Trials of the Penang Food Processing Industry

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In This Issue

Socio-economic & Environmental Research Institute
10 Brown Road,
10350 Penang, Malaysia
Phone: 604-2283306
Fax: 604-2267042
Email: seripg@tm.net.my
Website: http://www.seri.com.my

Introduction

Malaysian food is exported to more than 80 countries, including Singapore, Indonesia, Netherlands, Hong Kong, and USA. In terms of numbers, small and medium-sized firms dominate the food industry in Malaysia. Exports of processed food for 2001 were valued at RM3.9 billion whilst export earnings of agricultural products from the marine, livestock and crop sub-sectors have been growing steadily from RM6.5 billion in 1998 to RM8.7 billion in 2003. This impressive rise of 34 percent within a period of 6 years reflects the potential of this sector as an alternative source of economic growth. However, the inability of local production to fulfil domestic demands has led Malaysia to be a net importer of food with imports totalling about RM12.43 billion in 2002. The rise in the import bill over the corresponding years negates the rise in export earnings. In view of that, the government has embarked on aggressive plans to promote food production in the country.

At present, available data indicates that there are about 60 agro-based food processing industries in the Penang with approximately 40 in the PDC areas and industrial zones and 20 industries and SMEs outside the PDC industrial zones. These range from public listed companies to small medium enterprises for the marine, livestock and plant/crop sub-sectors. Statistics from the Penang Industrial Survey 2003 show that sales and purchases for food processing and agriculture products in the PDC industrial areas alone amounted to RM1.5 billion.

Penang shows greater strength as an exporter in the marine food sub-sector sector compared to the livestock and crop sub-sectors, where the products are mainly for local consumption. The share of livestock and crop sub-sectors exports for Penang are less than 10 percent, whilst marine or seafood exports account for approximately 85 percent of the food export market. It is not surprising then that Penang is the major point of export for marine products in the country. Three major exit points for marine exports in Penang are the Bayan Lepas International Airport, Batu Maung and the Northern Butterworth Container Terminal (NBCT).

This report will provide an overview of the food processing industries in Penang which carry out value-added activities on basic food materials with emphasis on the marine product, livestock and crop sub-sectors and its economic potential and impact on the Penang economy.
Penang is poised to benefit from further growth and development of the agribusiness sector because:

- agro-based industries have greater backward and forward linkages
- agro-based industries have greater domestic linkages than the non resource-based industries
- non resource-based industries have had a higher leakage effect than the agro-based industries
- national policies under the 9th Malaysia Plan (9MP) are expected to translate the vision of agriculture food production as an engine of economic growth into a visible action plan.

Major Food Industry Products in Penang

Marine based food products form the largest component of food exports for Penang. According to the Fisheries Development Authority Board (LKIM) Penang, the export amount has increased by 66 percent since 2001 (i.e. from RM488.6 mil in 2001 to RM810.4 mil in 2004).

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Table 1 below shows the major importing countries and the respective import value for marine based food products produced in Penang. Singapore is the largest importer followed by the US and Italy. An important point to note is that there are no Middle Eastern countries on the list. The ability of Penang based agribusinesses to penetrate the Middle Eastern region will present these enterprises with a huge untapped market, especially given the advantage Penang can have in establishing itself as a hub for *halal* food production.

Table 1: List and Value of Major Importing Countries for Marine Products Through NBCT 2004

No	Importing Countries	Value (RM millions)
1	Singapore	165.16
2	USA	121.42
3	Italy	86.48
4	Australia	59.18
5	Japan	55.32
6	United Kingdom	53.65
7	France	52.12
8	China	41.91
9	Holland	39.31
10	Spain	25.51
11	Hong Kong	13.61
12	Denmark	13.61
13	Belgium	13.36
14	Germany	11.63
15	Monaco	4.93
16	Brunei	4.87
17	New Zealand	4.75
18	Korea	4.26
19	Vietnam	3.96
20	Taiwan	3.55
21	Indonesia	3.40
22	Thailand	2.27
23	Others	7.85
	TOTAL	**792.09**

Source: Fisheries Development Authority Board (LKIM) Penang

The breakdown of marine-based food products for export are frozen marine foods at 61.5 percent, processed marine foods at 16.6 percent, canned marine foods at 12.18 percent, dried marine foods at 9.89 percent and chilled marine foods at 0.01 percent.

Major players in the Penang market in the processed seafood industry are Tropical Consolidated Corporation, Seapack Foods and Rex Canning Co. Sdn. Bhd. These leading canned and frozen food companies are major exporters who ship products such as tuna, crabmeat, sardine, shrimp, oysters, cockles, mussels, salmon, anchovy and crabsticks, amongst many others, to the overseas markets mentioned above. To increase marketability and to maintain market share in the face of escalating competition, most of these products have to undergo some value-added processes. The value-adding process results in very innovatively packed, canned and/or chilled products which come in great variety. Most of these innovations are locally driven and the outcomes of these processes have pushed Penang to the forefront of food processing in Malaysia. An excellent example is the ability to transform surimi into forms which resemble the taste and texture of a wide variety of seafood, including crab, lobster and prawn. These are high quality products which are very much in demand in the export markets.

