Economic Trends
(November 2011)

The World Economy
China has become the second largest economy in the world, overtaking Japan in 2010. China is poised to overtake the U.S. economy to become number one by 2016. Structural issues affecting both the U.S. economy and the Eurozone are fueling, once again, anticipation of a world economy to come with China in the centre. The prolonged twin deficits have led to further deepening of U.S. foreign debt which is simultaneously shouldered by other nations as alluded to by the Triffen paradox (potential dollar devaluation diminishing the value of foreign reserves of nations).

The problem in Europe is monetary union but comprised of independent sovereign nations. The Greek economy has fallen apart, while Italy, Spain, Portugal and Ireland are faltering. On a common currency, none can apply their own monetary policy tools. In fact the Euro-zone registers a trade surplus which means that Europe as a whole is not in crisis other than a handful of member countries in dire states. Financial bail-outs of badly managed nations are politically unacceptable to people in the well performing nations like Germany. Meanwhile, austerity demands are also unacceptable to the people in poor performing nations because they are imposed from abroad. The lesson learnt therefore is can countries remain politically sovereign to manage on their own but economically integrated such that all have to succeed or fail as one?

One thing is true though. Newly industrialized economies and emerging economies have overtaken rich countries contributing to global economic growth through higher growth of their economies and trade.

Economic Indications

Economic growth
Malaysia's GDP growth from 2011 to 2012, based on the Treasury's *Economic Report* released in October, is projected at 5.4% from RM557b. to RM588b. in 2000 constant dollars (RM775b. to RM838b. current dollars), moderated from the 7% high from 2009 to 2010 which was a recovery figure from -1.7% from 2009 to 2010. It is a fair estimate, given that the projection for ASEAN is in the same range. The world economy is expected to grow at 4.4% (2.5% for advanced economies and 5.6% for the newly industrialized and emerging economies).

Penang's population is 5.6% of the nation but contributes more than 8% of Malaysia's GDP. This means that on a per capita basis, Penang's gross regional product will be 1.3-1.5 times higher than Malaysia's per capita GDP if the Penang's economy grows at the same rate. Whether Penang will outpace the nation depends on two main factors: trade buoyancy and capacity constraints, which will be explored here.

Trade

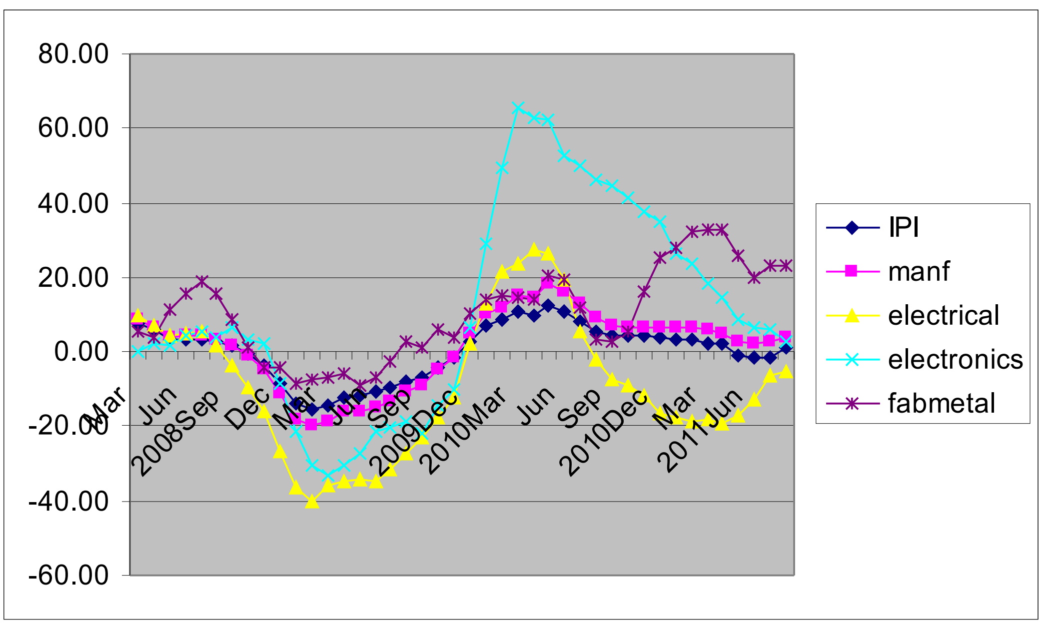
Malaysia's trade surplus of RM146 billion in 2010 is 20% of its gross national income (GNI) of RM750 billion in current dollars is a key component of its economy. Global trade recovered rapidly out of recession, registering 12% expansion in 2010, but it has moderated to the 7% mark. Imports by advanced economies have fallen even more to the mid 5% range but trade by the developing and emerging economies are helping to sustain global trade volumes. There is consensus (barring downside risks) from growth and trade numbers that the outlook for 2012 will not be very different from 2011.

