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Budget preview 2026: Modest consolidation; focus unchanged

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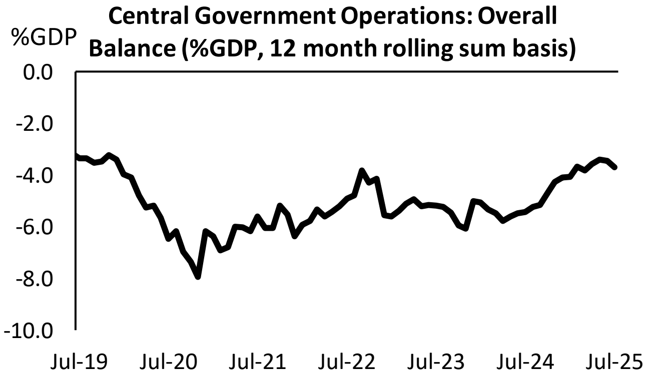
- The 2026 budget will be delivered on 10 October, and we expect modest fiscal consolidation to continue even as external headwinds build.
- We expect the 2026 fiscal deficit to be narrower at 3.4-3.6% of GDP from 3.8% in GDP in 2025. This is premised on resilient revenue growth assumptions as expenditures remain focused on operational items.
- With fiscal policy geared in the right direction, Bank Negara Malaysia (BNM) will likely remain on hold at its 6 November meeting. We still, however, see room for another 25bp cut in 1H26.

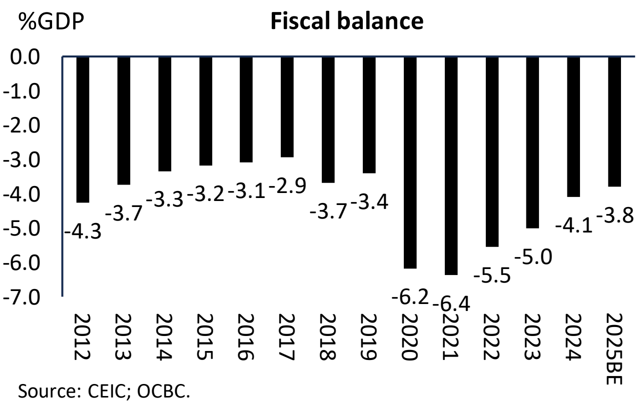
Budget 2026 will be delivered on 10 October against a backdrop of external headwinds juxtaposing domestic economic resilience. Although the authorities of Malaysia and US struck a deal for reciprocal tariffs at 19%, sector specific tariffs on semiconductors remains a critical unknown. GDP growth averaged 4.4% in 1H25, while incoming activity data for July pointed to some resilience ahead of the implementation of reciprocal tariffs on 7 August. We expect 2025 GDP growth to average 3.9% YoY, but the balance of risks is titled to the upside. For 2026, we expect GDP growth of 3.8%.

2025 budget deficit target likely to be met

The government is on track to meet its 2025 fiscal deficit target of 3.8% of GDP, in our view. Solid tax revenue collections and subsidy rationalisation have allowed the fiscal deficit to narrow to 3.7% of GDP on a 12-month rolling sum basis, as of July 2025. There is a chance that the 2025 fiscal deficit could undershoot the target, but this will be known only in 4Q25 once the mechanism of RON95 rationalisation is clearer. The announcement in this regard is expected at the end of September.



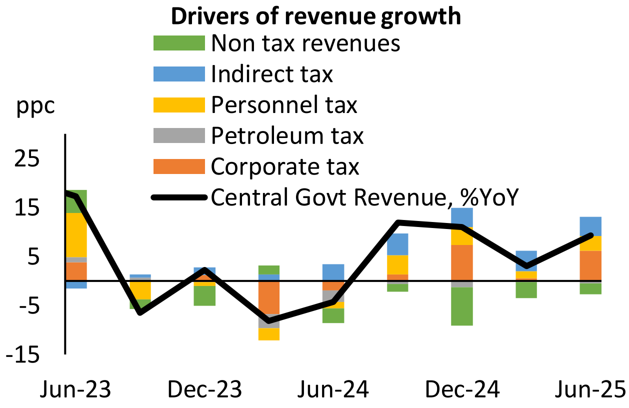
Source: CEIC; OCBC.