The livestock food processing market accounts for a much smaller portion of Penang based agribusinesses. Chicken and meat products are either processed or frozen and sold in the form of cuts. The major market for processed meat is local and the meat products are mostly sold to restaurants and hotels in the form of frankfurters, breakfast sausages, cold cuts and salami. At present, local hotels and restaurants are a niche market for these players. Manufacturers are aware of the huge potential of the export market and to date have sent product samples to neighbouring countries and the Middle East. Middle Eastern countries have expressed satisfaction with the high quality of the samples sent but are disinclined to buy from Malaysia due to the higher prices. These countries are willing to pay US 1.00 (RM 3.80) per kilo for processed chicken meat while the cost of production for processed chicken meat including freight stands at RM 8.00 per kilo for Malaysian processors.

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Competition within the local market is also getting stiff. Local Penang meat manufacturers like Miami Butcher House and FIKA Foods Corporation lament that there are now too many companies making sausages and chicken nuggets in the market and there is aggressive competition as compared to countries like Indonesia which have a large population but less than 10 factories producing such items. The potential for the Indonesian market is there but due to high cost of production and raw materials Penang companies have not made any inroads into market there as yet.

Another component of food based agribusinesses, albeit a small component, is food manufactured from plant or crop products. This does not represent a large market as most of these plant or crop-based food products have to be imported from overseas because Malaysia lacks the raw materials. Examples are red beans, mushrooms, bamboo shoots, sweet corn and baby corn. Most of these are imported from Thailand or China and are canned for domestic markets, both Peninsular and East Malaysian. The snack food industry also imports beans and nuts for the local market. Companies such as Rex Canning and FIKA Food have also begun to venture into newer products such as ready to eat foods to tap into the lifestyles of today's consumer. Amongst these products are roti canai, curry puffs, popiah, buns and rice, complete with accompaniments and condiments such as curry chicken or rendang. This industry also produces a wide spectrum of food and beverage products such as tropical fruit juices, canned coconut milk, mushrooms, vegetables, fruits in syrup and frozen tropical fruits.

Some Barriers to Growth

Supply of Raw Materials

Manufacturers in Penang's food processing industry face a common issue – insufficient local raw materials for processing. Hence, there is a need to import raw materials from other countries. This presents local businesses with a significant disadvantage - higher costs of production compared with countries like Thailand, Vietnam, China and Indonesia.

Marine food manufacturers interviewed say that they are presently importing 50 percent of their raw materials. Local producers account for only half their needs and much of the marine raw materials go into the fresh food market. Local fishing industries are also unable to assure factories of a constant volume and supply of raw materials. Shrimps, tuna, squids and cuttlefish are the most important raw materials needed in this industry.

The Penang frozen food and seafood packing industries pointed out that the domestic demand for shrimps exceeds that of local supply. Aquaculture accounts for 90 percent of production and 10 percent are from capture fisheries. The shortage is worsened by the fact that raw shrimps are exported to Thailand as they fetch higher prices there. The huge demand from the US has also created a lack of raw shrimps for processing. Shrimps are one of the more lucrative products that are in high demand within international markets. Thailand was the largest exporter to the US for 2002 at 27 percent (115,105 mt) of the market and this was closely followed by China at 12 percent and Vietnam and India at 10 percent each. Malaysia exports less than 10 percent of its shrimps per year. The Malaysian Frozen Foods Processors Association (MFFPA) has submitted a memorandum to the Ministry of Agriculture requesting a ban on exports of raw shrimps to enable our local food processing industry to increase its production. In view of the high value that shrimps fetch in the market, some Malaysian food processors have resorted to importing raw shrimps from China to overcome the shortage and to capitalise on the high margins. They then repack and reprocess the shrimps for re-export.

Interviews with seafood processing industries indicated that tuna is another item in great demand, a demand we again cannot meet. Malaysian companies are at a disadvantage in that they can only capture the neritic species that live in the continental shelf but less of the oceanic species which live in the deep seas. A local exporter of tuna said that Malaysian companies have limited financial resources to increase their fleet of ocean going vessels that will enable them to compete with other countries like Thailand. Bank loans for vessels are often difficult to obtain as these are deemed as dangerous and risky ventures by local banks unlike their Thai counterparts who have higher risk appetites.

As Malaysia is not a meat producing country, most of the meat products like beef and lamb are imported from countries such as India, Australia and New Zealand for table consumption as well as processing. Some chicken meat such as mechanically deboned meat (MDM) is imported from countries like Denmark, Holland and Brazil. The volume of production in these countries is very high. Malaysia does not have any MDM processing plants at the moment as it is a capital intensive and high technology operation. Some examples of Penang food manufacturers that process imported chicken meat include Miami Butcher Houses, Ayamplus Food Corporation, Lucky Frozen and Rex Canning.