Penang's trade is less diversified than the nation because of the dominance of export oriented manufacturing. Malaysia's exports, on the other hand, also contain commodities especially oil and palm oil that is enjoying the current trend of high commodity prices. This narrower focused source of growth for Penang can be noticed by looking at industrial production

Industrial production

Malaysia's industrial production index (IPI) shown in Figure 1, is a popular coincidental indicator of the economy because it is updated monthly unlike GDP numbers that are only released every quarter. A cyclical pattern can be detected with the IPI falling from the middle 2008 down to negative levels in the middle of 2009 and then turned upwards reaching the peak in the middle of 2010. A downward trend then began before signs of bottoming up appeared by the middle of 2011.

Fig. 1: Industrial Production Indices 2008-2011



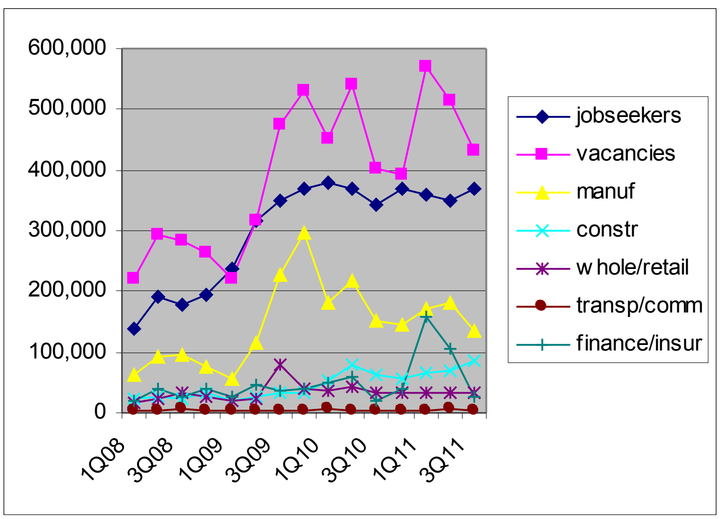
Source: based on Bank Negara Malaysia

Penang's economy is more sensitive to cyclical changes brought by the external economy. The manufacturing trend follows the IPI more closely. However, although both electrical and electronics production also follow the same trend, their cyclical amplitudes are more pronounced. These sectors faced very bad down turns in 2009 but the recovery, in 2010 especially in the case of electronics went well beyond the rest of the manufacturing sector. The fabricated metals sector was trending closely with the others but it appears to have broken away over the course of 2011 to outperform the other sectors. If the cyclical patterns maintain into 2012, there is suggestion that we are currently on the uptrend. This will be good news for Penang, in the sense that while trade figures will likely moderate, the focus on products like electrical and electronics as well as metal fabrication will help push Penang's economy upwards. However, this may not be enough to offset the high commodity prices, particularly oil and palm oil both of which are currently important drivers of Malaysia's GDP.

Consumption

Consumption in Malaysia is heading towards the two-thirds of the GDP that puts it in the ranks of the better developed economies. In China, for example, consumption only makes up one-third of the GDP. While both Malaysia and China are export oriented manufacturing nations with large trade and current account surplus, structurally they are very different. A large consumption share suggests that the middle class population is an important engine of growth in the economy. This should not be confused with the potential for a domestically driven economy shielded from global influences. Exports makes up 80% of the GDP, suggesting that much of Malaysian business and jobs are highly dependent on the outcome of global demand.