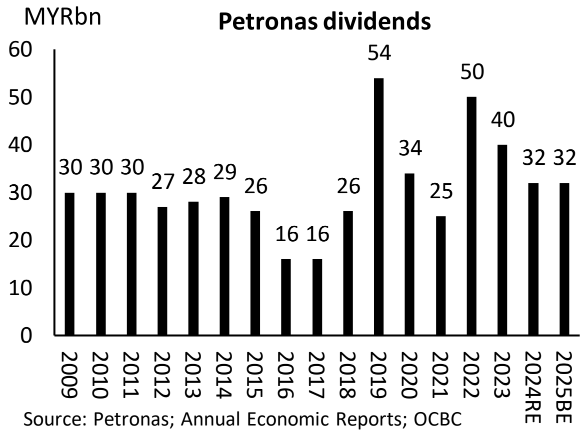
Source: CEIC; OCBC.

Robust tax revenue growth

The details of the drivers of revenue and expenditures, available for 1H25, are encouraging. Revenue collections grew 6.1% YoY in 1H25 compared to 3.1% in 2024. Within this, tax revenues were up 12.6% YoY in 1H25 well outpacing nominal GDP growth of 3.4% for the period. Corporate revenues along with sales and services taxes were the biggest contributors to revenue growth. By contrast, non-tax revenues fell by 12.6% YoY in 1H25 from -11.3% in 2024, likely reflecting lower Petronas dividends and anaemic commodity prices.



Source: CEIC; OCBC.



Source: Petronas; Annual Economic Reports; OCBC

Revenue collections need to rise 3.5% YoY in 2H25 in order for the government to meet the full year target, based on the original budget estimates. However, tax revenues will likely play a bigger part in 2H25 compared to the budget estimate. The government expanded the scope of the sales and services tax on 1 July to a wider array of consumer and luxury goods and thirty previously untaxed services, which could give tax collections a second wind. Our 2025 GDP growth forecast of 3.9% YoY assumes a sharper slowdown in 2H25 compared to 1H25. However, given recent signs of growth resilience, the balance of risks is to the upside further adding to tax revenue prospects.

These will help adjust for the weakness in non-tax revenues, which are likely to fall short of the budget estimates. We nonetheless expect the transfer of Petronas dividends of MYR32bn to continue as projected in Budget 2025.

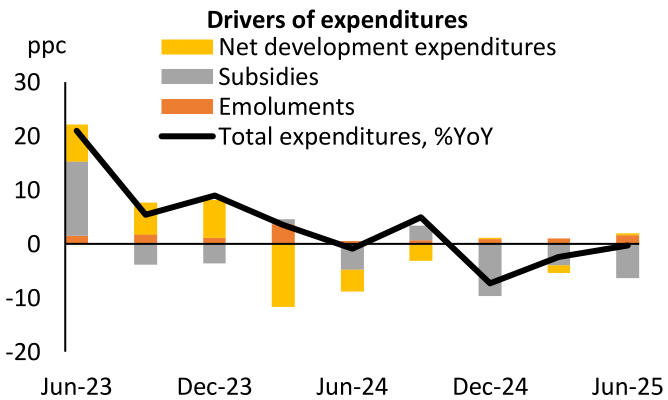
Expenditures will remain geared towards current expenditures

Meanwhile, central government expenditures dropped by 1.3% YoY in 1H25, with current and net development expenditures contracting by 1.1% YoY and 2.4%, respectively. Within operating expenditures, 'subsidy and social assistance' spending fell to -25.7% YoY from -21.2% in 2024 supported by the impact of previous electricity tariff rationalisation, volume restrictions for subsidised RON95 and lowered than budgeted oil prices (USD70/barrel for Brent versus USD80-85/barrel assumed in Budget 2025).