Another issue is that of the constant price fluctuation of chicken meat. Present prices of live chicken in Penang have risen to RM4.60 per kg compared to RM2.80 per kg last year. Prices of feed, which are often imported, have risen in recent years and these in turn have pushed up the cost of production. Chicken farmers remain cautious in raising production levels due to the uncontained outbreak of avian flu in neighbouring countries although Malaysia itself is free of the disease.

An officer of the Veterinary Services Department said that in foreign countries, farmers' associations collectively determine the amount of production of live chicken in their country and are thus able to control prices and ensure constant supply and price stability. This is not the case for Malaysia where chicken farmers are not united and often overproduce or under produce for the local market. When there is over production the prices would drop as there is a lot of under-cutting.

Raw materials for plant/crop food processing except for oil palm are also not available in sufficient quantities in Malaysia in general and more so in Penang. Since self-sufficiency for these products are not achievable in the near future due to rising labour costs and farm inputs, we remain highly dependent on imported raw materials from countries such as Thailand, Vietnam and China. In an attempt to overcome this shortfall, several agricultural agencies like MARDI, Department of Agriculture, and the Penang Integrated Agriculture Development Project (IADP) have embarked on initiatives to cultivate cash crops in Penang in past years but have been unsuccessful. Suitable land for cultivation is also scarce in Penang.

Research & Development (R&D)

Most Penang agro-based manufacturers interviewed indicated that they spend between 5 to 10 percent of their total budget on R&D whilst smaller companies indicated that they have no budget for R&D at all. Most companies are involved in contract packing where they manufacture foods following the specifications of their buyers and thus R&D does not figure. There is also a fair amount of "copy-catting" R&D where R&D is conducted to create products similar in taste to market leaders. There is however a small percentage of manufacturers who have attempted to create new products and taste.

In the food processing industry, R&D is often conducted on adding value to present products to turn them into gourmet or delicatessen food. R&D is aimed at producing a wide product range, quality food service and competitive prices. Some R&D initiatives have resulted in products which include curry, chilli sauce, soy sauce and mayonnaise. In terms of meat products, examples of value added products are pepper, garlic and cheese sausages. R&D also looks into the packaging aspect of products. Presently, more popular forms of product packaging include food pouches in silver or plastic foil, paper and plastic wraps. Ready to eat meals have been packaged to capture the niche market of young working professionals and or people on the move. Products are also packed in different sizes and quantities to cater for the differing needs of consumers. Another aspect of R&D in the food processing business is research into the area of using the by-products of the processing plants such as the innards of chicken and fish for the pet food industry. The pet food industry is another huge industry which till now has been dominated by Thailand.

...the food processing industry is an important source of employment generation especially in rural areas…

Some companies do not conduct their own R&D locally but have them done in foreign countries that they have branches in like Thailand, China and Indonesia. The cost of hiring graduates in such countries are lower and those in countries such as Thailand are said to be more experienced as the universities offer courses on food product development as well provide entrepreneurial skills to their undergraduates.

Labour

Food processing industries are thought to be automation driven. This is only partly true as the operations for processing raw material for canning or freezing require intensive labour that cannot be performed by machines. These operations include stripping, cleaning and cutting to size of raw materials. A certain level of skill is required for such operations and workers are often trained to perform these tasks. In fish products, the scales, gills, bones and innards are removed manually.

As such, the food processing industry is an important source of employment generation especially in rural areas. Factories that are located outside the industrial parks traditionally obtain their workforce from the surrounding villages. Several factories interviewed use 100 percent local workers. There is the issue that as these older workers retire, there may be a labour shortage issue as local youths are more attracted to jobs in the electronics sector which does not fall under the 3D (dirty, dangerous, demeaning) category. At present those that have 100 percent local workers have not resorted to employing foreign workers as yet.

On the other hand, food processing operations located within the industrial parks employ up to 70 to 80 percent of foreign labour for their operations. These are often female Indonesian workers.

Workers are also sent for Hazard Analysis and Critical Control Point (HACCP) training. HACCP is a requirement for exporting food products to foreign countries, especially the European market. This training is fully sponsored by the Department of Fisheries and the Health Department at no cost to the food manufacturers. Despite this, some factories are unwilling to participate as these courses are conducted in Terengganu and many feel that productivity is lost when workers spend time travelling and attending the courses. Companies who utilize a large portion of foreign labour have to constantly resend workers for training due to high turnover of workers. Many have requested for these courses to be conducted in Penang since Penang is a major seafood producer and exporter in the country.