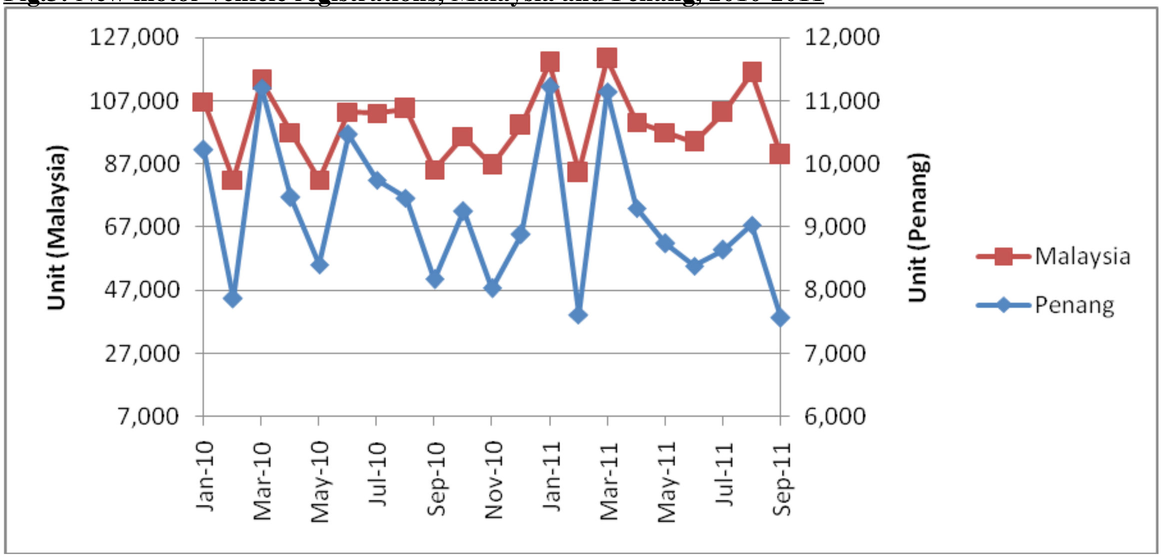
Fig.2: Job vacancies 2008-2011



Job vacancies are shown in Figure 2, revealing also the current downtrend from the middle of 2011. Construction is the exception. However, the number of vacancies remains higher than the 2008 peak and therefore not much negative impact on consumption will be expected during the current downturn.

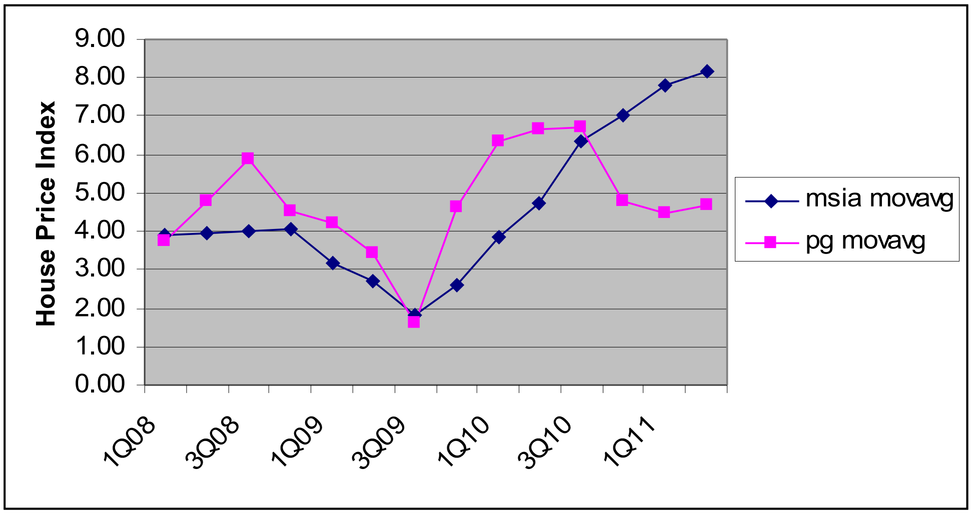
New motor registration is a useful consumption indicator that captures business cycle trends. Consumption of ordinary items tends to be maintained even during economic downturns because people are used to their lifestyles and will offset savings (by more use of the credit card for example) to weather through. People will, however, postpone buying a new car because it is expensive and there is uncertainty about loan servicing during downturns. New motor registrations for both Malaysia and Penang, shown in Figure 3, reveal the downtrend from the middle of 2010 and rising to it peak in 2011. In terms of volume, the peak monthly number at the end of December was around 10000 vehicles in Penang and 110000 for the country, in other words, Penang having a 9% share roughly reflecting the relative size of Penang's economy compared to the nation, suggesting that the state economy is trending closely to the national economy.

