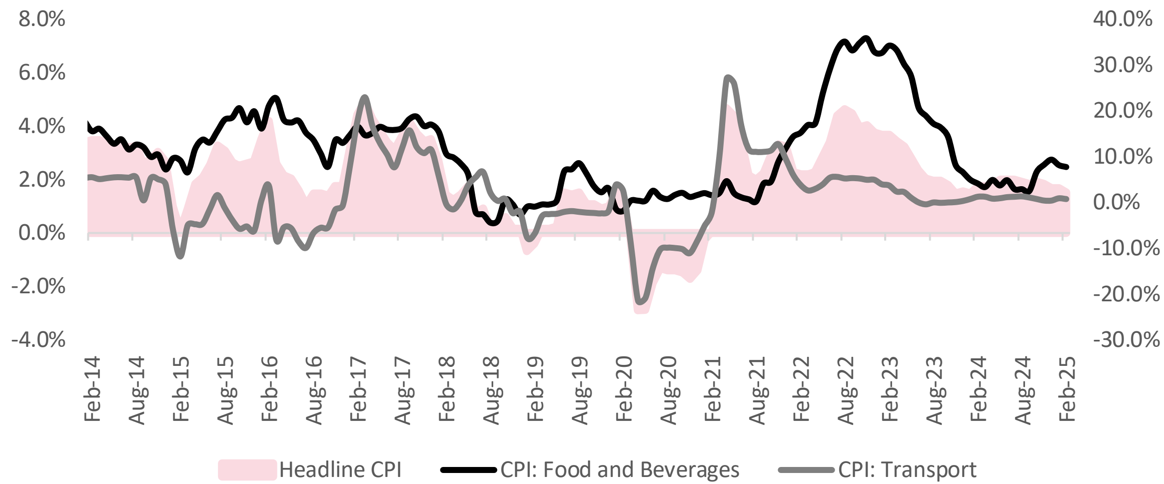
- Over the past decade, Malaysia has made several adjustments to its fuel subsidy mechanism, and each change has had a notable impact on inflation, particularly in transportation costs, which make up a major portion of the Consumer Price Index (CPI). Despite being the third largest component of the CPI basket, headline inflation movements closely mirror the movement of transport index rather than the food and beverages index (refer to chart 8 and 9). A significant pickup in inflation occurred particularly when the government implemented the managed float system during a period of rising global oil prices. The 10-year period, from 2014 to the present, will be used to observe inflation trends whenever adjustments are made to the fuel subsidy pricing system.

Chart 7: Fuel Price (RM/litre) vs Brent Oil (USD/barrel)



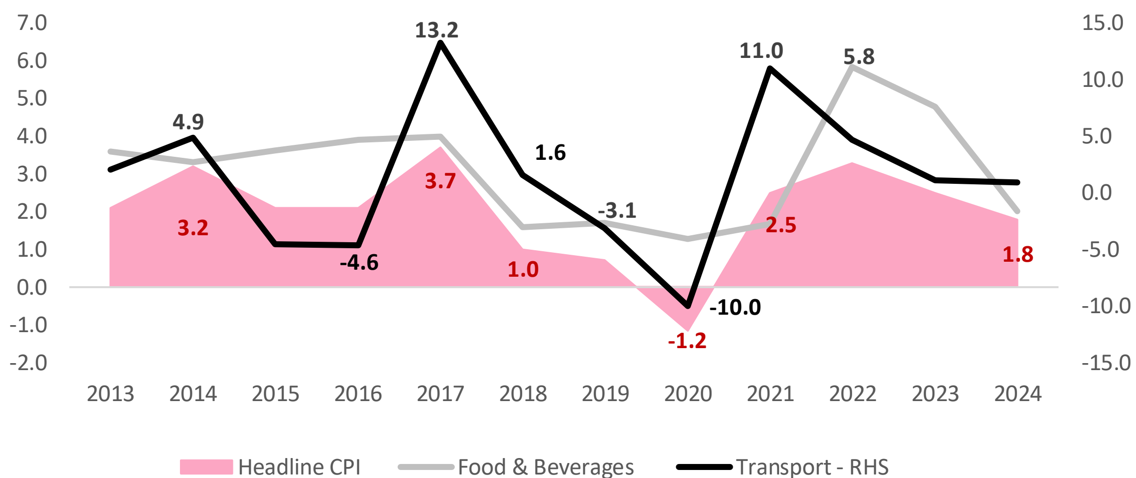
Sources: DOSM, CEIC, Bloomberg

Chart 8: Monthly Headline Inflation with Key Components (yoy, %)



Sources: DOSM, CEIC

Chart 9: Annual Headline Inflation with Key Components (yoy, %)