Another common lament is that trained and skilled workers are often lost when workers switch jobs (in the case of local workers) or return to their own country after the expiration of work permit. When compared to foreign labour, local workers are less reliable and cooperative, being unwilling to work long hours, prone to take leave more often and to job hop. 80 percent of companies interviewed said that they had little problem obtaining permits for foreign labour but wished for the liberalization of labour policies for foreign workers.

Several firms cited the liberal laws in neighbouring countries such as Thailand for the loss of competitiveness in the industry. They claimed that the conditions of employment in such countries are very conducive for foreign labour intake. Employers can apply for work permit for workers in their companies regardless of whether these workers have valid travel documents or not. Work permits are approved for foreign workers as long as local companies are willing to employ them. They cited the example of employment of Myanmarese workers in Thailand's food processing industries where they were employed first and then applied for work permits later.

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Food Safety & Quality

Penang and Malaysia's ability to make inroads into the developed countries' markets depends largely on the key players' ability to comply with the stringent international standards of quality and food safety. Global patterns have shifted towards a preventive food chain approach, that is, food safety from the farm to the table. This shift has been spurred by concerns among consumers, farmers, manufacturers, retailers and governments on the need to improve traditional food safety systems and to remove unsafe food from the marketing chain as well as permit greater traceability of food products. Food is deemed unsafe if they have been contaminated by zoonotic agents, pathogens, industrial contaminants and agriculture chemicals which may pose a serious health threat to consumers. This approach will also facilitate the tracking of the food source to aid in the fast withdrawal of contaminated food and hazardous food from markets as well as identify weak links in the food chain.

Feedback from manufacturers indicates that Malaysian food safety is more reputable than that of Thailand, Vietnam and China. The countries have been repudiated for their widespread use of chemicals in the production of raw materials as well as processed food. The use of antibiotics is high and some aquaculturists are also said to have thrown antibiotics into their ponds. Malaysia is perceived to be more stringent on such issues and has developed high quality and safe food over the years.

Many firms are unsure of the procedures in applying for and obtaining the "halal" logo

Penetration of the Halal Food Market

There is immense potential for Penang and Malaysia to develop itself as a halal food hub. With its strategic location in the north of Peninsular Malaysia and the existing infrastructure in place, Penang is poised to become the northern *halal* food hub of Malaysia. Malaysia enjoys good reputation as an advanced Islamic country and thus should exploit the *halal* certification issued by our Department of Islamic Development Malaysia (JAKIM), which is recognised worldwide to establish itself as a major *halal* producer and exporter of agro-food produce and processed food products. Some companies in Penang such as Rex Canning are already producing *halal* food in compliance with USFDA requirements and successfully implementing the Hazard Analysis Critical Control Points (HACCP). At present little is known about how much is exported from Penang to Muslim countries in the Middle Eastern region. Firms interviewed indicated their interest to do business in the Middle East but are presently at the exploratory stage. Many firms in Penang are keen to export to the Middle Eastern markets but are unsure of the procedures in applying for and obtaining the "*halal*" logo. It is hoped that JAKIM and other government organisations will provide clear guidelines for such food and standardize procedures as well as disseminate information on how to obtain approval for the *halal* logo.

Malaysian processed food as a whole are widely accepted as products that meet stringent standards such as the HACCP and *halal* certification under the United Nations' Codex Alimentarius.

Almost all of the manufacturers interviewed expressed disappointment on past performance and remain cautious about the future growth prospects of the industry.

Industry Outlook & Recommendations

Almost all of the manufacturers interviewed expressed disappointment on past performance and remain cautious about the future growth prospects of the industry. Many of them indicated that maintaining the status quo is the best option for the time being. Thailand, popularly known as the "Kitchen of the World" poses stiff competition and is a serious threat to Malaysian food processors. Other threats to the food manufacturing industry here are Vietnam, China and Indonesia.

Some recommendations that may help to improve the competitiveness of the industry as well as enlarge the market for the food manufacturing industry in Penang are listed below:

- ***Agro-based Food Manufacturing Area***
Food manufacturers hope that the Penang State Government can allocate an area specifically for food manufacturers in Penang. At present, some plants are located in areas outside the industrial zones which do not meet the requirements and regulations of the local councils as they may be situated near residential areas. To meet international standards on GMP and HACCP, food industries should not be located around residential areas nor near other polluting industries. Manufacturers indicated that they are willing to relocate to such areas if and when the Government decides on the location. This will also help them avoid fines from local authorities.

- ***Lead agency to assist local food manufacturers***
There is a need for a 1-stop lead agency to assist local food manufacturers in penetrating overseas markets. Almost all manufacturers interviewed expressed a strong interest to penetrate the Middle-Eastern markets but are unsure of the business culture and practices there. They are also uncertain of the rules and regulations. Penang meat manufacturers are also eyeing the niche market for supplying hotels and restaurants with premium quality cold cuts and gourmet meat products such as sausages, salami and smoked meat.