Fig.3: New motor vehicle registrations, Malaysia and Penang, 2010-2011



House prices in Penang appear more volatile in Penang compared to the nation. Prices rose much more quickly at the beginning of 2008 and thus took a more severe plunge through to the third quarter of 2009 when the economy went into recession. It made a much faster recovery at the beginning of 2010 but unlike the rest of the nation, prices did not sustain resulted in moderated property values. Consumption of Penang properties is much more affected by foreign buyers (for example under the MM2H programme). There will thus be pronounced cyclical patterns brought about by housing starts and sales promotions.

Fig. 4: House Price Index, Malaysia and Penang, 2008-2011



Middle income trap

In its special report on the world economy, *The Economist* (Sept.24 2011), referring to China' economy, said that the export led economy fueled by low cost labour and infrastructure development is last year's model of economic growth. With its consumption share of the GDP being only one-third compared to Malaysia's two-thirds, China is further behind in its ability to transform the economy. Yet, despite its broader middle class base, income distribution continues to nag at the robustness of Malaysia's economy. With 12.7 million in its labour force (about 700000 in Penang), there are only 6.4 million people registered tax payers and only 2.4 million active tax payers (the rest either earning below taxable income or have retired). This suggests that much of the local economy remains informal with sources of income that are not easily recorded. Personal income tax collections (RM19.7 billion in 2011) account for only 2.5% of the GDP. Meanwhile business profits tax (RM44 billion in 2011) accounts for 5.7% of the GDP. These numbers are indicative of the low wage content inside the GDP as well as low tax incidence.

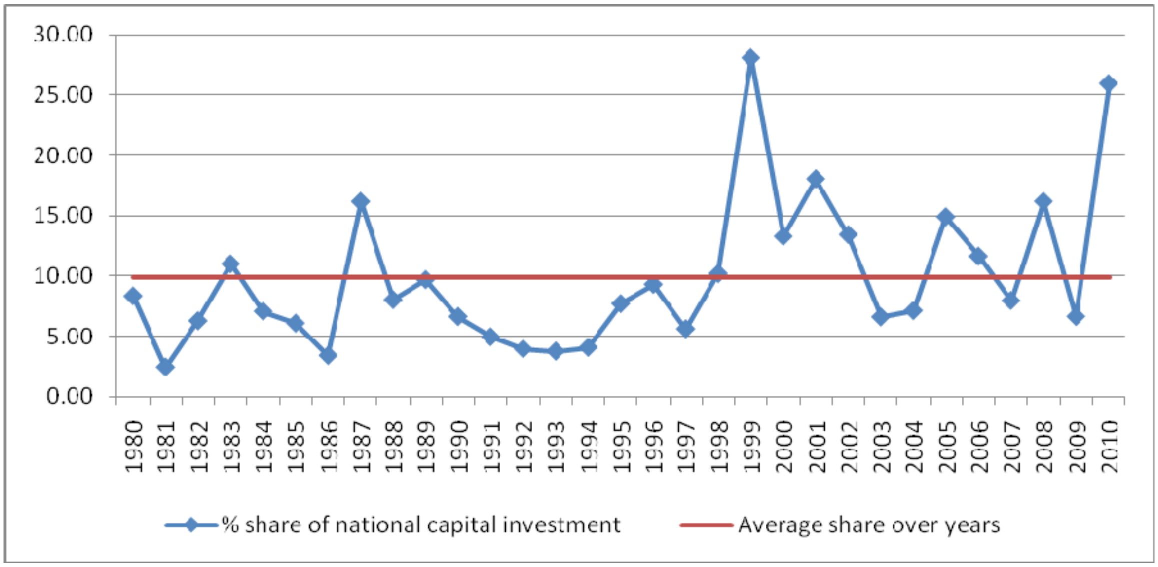
There remains therefore a lot to do if Malaysia's economy is to be transformed in which the means of production moves away from capital and into labour so that more of the income source will come from skills and talent (professionalism) rather than from sales margins. For this to occur, business models must transform to higher value added activities and the skills gap bridged through training of the labour force.