Sources: DOSM, CEIC

November 2014 – March 2018: Introduction of Managed Float System

- In November 2014, Malaysia phased out its long-standing blanket fuel subsidy system and transitioned to a managed float mechanism. Under this system, fuel prices were adjusted monthly in line with global crude oil movements. At the time, the government reduced petrol and diesel subsidies by 20 sen, setting the retail prices of RON95 and diesel at RM2.30/litre and RM2.20/litre, respectively. This shift coincided with a decline in global oil prices, with Brent crude averaging USD79.60/barrel in November 2014 (October: USD88.05/barrel). The move was aimed at allowing consumers to benefit from lower pump prices during periods of falling global oil prices, while simultaneously easing the government's fiscal burden by reducing fuel subsidy allocations.

- However, by 2017, as global oil prices rebounded, the managed float system led to frequent price increases at the pump. This contributed to a sharp 13.2% rise in transportation costs, a significant reversal from a 4.6% decline the previous year. The spike in transport costs became the primary driver of inflation that year, which surged to 3.7% after being steady at 2.1% for two consecutive years. Notably, the transport index contributed 1.6 percentage points to overall inflation, surpassing the 1.3 percentage-point contribution from food and beverages, despite the latter having a larger weight in the CPI basket. Part of the increase in transport inflation was also due to a low base effect from the previous year.

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2018: Fixed Price Cap Reintroduced

- In April 2018, the newly elected Pakatan Harapan government reinstated a fixed price ceiling for RON95 petrol and diesel at RM2.20/litre and RM2.18/litre, respectively. This measure was introduced in response to rising global oil prices, with the aim of stabilizing domestic fuel costs and shielding consumers—particularly those in lower-income groups—from sudden price spikes. The reintroduction of price controls played a key role in curbing inflationary pressures. Headline inflation dropped sharply to 1.0% in 2018, a significant decline from 3.7% in the previous year. Transportation inflation also eased markedly to 1.6%, following a steep rise in 2017, while inflation in food and beverages similarly moderated to 1.6%. The fixed price mechanism was designed to provide consumers with greater cost stability amidst global oil price volatility. It also reflected the government's broader commitment to controlling the cost of living. In addition to fuel price stabilization, the significant moderation in overall inflation in 2018 was further supported by the zero-rating of the Goods and Services Tax (GST), which took effect in June 2018 and temporarily eliminated the 6% consumption tax, providing additional relief to households and businesses.

2019-2020: Fluctuating Fuel Prices and COVID-19 Impact

- In January 2019, the government reverted to a weekly managed float system for fuel pricing, aligning domestic prices more closely with global crude oil movements. This transition allowed consumers to benefit from falling oil prices, with RON95 petrol dropping to RM1.99/litre and diesel prices declining by 6 sen from the previously fixed ceiling. However, amid renewed volatility in global oil markets, the government reinstated a price ceiling in March 2019, capping RON95 at RM2.08/litre and diesel at RM2.18/litre to provide a degree of price stability. The lower average fuel prices in 2019 compared to 2018 contributed to a notable decline in transport costs, which recorded deflation of -3.1%. This, in turn, helped pull overall inflation down to just 0.7%, even as the food and beverage index remained stable at 1.7%. The data clearly illustrates that transport inflation—heavily influenced by fuel prices—tends to move in tandem with headline inflation.

- This pattern continued into 2020, when the COVID-19 pandemic triggered a steep collapse in global oil prices. In response, the government fully removed the fuel price ceilings in February 2020 and shifted to a floating market-based pricing mechanism. With Brent crude oil averaging just USD43.20/barrel that year, down from USD64.20/barrel in 2019, domestic fuel prices dropped significantly. As a result, inflationary pressures eased further—headline inflation turned negative at -1.2%, while the transport index plunged to -10.0%. These developments underscored the close correlation between fuel prices and Malaysia's broader inflation dynamics.

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2021 - 2023: Price Capping Amid Rising Oil Prices

- Following the gradual reopening of economies after the health crisis, global oil prices began to recover. In response, the Malaysian government implemented a price ceiling on RON95 petrol and diesel at RM2.05/litre and RM2.15/litre, respectively, starting in March 2021. Despite the cap, the rebound in fuel prices exerted inflationary pressure, particularly on transportation costs, which surged by 11.0% in 2021 (2020: -10.0%). As a result, headline inflation rebounded to 2.5% (2020: -1.2%). However, inflation in the food and beverages category remained relatively contained, edging up to 1.7% from 1.3% in the previous year.