  The presence of a lead agency which is able to conduct research into the market potential, business practices, rules and regulations and link up local manufacturers with potential buyers will greatly improve the chances of success of these companies in venturing into new product and geographic markets. For example, local food manufacturers have identified the pet food industry as a potentially lucrative one, which once again is dominated by Thailand. The raw material needed for the pet food industry such as innards, skins, bones and other by-products are easily available in Penang. A lead agency would be able to coordinate efforts to help establish this industry.

- ***Halal Market***
There should be more cohesive efforts to bring together the food manufacturers who are keen to tap the vast *halal* market. The ability to capitalise on our Islamic country status will provide the country and the industry with the much needed competitive advantage necessary for competing with the other key players of this industry.

- ***Assistance in obtaining the Veterinary Health Mark (VHM)***
Food manufacturing industries for livestock products indicated that the VHM logo is very important for the export market. There are presently no formal courses offered although the State Veterinary Services Department has been commended for proactively providing the much needed advice and assistance to such industries to help them comply with the regulations and standards before approval. They hope that formal courses will eventually be provided.

- ***Information & Data Gathering***
There is a severe lack of information and data on food manufacturing industries in Penang. More information is available on some sub-sectors than others and such data is collected only on the initiative of some Government agencies and the Customs Department for exported products. Data on products for the local market are not collated by any particular agency. Manufacturers hope that more information and data gathering activities can be provided by the State for those in the PDC industrial areas and those outside to enable them to make more informed business decisions.

- ***Undergraduate courses and training***
Local universities should provide more comprehensive courses on entrepreneurship in addition to food science courses similarly to those offered in the case of Thailand where such courses have been able to produce innovative well-trained graduates. There should also be specialization within the food sciences for graduate programmes so that specific needs for the marine products, livestock and crop sub-sectors can be met.

- ***Training of Food Handlers Course***
  Compulsory training of Food Handlers by the Ministry of Health is deemed bothersome and unnecessary as companies that have attained HACCP standards are already complying with even more stringent standards imposed by the European Union. It is felt that the local authorities should confine this to food handlers in the restaurants and food outlets but not factories which already have high standards of hygiene. Food processing industries again face the problem of high turnover of foreign and local workers and the need to show proof of workers who have attended such food handling courses have been burdensome as many workers have already left the employment of the companies.

  Manufacturers also indicated that there is a need for the Government assistance in providing courses to their workers such Good Manufacturing Practices (GMP), *Halal* Food, HACCP, ISO certification amongst others. The costs of these trainings which are conducted by private companies average around RM200 to RM300 per worker. It has been suggested that agencies such as the Penang Skills Development Centre (PSDC) consider providing such courses for the food manufacturing industries.

- ***Mechanical Deboned Meat (MDM) processing plants***
  Livestock food manufacturing companies interviewed said that Malaysia has only small MDM plants that are unable to meet local demand. Penang manufacturers cited the example of some chicken processing plants in Brazil that are able to produce up to 1 million metric tons a day. Setting up of such plants are expensive but will provide the necessary raw material for their industry. At present they have to import such meat from overseas.

- ***Energy costs***
  Some manufacturers said that increasing energy and fuel costs have made them less competitive in their production. A case in point is the recent rise in diesel prices which has raised the cost of operating machinery and transportation.

- ***Loans for purchase of deep sea-faring vessels***
  Companies that wish to purchase vessels for deep-sea fishing should be provided bank loans for vessels and equipment. These are presently seen as high-risk ventures and local banks are not willing to provide such loans.

- ***Trade missions and exhibitions***
  Manufacturers indicated there should be more overseas trade missions and exhibitions in the food industry.

- ***The Ringgit Peg***
  The Ringgit peg is deemed useful and should remain as this ensures that prices in Malaysia are more stable compared to other competitors.

Conclusion

In recent years, there have been dramatic shifts in the trade pattern at the international market for global food demand. Globalization has created new markets as the process of urbanization, increased income growth and mobility of labour and migrant workers and subsequent changes in food consumption has led to a demand for foreign food in many countries. These changes in the trade patterns offer bright prospects for the agriculture food sector and the trend is expected to continue well into the future. It is obvious that the true growth potential for these businesses lie within international markets. The ability of Penang based companies to tap into international markets will see improved growth prospects for this industry.

The Government needs to provide more assistance in terms of financial aid, training and exposure to penetrate new markets in Europe and the Middle East. Much more needs to be done for local food manufacturers who feel that they are being neglected when compared to the Electrical & Electronics industries. Although a number of incentives for agriculture and agro-based industries are already in existence, some manufacturers are not aware of these or how to access the incentives. More awareness and information needs to be disseminated to food manufacturers through road shows and seminars.

The major setbacks for this industry are the lack of raw materials and the relatively higher cost of labour and production.