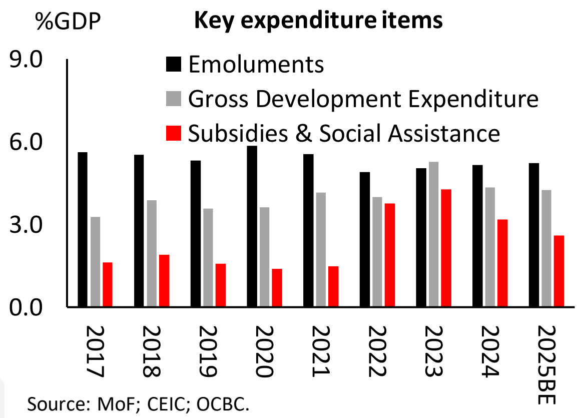
MYRbn	2024		2025		1H25		2H25	
	Actual	%YoY	Budget estimates	%YoY	Actual	%YoY	Based on BE	%YoY
Central Govt Revenue	**324.6**	**3.1**	**339.7**	**4.6**	**147.6**	**6.1**	**192.1**	**3.5**
Tax Revenues	240.2	4.8	259.0	7.8	119.1	12.6	139.9	4.1
Non-Tax Revenues	70.1	-11.3	80.7	15.1	27.0	-12.6	53.7	36.9
Central Govt Expenditures	**403.8**	-0.6	**419.7**	**3.9**	**188.1**	**-1.3**	**231.6**	**8.7**
Central Govt Current Expenditure	**321.5**	3.3	**335.0**	**4.2**	**155.3**	**-1.1**	**179.7**	**9.3**
Emoluments	99.8	8.6	105.9	6.2	51.0	4.1	54.9	8.1
Pension and Gratuities	35.9	5.3	40.6	13.0	19.5	1.8	21.1	25.6
Debt Service Charges (DS)	50.5	9.0	54.7	8.4	26.4	7.9	28.3	8.8
Supplies and Services	37.7	4.9	40.7	7.9	16.8	9.6	23.8	6.8
Subsidies & Social Assistance	61.4	-21.2	52.6	-14.4	23.6	-25.7	29.0	-2.2
Asset Acquisition	1.2	16.2	1.2	-0.6	0.3	44.2	0.9	-10.1
Net Development Expenditure	**82.3**	-13.5	**84.7**	2.9	**32.7**	**-2.4**	**51.9**	**6.6**
Gross Development Expenditure	84.0	-12.6	86.0	2.4	33.3	-1.9	52.7	5.3
Loan Recoveries	1.7	72.4	1.3	-23.9	0.5	37.5	0.8	-41.9
Fiscal balance	**-79.2**	-13.4	**-80.0**		**-40.5**			
% GDP	-4.1	-18.2	-3.8					

Source: Ministry of Finance; OCBC.

There is other subsidy rationalisation in the pipeline to further the fiscal consolidation agenda. The government did press ahead water tariff rationalisation. Effective 1 September, the water tariffs for high consuming households and industrial consumers will rise anywhere between 22-33%, while the tariff rate for low-use domestic households will remain unchanged. Importantly, the government is due to announce the mechanism of RON95 rationalisation by end of the month – the timeline for the reform was delayed from mid-2025 until end September.



Source: CEIC; OCBC.



Source: MoF; CEIC; OCBC.

Meanwhile, emoluments as well as pensions and gratuities expenditures are expected to remain sticky. Emoluments spending rose by 8.1% YoY in 1H25 from 8.6% in 2024, while 'pensions and gratuities' expenses were up by 25.6% YoY from 5.3% in 2024. These reflect policy changes including the first phase of civil servant salary increases, effective 1 December 2024. By contrast, development spending will likely remain more constrained. Although the decline in gross development expenditures narrowed to -1.9%YoY in 1H25 from -6.3% in 2024, the full year budget implies a drop of 6% YoY in 2H25.

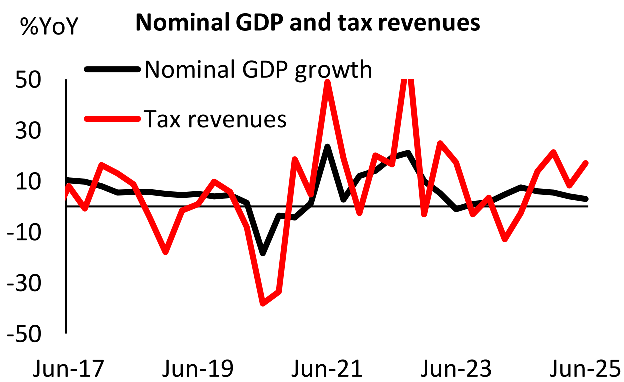
Budget 2026: Modest consolidation, similar focus

The pre-budget statement indicates three focus areas for Budget 2026 including driving reform and good governance, raising the ceiling, and raising the floor. Each of these priorities is further fleshed out. To drive reform and good governance, the government will focus on fiscal governance, modernising public finance through technology and stepping up GovTech initiatives. In order to raise the ceiling, the government will focus on key policy levers introduced in recent years, and to raise the floor, the focus will be labour market reform and public services such as healthcare and education.