Investments

Malaysia's exports help boost its current account surplus (15% of the GDP) because total domestic investments is 20% of the GDP despite the sizable national savings of 35% GDP. Such a circumstance (which has prolonged for many years) offers Malaysia a lot of shielding from external economic turmoil whether it is exchange rate or trade related. However, it is also indicative of uncompetitive rate of returns from investing locally that has led to capital flight (Malaysians investing overseas) and less foreign direct investments into Malaysia.

Penang topped the manufacturing investments approved by MIDA list in 2010 by getting RM12 billion out of the total of RM47 billion for the whole country. Penang's gross regional product (GRP, the state equivalent of the GDP) makes up less than 9% of the nation and therefore it cannot receive a quarter of the total investments all the time. The amount of investments approved in a particular year will only be spent in stages during subsequent years as the industrial projects get off the ground. A more accurate picture is Figure 5, which shows the investment share over the past 30 years. The average over this period is 10%, which is closer to Penang's contribution to the national economy.

Fig. 5: Penang' share of approved manufacturing investments 1980-2010

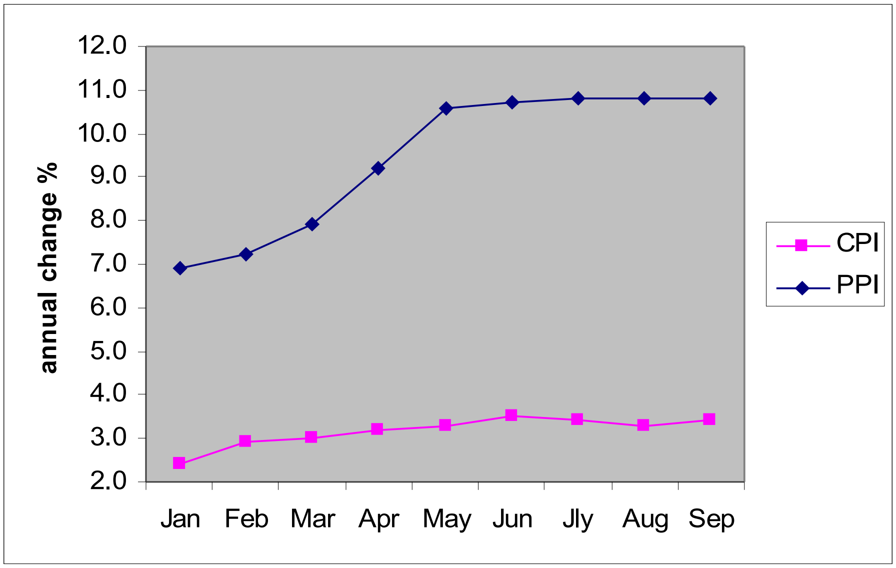


Source: Based on MIDA statistics

Inflation

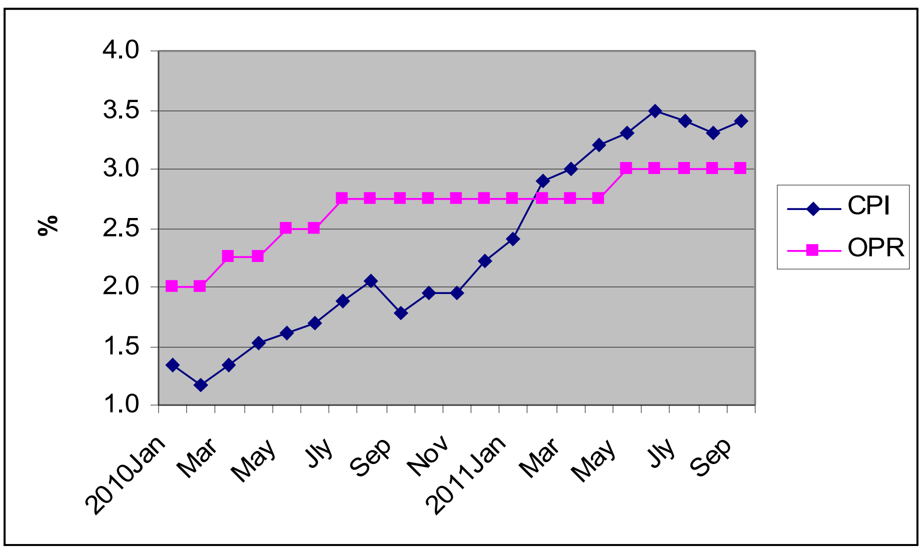
The current global trend is high commodity prices fueled by demand and capacity constraints. Excess of demand over capacity issues, worldwide, pushes up the producer's price index into the low double digits in the second half of 2011 can be seen in Figure 6. Consumer prices have also eased upwards putting monetary policy into a dilemma. The overnight policy rate (OPR) has been revised upwards from the beginning of 2010 in the attempt to stem the quickly rising CPI as shown in Figure 7. Bank Negara, however, has been careful not to put too much braking on the economy and have resisted further upward revisions of the OPR from 3%.