The major setbacks for this industry are the lack of raw materials and the relatively higher cost of labour and production. On the other hand, Malaysia has an established reputation in terms of producing high quality, innovative and *halal* food products. If Penang capitalises on its reputation for quality and "*halal*-ness" it would be a step ahead of its competitors in claiming a larger proportion of the international market share as food safety and quality, not purely cost related factors, are key criteria for export markets. **§ *Khor Hung Teik***

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Report card for Malaysia's economy in 2004: The Bank Negara report

Introduction

PENANG ECONOMIC MONTHLY

Bank Negara Malaysia released its report on March 23 2005 for the 2004 economy. As usual the text runs over 250 pages and the accompanying tables another 80 pages or so. It is certainly a daunting task to rummage through the details to assess not just the performance of the economy but its health in longer and more holistic terms. The findings have been quite reassuring, as the rest of this article will show.

In order to conduct this exercise, it is best to inspect the various components of Malaysia's national accounts and draw inferences from their numbers. There are basically four components that make up the national accounts: I) production and output, II) income and outlay, III) accumulation, IV) external or rest of the world accounts, which can be laid out in a matrix as shown on Table 1.[1]

Table 1: System of National Accounts, Malaysia 2004
(Current RM million) – Bank Negara Malaysia (preliminary)

	I	II	III	IV	TOTAL
I		C+G= 251373	I = 91818	X-M= 95694	438885
II	GDP=Y-P= 447548			P= -24480	Y=GNP= 423068
II	D= -8664	S= 157062			148398
IV		T= 14633	CA= 56580		71214
	438885	423068	148398	71214	

Gross investment = 91818 + 8664 = RM100482 mil.
Source: developed from numbers reported in Bank Negara Report 2004 (released March 2005)
C+G = pvt. and govt. consumption, I = investment, P = net factor payments abroad (negative numbers indicate outflow), D = depreciation (negative numbers indicate increase in the stock level), S= savings,
T = net transfers abroad (positive numbers indicate outflow), CA = current account balance

Forecast from last year's report compared against this year's preliminary numbers

A good way to look at the health of a nation's economy is to look at how the total national income (i.e., the gross national product or GNP) is broken down into proportions that make up consumption, investment, savings, and cross border transactions. Table 2 shows such proportions within the four sub-accounts that compare what was forecast a year ago with the preliminary numbers released this year in the Bank Negara report for 2004.

[1] *See our March 2004 issue for our previous presentation of Malaysia's national accounts. The national accounts is based on United Nations (1968) A System of National Accounts. Studies in Methods Series F No.2, United Nations Statistical Office, New York.*

Table 2: 2004 Preliminary Numbers and Forecast Numbers (% of GNP)

	I	II	III	IV	TOTAL
I		59.42 (61.7)	21.70 (22.3)	22.62 (21.5)	103.74
II	105.79 (106.3)			-5.79 (-6.3)	100.00
II	-2.05 (-0.8)	37.12 (35.8)			35.08
IV		3.46 (-2.5)	13.37 (12.70)		16.83
	103.74	100.00	35.08	16.83	

Source: Developed from Bank Negara Report 2004 and Bank Negara Report 2003.Bracketed numbers are forecasts made in last year's Bank Negara report released in March 2004

...FDI, although helpful in boosting Malaysia's economy, will not in the long run contribute to national income growth...

Account I: production output and demand[2] (C+G+I+(X-M) = Y-P+D)

The RM447.5 billion in current dollars of gross domestic product (GDP) is reported to be 5.8 percent higher than the national income, i.e., gross national product (GNP). The difference between GNP and GDP is the amount of net factor payments abroad by way of salaries, profits, rental and interests accrued to Malaysians from economies abroad less similar payments to non-nationals resulting from production in Malaysia's economy. As Malaysia's GDP is less than its GNP, it means that there is much more foreign participation in Malaysia's economy than Malaysian participation in economies abroad. If Malaysian nationals begin to invest more and more in economies abroad, earn salaries, rental and interests from outside Malaysia, the current negative factor payment gap will narrow or even move in the other direction, i.e., GDP becoming lower than GNP. This is why foreign direct investments or FDI, although helpful in boosting Malaysia's economy, will not in the long run contribute to national income growth as profits from these have to be deducted from the GDP as factor payments. However, the –5.8 percent leakage from the national income in terms of factor payment flows abroad is slightly smaller than the forecast (made in March 2004) of –6.3 percent. This reduction in leakage from factor payment outflows is beneficial to the nation's economic health.

...healthier economy than what was forecasted for 2004 by Bank Negara a year ago.

Malaysia's public and private sectors consumed 59.4 percent of its national income in 2004 (slightly less than the forecast of 61.7 percent). Domestic investments by both the public and private sectors are reported to be 21.7 percent of GNP (slightly below the forecast figure of 22.3 percent). The trade balance (merchandised goods and services) is reported to be 22.6 percent of GNP (slightly stronger than the forecast of 21.5 percent). These preliminary numbers for 2004 released by the Bank Negara this year thus show a healthier economy than what was forecasted for 2004 by Bank Negara a year ago. Consumption below forecast may indicate weaker demand but the fact that the trade balance has gone up shows sufficient buoyancy in the economy.