We expect objectives to be translated into revenue, expenditure and deficit targets for Budget 2026 in line with medium-term fiscal targets. The 13 Malaysia Plan (MP), passed in parliament on 3 September 2025, reaffirms the government's commitment to reduce the fiscal deficit to below 3% of GDP and the public debt to GDP ratio to under 60% by 2030. These medium-term commitments were set out in the Public Finance and Fiscal Responsibility Act 2023 (FRA).

For 2026, we assume revenue growth of 6-7% YoY supported mainly by tax revenue collections, which are still likely to outpace nominal GDP growth, at close to 10% YoY. Our 2026 GDP growth forecast is 3.8% YoY from 3.9% in 2025. We expect revenue growth to be supported by reforms enacted so far including the broadening of the sales and services tax base and the full adoption of e-invoicing across all companies. Continued efforts towards digitalisation and efficiency improvements to bolster revenue collections.

In terms of new taxes, the government noted in Budget 2025 that it will introduce a carbon tax in 2026. Given the government's focus on boosting public health services, incremental hikes to 'sin' products such as alcohol and tobacco cannot be ruled out. Higher tax rates for these products can be used to cross-subsidise healthcare priorities. The reintroduction of the goods and services tax (GST) may not be explored in Budget 2026 considering external headwinds. However, if it is, we would view it as a positive development.



Source: CEIC; OCBC.

Key infrastructure projects mentioned in 13MP
Regasification Terminal 3 (RGT 3)
Electricity grid Sarawak to Peninsular Malaysia
Special Tourism Investment Zone in Johor, Melaka, Negeri Sembilan, Sarawak
Westports 2 container terminal
Elevated Autonomous Rapid Transit (E-Art) in Iskandar Johor Baru
Penang Pearl Light Rail Transit
Widening of PLUS highway for Senai Utara-Machap, Johor and Juru-Sg Dua, Penang
Upgrading Tok Bali, Kelantan port
Upgrading Sepanggar, Sabah port
Hospitals - Sultanah Aminah 2 JB, Cancer Centre Sg Petani
Third terminal: Carey Island
Affordable housing and housing in Kota MADANI
Expansion of Sapanggar Bay Container Port
Water catchment-water treatment-flood mitigation plant - Sg Klang to Sg Rasau Selangor

Source: 13th Malaysia Plan; OCBC.

On the expenditure side, we expect growth of 5-6% on account of current expenditures, namely social assistance, emoluments and pensions/gratuities. Under phase 2 of the Public Service Remuneration System, the incremental salary for civil servants will rise by 3-7% depending on the grade of the civil servant from 1 January 2026. We also pencil in additional support for households and businesses, particularly SMEs, that are juggling higher costs including electricity and water bills, minimum wages hikes and a potential progressive wage policy from 2026 onwards. The government has room to provide counter-cyclical policy measures to support household spending in the form of cash handouts. Support measures for SMEs could come in the form of delayed tax payments and/or credit allowances.

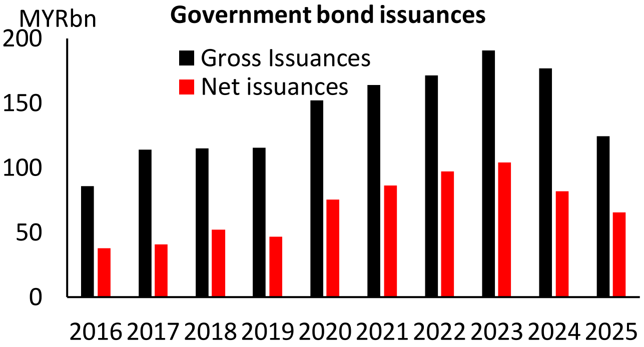
On subsidy rationalisation, we expect the government to press ahead with a targeted approach. The finer details of the RON95 rationalisation, to be announced at the end of September 2025, will determine the extent of fiscal savings and the impact on inflation in the coming months but importantly 2026.