- In 2022, although global oil prices continued to rise, the fuel price cap helped to moderate transportation inflation, which increased by a more subdued 4.7%. In contrast, food and beverage inflation accelerated sharply to 5.8%, becoming the main contributor to the headline inflation rate of 3.3%. As illustrated in Chart 9, inflation during this period was primarily driven by food prices. Several factors contributed to this surge, including pent-up post-pandemic demand, persistent global supply chain disruptions—exacerbated by the Russia-Ukraine war—and a weaker ringgit, which raised the cost of imported food items. Without the government's continued price controls and fuel subsidies, inflation in 2022 would likely have mirrored the sharper price increases seen in many other economies.

- In 2023, the food and beverages category remained the key driver of inflation, accounting for 1.5 percentage points (ppt) of the 2.5% overall increase in headline inflation. In contrast, transportation inflation was subdued, rising only 1.1%, as fuel prices (RON95 and diesel) remained unchanged under the existing price cap.

2024: Diesel Subsidy Removal in Peninsular Malaysia

- Effective June 10, 2024, the government removed diesel subsidies in Peninsular Malaysia, causing diesel prices to surge from RM2.15 to RM3.35 per litre. Despite the sharp price increase, the overall impact on inflation was relatively modest, as diesel makes up only a small portion of the CPI basket. As a result, transportation costs recorded an average increase of just 1.0%, while food and beverage inflation remained moderate at 2.0%. Consequently, headline inflation registered at 1.8% for the year, reflecting the limited pass-through effect of diesel price adjustments on broader consumer prices.

FUEL PRICES AND INFLATION DYNAMICS IN MALAYSIA: A CLOSER LOOK

- In Malaysia, the relationship between fuel price movements and headline inflation is notably strong, largely due to the direct impact of fuel costs on transportation prices, which in turn represent a significant component of the CPI. Although the food and beverages (F&B) category carries a larger weight in the CPI basket, historical trends show that changes in fuel prices tend to drive more immediate and pronounced shifts in headline inflation.

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- This pattern is particularly evident during periods when domestic fuel prices are allowed to float, aligning more closely with global crude oil prices. In such instances, the transport index often becomes the main driver of inflation trends, overshadowing other components of the CPI. Conversely, during periods of government interventions such as price ceilings or subsidies—the pass-through effect of global oil price fluctuations to domestic inflation is significantly dampened. This weakens the traditional correlation between fuel prices and headline inflation, resulting in more stable inflation readings despite volatile international energy markets.

- For instance, in 2022, global oil prices remained elevated following supply shocks triggered by the Russia-Ukraine conflict and lingering post-pandemic supply chain disruptions. However, the Malaysian government's decision to maintain the RON95 petrol price cap at RM2.05/litre insulated consumers from the full impact of higher global energy costs. As a result, transportation inflation rose only moderately by 4.7%, while food and beverage inflation surged by 5.8%, becoming the primary contributor to the 3.3% headline inflation rate. This marked a significant shift in inflation dynamics, as F&B inflation overtook transport inflation as the dominant driver, a rare occurrence in Malaysia's inflation history.

Looking at longer-term trends, fuel price deregulation—such as during 2018 and prior to mid-2021—has historically led to stronger correlations between transportation and headline inflation. When domestic prices are not shielded from global fluctuations, as seen in earlier subsidy rationalization phases, any surge in international oil prices tends to transmit rapidly into the CPI via the transport component.

- Most recently, in June 2024, the government removed diesel subsidies in Peninsular Malaysia, leading to a price hike from RM2.15 to RM3.35 per litre. While this was a significant increase in relative terms, its overall inflationary impact remained limited due to diesel's low weight in the CPI basket. Consequently, transportation costs rose by only 1.0% on average, while food and beverage inflation stood at 2.0%, bringing headline inflation to just 1.8%. This episode illustrates how fuel-specific impacts on inflation depend not just on price changes but also on the weight of the item in the CPI basket and the breadth of its pass-through to other sectors.

- In summary, while fuel prices play a crucial role in shaping Malaysia's inflation trajectory, the degree of their influence is largely policy-dependent. When subsidies and price controls are in place, the link between fuel prices and inflation is weakened, often shifting the burden of

  inflation to other components like food. In the absence of such controls, fuel prices—particularly petrol—exert a stronger and more direct influence on headline inflation. As Malaysia continues to navigate fuel subsidy reforms, understanding this relationship will be critical for forecasting inflation and designing targeted policy responses.

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WHAT TO EXPECT FOR INFLATION IN 2025: A POLICY-CALIBRATED OUTLOOK

- Malaysia's inflation trajectory in 2025 will be shaped by a combination of domestic policy adjustments and evolving global macroeconomic conditions, particularly those tied to energy subsidies, wage reforms, and trade policy risks.