The negative depreciation number (-2.05 percent) shows a fairly large build up in the stock level.[3] This is an indication of a weaker demand in the economy in 2004 than forecasted. Production (GDP) is 2.05 percent higher than the sum of consumption, investment and net trade, causing an increase in stock level by RM8.66 billion, much larger than the previously forecasted 0.8 percent stock increase.

Account II: income and outlay ((Y-P)+P = C+G+S+T)

As mentioned above, Malaysia's public and private sectors consumed only around six-tenths of the total national income. Non-factor payment transfers abroad (for example, what parents give to their children studying abroad), were reported higher than previously forecasted (3.46 percent compared to 2.5 percent). After deducting consumption at home

[2] The row sums of these components equals the column sums on Table 1.
[3] More will be said about stock level in the discussion for Account III below.

...the country is either saving too much or investing too little.

and transfers abroad from the national income or GNP, there remained a healthy 37 percent of the GNP that formed the national savings (higher than the forecasted savings of 35.8 percent of GNP), which when compared against total domestic investments leaves 13.37 percent of GNP (higher than the 12.7 percent forecasted) in terms of savings over investments, i.e., a negative resource gap indicating that the country is either saving too much or investing too little.

This is not a widely subscribed notion, but a nation should strive to achieve a current account balance as close to zero as possible. Doing so will help keep exchange rate stabilized. Since Malaysia is on a fixed exchange rate of 3.8:1 ringgit to the dollar, the need to keep current account close to zero becomes even more crucial. The 2004 current account surplus reported (by as much as 13.37 percent of the GNP) could be translated (on the capital accounts) into Malaysia's reverse foreign direct investments into economies abroad. In the long run, these would earn factor payments in the future and help narrow or even reverse the difference between domestic production (GDP) and national income (GNP). The current account surplus could also be brought down by increasing domestic investments, i.e., narrowing the difference between investments and savings. This would build up domestic production capacity in the future.

PENANG ECONOMIC MONTHLY

Unfortunately, much of Malaysia's current account surplus, as will be discussed below, goes instead into lending (i.e., purchase of bonds and other financial securities) that shows up in the expanding size of the foreign exchange reserves. This results in a *conflicted virtue* situation for Malaysia, because the lending is done in a foreign currency. If the ringgit is expected to strengthen relative to foreign currency in the long term, the money lent would be expected to fall in value when they are converted back into ringgit when it is paid back and in the process wipe out whatever earnings from the lending.[4]

Account III: accumulation (D+S = I+CA)

Too much imports relative to exports being the cause of a current account deficit is a common misperception. As the items of account IV show, the current account balance is the difference between savings and investments (also called the resource gap). When total domestic investments are more than national savings, there will be a current account deficit. Accordingly there must be an inflow in its capital account of the same amount to cover up the resource gap to pay for the excess of investment over savings. Conversely when savings are less than investments, the current account will go into surplus (in 2004 by 13.37 percent of GNP, slightly higher than the projected number of 12.7 percent) and there should be an outflow in its capital account.

The difference between total production in one year and the sum of the demand components, i.e., consumption, investments and the trade balance are entered into the national accounts as stock level changes (statistical discrepancies are also entered here). As mentioned, production in 2004 is reported to be higher than the sum of the demand components by as much as 2.05 percent (much higher than the forecasted excess of output over demand of 0.8 percent). In Malaysia, the stock level change numbers normally flips back and forth between positive and negative by a magnitude of about 1 percent, suggesting that production output matches overall demand except for minor variations each year. Thus the large difference in the 2004 stock change is fairly awkward, indicative of possible discrepancy between possible demand (actual GDP) and output (potential GDP, a function of resource inputs and their productivity). When output consistently exceeds demand over many years, there is indication of weak sentiments. On the other hand, if output has consistently been below demand levels, there is indication of an overheating economy in which production capacity is insufficient for meeting a more buoyant economy.

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[4] See our March 2005 issue of Penang Economic Monthly for a discussion on conflicted virtue and various other catchy phrases related to exchange rate regimes.

Account IV: external or rest of the world (T+CA = (X-M)+P)

Thus it is expected that the 2005 economy will be more upbeat than in 2004...

The trade balance (merchandise goods and services) is reported to amount to 22.6 percent of the GNP, which is higher than the 21.5 percent forecasted. The factor payment effects have been discussed above under account II.