On-budget investment spending likely to remain stable

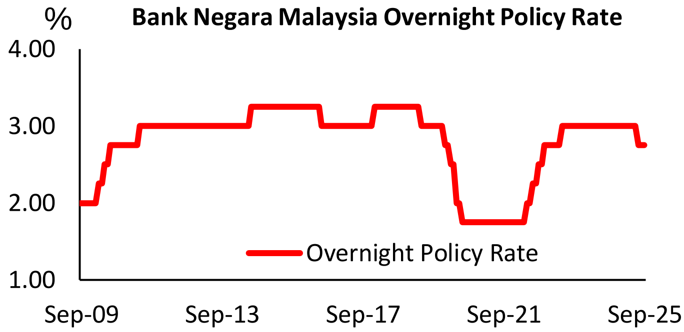
Development expenditures are projected to be MYR430bn for the period of 2026-30, i.e., MYR86bn per annum. This is similar to the amount pencilled in 2025, implying relatively steady development expenditure assumptions for 2026. Apart from the federal government, we see support for investment spending coming from other players as well including the private sector, state and local governments, statutory bodies and non-financial public companies. Indeed, there is a strong pipeline of public projects that can sustain development spending through the 13MP (2026-30) and be supported through public-private partnerships. These include the construction of the third terminal at Carey Island, Westports 2 container terminal, Perlis land port and Penang Pearl LRT projects. In addition, public sector contribution to development objectives will likely be supported through programs such as GEAR-uP that encourages GLICs to increase investment spending.

Fiscal deficit and debt profile

Putting it altogether, we estimate that the fiscal deficit for 2026 will be pegged between 3.4-3.6% of GDP from 3.8% of GDP in 2025. As of end-June 2025, we estimate that the outstanding MGS, MGII and MITB was below the 65% of GDP ceiling at 62.5%. We expect the government will retain this measure of debt below the stipulated ceiling, assuming the 2025 fiscal deficit is met.



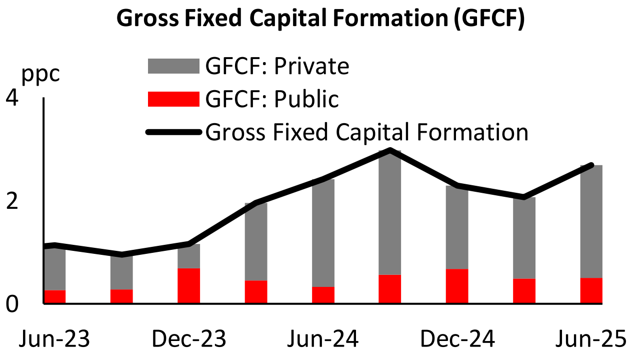
Source: BNM; OCBC.



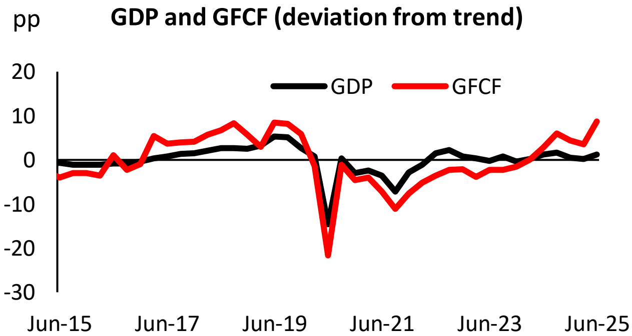
Source: Bank Negara Malaysia, CEIC, OCBC

Watching broader investment spending trends

Despite the softness in on-going government spending, investment spending trends have remained strong in 1H25. Recent investment spending has been broad-based supported by the public and private sectors, corroborated by strong investment approvals. Indeed, gross fixed formation as measured on the national accounts has been expanding above trend for 4-6 quarters through to 2Q25.