- **Shifting Weight in CPI: Less Inflation Sensitivity from Transport**. Historically, the transport index has been a key determinant of headline inflation, particularly due to its sensitivity to fuel price movements. Prior to 2024, transport made up 14.6% of the Consumer Price Index (CPI) basket, with fuel and lubricants for personal transport alone accounting for 8.5%. However, following the CPI basket rebasing in 2024, the transport category's weight was reduced to 11.3%, with fuel's subcomponent falling to just 5.9%. This structural shift implies that changes in domestic fuel prices—while still relevant—will now have a diminished direct impact on overall inflation compared to previous years. In comparison, food and beverages (29.8%) and housing and utilities (23.2%) remain the largest CPI categories, meaning that inflationary pressures stemming from these segments will likely play a larger role in shaping headline trends going forward.

Table 1: Weightage of CPI basket by Main Group

Groups	Weightage (%)	
	Before	Now
Food & Beverages	**29.5**	**29.8**
Housing, Water, Electricity, Gas & Other Fuels	**23.8**	**23.2**
Transport price	**14.6**	**11.3**
Fuels & lubricants for personal transport equipment	8.5	5.9
Others	**32.1**	**35.7**

Sources: BNM, Bank Islam

- **RON95 Subsidy Reform: Muted Inflationary Impact Expected**. If the government proceeds with its proposed plan to remove RON95 fuel subsidies in mid-2025, targeted specifically at the T15 income group and foreigners, the inflationary impact is expected to be manageable and narrower in scope than during previous subsidy rationalisation episodes. For context, in 2017, the full implementation of a managed float system—combined with surging global oil prices—led to a headline inflation spike to 3.7% (2016: 2.1%) and transportation inflation skyrocketing to 13.2%. However, today's environment is markedly different:

    - The smaller weight of the transport index reduces the mechanical impact on CPI.
    - The subsidy reform is targeted, not universal.
    - There is a softer outlook for global oil prices, driven by concerns over slowing global demand, potential oversupply, and escalating US-led reciprocal tariffs that are expected to disrupt trade flows and weigh on energy consumption.

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- Should Brent crude oil prices fall below USD 50/barrel amid weaker global growth, the removal of RON95 subsidies is expected to lift inflation only marginally to around 2.2%. Conversely, if subsidies are left in place, inflation is likely to remain anchored near 2.0%.

- **Trade Tensions and Tariff Impacts: Risks Skewed to the Upside.** The recently announced reciprocal tariffs by the US on Malaysia and other trading partners add a new layer of complexity to the inflation outlook. While the direct impact on CPI is likely limited in the near term, the broader spillover effects from global supply chain disruptions and reduced trade flows could create upward price pressures, especially if input costs rise or import substitution takes hold. Moreover, heightened geopolitical uncertainty and potential retaliatory actions—even if Malaysia chooses a non-retaliatory path—could reduce global trade efficiency, increase logistical costs, and lead to imported inflation across several categories, particularly food and manufacturing inputs.

- **Domestic Cost Pressures: Wages, SST, and Tariffs**. On the domestic front, several policy shifts are expected to push inflation modestly higher:

  1. Minimum wage increased to RM1,700 effective February 2025 is likely to raise wage costs across sectors, especially in services and F&B, with potential pass-through to consumer prices.
  2. Broader Sales and Services Tax (SST) coverage, as announced in the government's fiscal consolidation plans, may also add an upward pressure on prices, particularly for discretionary goods and services.
  3. A revised electricity tariff is anticipated in 2H2025 as part of Regulatory Period 4 (RP4). The change is part of the 3-year Regulatory Period 4 (RP4) that will be effective from January 2025 to December 2027, replacing RP3 2022-2024. While electricity only accounts for 3.1% of the CPI basket, any upward revision—especially amid rising energy transition costs—could feed into household and industrial expenses. That said, the government has provided a six-month grace period (January to June 2025) to ease adjustment pressures.

- **Our Baseline CPI Forecast for 2025**. Taking into consideration multiple factors, including the planned targeted removal of fuel subsidies, a soft outlook on global oil prices, and potential inflationary spillovers from recent reciprocal tariffs, we are maintaining our headline inflation forecast at 2.7% for 2025. This forecast remains well within the Ministry of Finance's projected range of 2.0% to 3.5%. While we acknowledge that the balance of risks has shifted to the upside, particularly in light of escalating trade tensions, possible global supply chain disruptions, and the risk of a commodity price rebound—we believe these pressures will be mitigated by existing policy buffers. These include targeted fuel subsidies, ongoing price controls, and the phased implementation of major policy changes, such as electricity tariff adjustments and minimum wage hikes. Given these offsetting factors, we see no compelling reason to revise our forecast at this juncture. We will, however, continue to monitor global developments closely, particularly as the full implications of the US tariff measures become clearer in the coming months.

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