Fig. 6: CPI and PPI Jan-Sept 2011



Source: based on Bank Negara data

Fig. 7: CPI and OPR Jan-Sept 2011

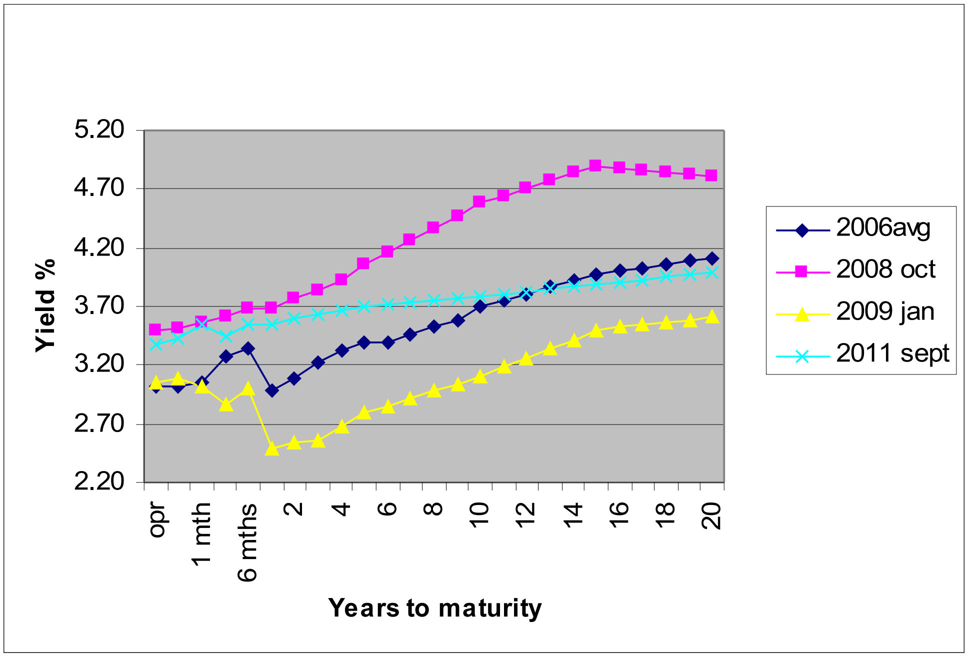


Source: based on Bank Negara data

Economic outlook

Changes in economic circumstance will inevitably reveal itself in the shape of the yield curve. Interest rates are influenced by two components: loss of current use of one's money when lending and potential losses due to inflation when the money is returned. There is also the added risk of lending in the long term. Thus the longer the lending period (time to maturity or the tenor of the loan), the yield curve will normally slope upwards. This is the natural tendency which is disrupted as a result of policy intervention introduced to deal with inflation and economic growth. Yield curves for Malaysia for selected periods are shown in Figure 8.

Fig 8: Malaysia's yield curve (selected periods)



Source: Based on Bank Negara (short term numbers are interbank rates, long term loans are Malaysian Government Securities.

In 2006, when the economy was stable, the yield curve has its natural shape. Within a couple of years, upward pressures that accompany economic growth led to higher interest rates partly because of upward revision of the overnight rate by 50 basis points from 3% to 3.5%. Meanwhile shifting focus from long term lending to short term lending also push up the long term interest rates. When the economy shifted into recession, between 2008 and 2009, interest rates had collapsed very quickly. In fact the overnight rate fell to only 2% despite upward pressures arising from the competition for short term funds. The focus also shifts funding to long term lending causing long term rates to fall resulting in a much flatter yield curve.