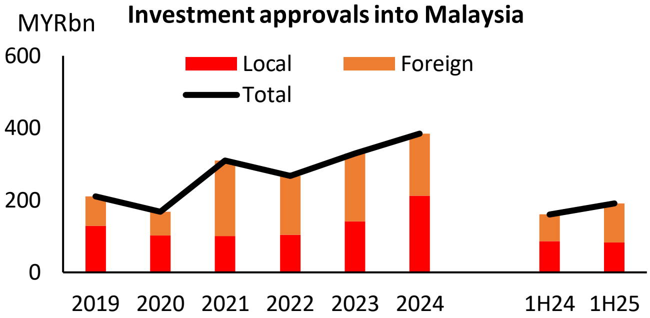
Source: CEIC; OCBC.



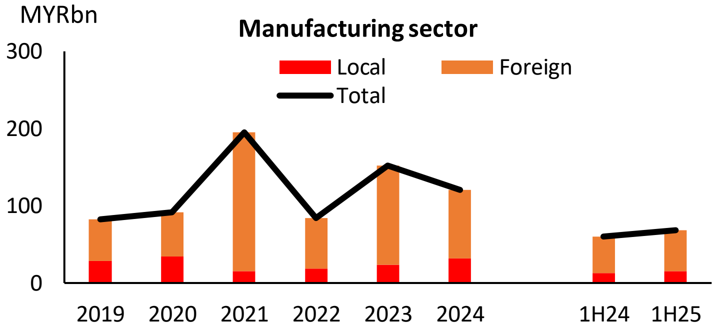
Source: CEIC; OCBC.

Heightened external uncertainties will likely give firms pause of cause as supply chains reorient to accommodate for reciprocal tariffs and rising trade barriers. Our baseline has pencilled some moderation in broader investment spending in 2H25 and 1H26 given the heightened external uncertainties.

Admittedly, the latest data is mixed in this regard, but we do discern some changes that could be telling. Private sector investment approvals for the primary, manufacturing and services sectors suggest some divergence between foreign and local approvals. Foreign approvals rose by 43.5% YoY in 1H25 from -9.1% in 2024 even as approvals for local investments dropped by 2.7% YoY in 1H25 after rising 51% in 2024.

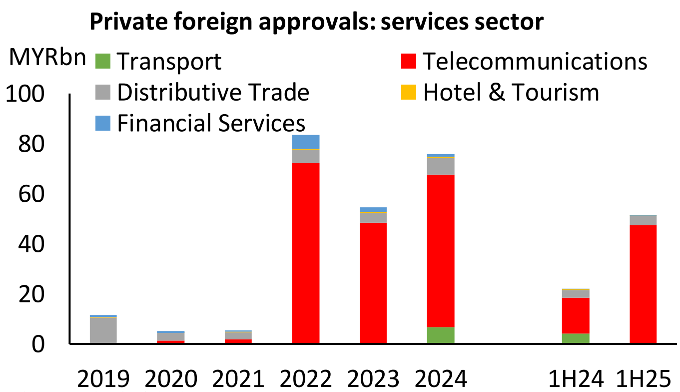


Source: CEIC; OCBC.

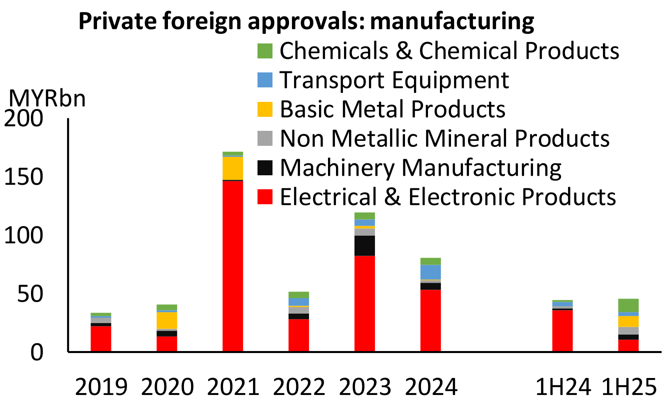


Source: CEIC; OCBC.

Foreign approvals supported the services sector and manufacturing sectors. Within the services sector, approvals in the telecommunications sector increased sharply in 1H25 likely to support the strong manufacturing investments in data centres in recent years[1]. Interestingly, on the manufacturing side, foreign approvals for the electrical and electronics products (E&E) sector narrowed sharply to MYR10.5bn in 1H25 from MYR35.6bn in 1H24 (2024: MYR53.3bn) while approvals became more broad-based for other sectors such as basic metal products and chemicals and chemical products. This ties in with anecdotal evidence that investments into data centres may be slowing[2].