Currently, the yield curve is flat. Short term rates have gone up to stem inflation. The overnight rate has been revised four times to the current level of 3%. The funding focus continues to pay attention to the long term given the current economic circumstance that does not lead to too much borrowing.

The flat yield curve will make it hard for Bank Negara to push interest rate up any farther even if inflation continues to be an issue. Instead it will be better to stimulate the economy that draws long term funds into the short term.

The public sector and the national debt

It is fortunate that the currently waning economic circumstance will be somewhat offset by the big investment plans being implemented under the Economic Transformation Programme (ETP) and the Tenth Malaysia Plan 2011-2015. As a result, Malaysia's national debt continues to rise.

Malaysia's national debt is currently RM437 billion (>50% GDP), 96% (RM421 billion) of which is domestic borrowings and only 4% (RM16 billion) is foreign borrowing. In 2001 it was RM145 billion (41% of GDP) of which 83% (RM121 billion) was domestic and 17% (RM24 billion) foreign. The federal government's foreign debt exposure, however, has been reduced both by both amount and proportion in the national debt.

Malaysia's foreign debt currently is much lower at RM241 billion. The RM16 billion from the foreign component of the national debt is one part of this. The other parts of the foreign debt comes from the non-financial public enterprise (NFPE), RM61 billion, private sector and individual borrowings, RM71 billion, and short-term debt, RM92 billion. The *Economic Report* released by the Treasury on budget day in October tabulates Malaysia's foreign debt under the title "National Debt" on Table 4.9. This might lead to confusion to some readers.

Outlook for Penang

2011 is the first year of the Tenth Malaysia Plan 2011-2015. For Penang, the three main projects are the Second Penang Bridge, the refurbishment if the Penang International Airport and the extension in frequency and coverage of public buses operated by Rapid Penang. The first two are undergoing construction and are on schedule. Public busing, however, remains ambivalent to Penangites. Daily bus riders are les than 100000 despite having 700000 in the labour force. Road congestions especially during commuting hours do not allow buses to run on time. Achieving frequency and coverage of public busing in Penang would thus require state-federal collaboration that helps rapid buses run smoothly on dedicated bus lanes. At the moment traffic policy is on hold pending the Traffic Master Plan that the MPPP has commissioned.

Labour shortage continues to be an issue. Demand for cheap foreign labour is a persistent policy conundrum for the federal government that hopes to wean the nation away from foreign labour dependence. Over the past year or so, loan disbursement in Penang has been more buoyant than in the nation suggesting that inflation in Penang will outpace the nation. This means that while nominal growth might be higher in Penang, real growth (after adjusting for inflation) for Penang will not be as high.

Under the design of the Tenth Malaysia Plan, Penang's GRP growth will outpace the national GDP by 0.018%. This means that the 5.4% GDP growth for Malaysia will translate into Penang's GRP growth of 5.418%. At this rate, Penang's GRP share will rise only marginally from 8.93% to 8.95% of the national economy between now and 2015. If Penang's economic growth can surpass the national growth rate by 1%, the share of Penang's GRP out of Malaysia's total GDP will be able to rise by 0.4%. This is an unlikely scenario under present circumstance, because of capacity constraints and slower rise of exports. Penang's economy is a subset of the nation and hence an increase in share implies that the economy of some other states will fall in their share contribution.

Downside risks

Although 2011 has been an eventful year, plagued by earthquakes and bad weather, the economy has faired pretty well. Commodity prices rose quickly but have begun to taper off, remaining higher than rates a few years ago. Meanwhile, 2011 has also been politically eventful – not only the Arab Springs uprising but also street protests in Europe resulting from economic policy decisions made in response to the crisis over the Euro. This year, China had suffered its first trade deficit in 7 years, partly due to falling world demand (its exports to Europe is down by half) and also rising commodity prices that pushed up the cost of imports into China. Singapore, too, was not been spared. The economy shrank by a hefty 6.3% in the second quarter. Had the economy continued to decline in the third quarter, Singapore would have suffered a technical recession (defined as two continuous quarters of recession). Fortunately, third quarter figures showed a 1.3% rise, thus allowing Singapore to avoid a recession.