Source: CEIC; OCBC.



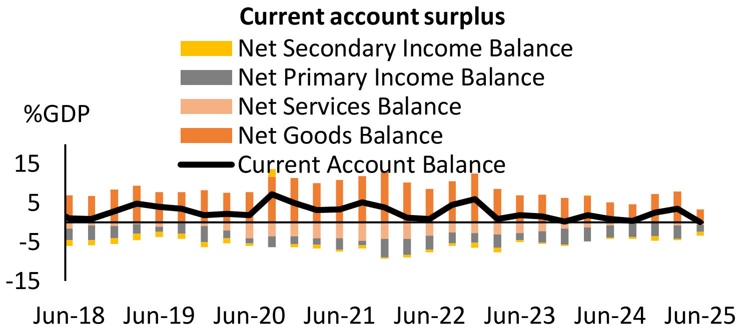
Source: CEIC; OCBC.

Current account surplus dynamics warrants a closer look at imports

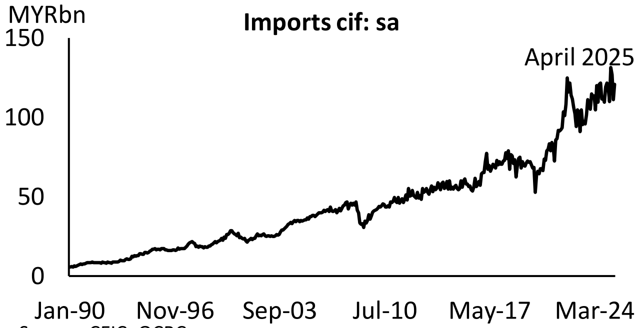
Moreover, investment spending growth could be impacted by a more staggered pace of importation of capital and intermediate goods. This would be done to mitigate some of the recent volatility witnessed in the trade and current account surpluses. Investment spending has a direct impact on the current account balance through the savings minus investments identity. With investment spending rising sharply in recent years, the current account surplus has narrowed sharply to 0.1% of GDP in 2Q25 from 3.4% of GDP in 1Q25 (2024: 1.4% of GDP).

[1] Malaysia is emerging as a data center powerhouse amid booming demand from AI, CNBC, 16 June 2025.
[2] Malaysia reins in data centre growth, complicating China's AI chip access, Reuters, 12 September 2025.

Specifically, the trade surplus narrowed to MYR0.8bn in April, the lowest since the pandemic. The monthly import bill hit a historic high of MYR131.4bn in April 2025 (in seasonally adjusted terms) while export growth remained volatile subject to tariff related idiosyncratic behaviours.



Source: CEIC; OCBC Bank



Source: CEIC; OCBC.

The interplay of the impact of tariffs on Malaysia's exports to the US and resilient domestic demand will pressure the current account surplus in the coming months. The services, primary and secondary income accounts will likely remain in a deficit in 2H25 and 2026, hence the trade surplus is expected to support the overall current account surplus. Our base case is for a current account surplus to be maintained at 1.4% of GDP in 2025 and 1.1% in 2026. This would, however, imply a reduced pace of importation.

While a monthly trade deficit cannot be ruled out in the coming months or 2026 considering export volatilities, we believe imports will become more staggered as capital and intermediate goods imports are paced out. This was underscored by smaller monthly import bills from May-July 2025. The wild card is export growth, which is likely to be more volatile in the coming months as the impact of the frontloading of exports to the US fades (see *ASEAN-5 & India: Bracing for impact*, 19 August 2025).

Monetary policy to remain in wait-and -see mode

In terms of monetary policy implications, continued fiscal consolidation, a focus on the reform agenda and BNM's less dovish to more neutral bias at its 5 September meeting suggests that monetary policy will remain in wait-and-see mode in the near-term. We now expect BNM to remain on hold at its 6 November meeting.

However, given our view that GDP growth will slow sharply in 2H25 and 2026, we see the door as open for another 25bps rate cut from BNM likely in 1H26. The risk to our call stems from GDP growth remaining more resilient than is pencilled into our baseline for the remainder of this year and 2026. This would likely allow BNM to keep monetary policy settings unchanged rather than ease further.

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