Comparisons made above between the forecast for 2004 made in the Bank Negara Report released in March 2004 and the preliminary figures for 2004 released in March 2005 show that the forecast made last year was conservative. Despite the healthy numbers reported, there is some hint that the economy has been, in terms of performance, more lackluster than forecasted from the lower domestic consumption and investment numbers as well as the much higher than expected building up of stock resulting from the GDP numbers being ahead of the sum of consumption, investment and net exports by as much as 2 percent (well above the traditional plus/minus 1 percent mark). Nonetheless, net exports are higher on the positive side than forecasted. National savings at 37 percent is also much higher than forecasted, both these factors acting to boost current account surplus to a higher number than forecasted. Another positive indication is that net factor payment abroad (outflow) is smaller than forecasted, which means that GDP (national output) and GNP (national income) are much closer to one another than in the forecast.

Outlook for 2005

Forecast numbers, such as those reported by Bank Negara for 2005, are not meant to be looked upon as if gazing into a crystal ball. Instead, the numbers do reveal what goes on in the minds of those who put these forecast numbers together even though they do not usually list down the assumptions that enter into their forecasts. Table 3 compares the proportions of the GNP that make up the various components of the national accounts between 2003 and the forecast for 2005.

Table 3: Forecast for 2005 compared against 2003 (% of GNP)

	I	II	III	IV	TOTAL
I		62.15 (61.15)	20.09 (23.43)	24.06 (22.24)	106.30
II	105.94 (106.6)			-5.79 (-6.06)	100.00
II	0.36 (0.76)	34.67 (36.35)			35.02
IV		3.18 (2.50)	14.94 (13.68)		18.12
	106.30	100.00	35.02	18.12	

Source: Developed from numbers reported in Bank Negara Report 2004. Bracketed numbers are for 2003

Consumption levels as a share of GNP, which fell in 2004, is expected to recover and strengthened against 2003 proportions to 62.15 percent of GNP. Investment levels, however, is expected to fall further in proportion relative to the GNP. Net exports are forecasted to continue rising relative to the GNP from its 2003 proportion. Thus it is expected that the 2005 economy will be more upbeat than in 2004.[5] Stock level changes will fall by 0.36 percent (instead of rising by 2 percent for 2004 as discussed above) when GDP output is compared against the sum of consumption, investment and net exports. This means that output and demand will better match one another within the 1 percent difference mark.

[5] *It may be reported elsewhere that the 2005 performance of the economy is expected to decline. Nonetheless, except for falling investment levels, rising proportions in consumption and net exports of the national income, the falling proportion in savings and a fall in the stock level does indicate a more upbeat economy.*

...Malaysia's economy is highly sustainable.

The higher buoyancy forecasted for 2005 will show up in the fall in national savings to 34.67 percent. Non-factor payment transfers will remain high at 3.18 percent, but regardless, despite the lower national savings, much lower domestic investment levels will further push up the current account surplus to nearly 15 percent of GNP.

It is safe to say that Malaysia's economy is highly sustainable. Savings rate is more than one third of the economy. Think about it, Malaysians, as an aggregate, spend only two thirds of their income. Export earnings (after deducting imports) make up a quarter of the national income, and investments that form a fifth of the national income is used to build up future production capacity. The only weak spot is the leakage in the form of factor payments outflows to non-nationals participating in Malaysia's economy and non-factor payment transfers abroad, which when added together, is almost a tenth of the national income.

Capital flows

The strong current account surplus of nearly 15 percent of the GNP is much more difficult to understand. A surplus is usually seen in positive light but considering that a surplus implies an outflow, it is important to look further as to what this money is used for. Bank Negara did not provide a forecast on the capital flows for 2005 but the 2003 and 2004 preliminary numbers might help give a picture of the capital flows situation across Malaysia's borders.

Table 4 Capital Flows 2003-2004 (current RM mil.)

	2003	**2004**
Current Account	50848	56580
Reverse FDI	-5204	-7111
FDI	9398	17934
Portfolio	4168	33112
Other investments	-20508	-28550
Total Capital Flow	**-12146**	**15385**
Current AC and Capital Balance	38702	71965
Errors	358	11095
Overall Balance	**39060**	**83060**
Foreign Reserves		
2002	**2003**	**2004**
131394	170454	253514

Source: Bank Negara Report 2004.

Table 4 shows the positive current account figures for 2003 and 2004 (preliminary) reported by Bank Negara. As mentioned, balance of payments is by definition zero, and thus there must be a capital flow in the opposite direction by the same amount as in the current account to achieve this balance. Thus given that Malaysia's current account is in surplus, a capital outflow is to be expected. In 2003, Malaysia made RM5.2 billion worth of (reverse) foreign direct investments abroad plus another RM20.5 billion in the form of other investments abroad. This is only about half of the amount available to flow out from the RM50.8 billion in the current account surplus. To complicate matters, there was RM9.4 billion of foreign direct investment inflows into Malaysia plus another RM4.2 billion of portfolio investment inflows, both causing the net total outflow to reduce to only RM12.1 billion. So when we subtract this net outflow from the current account surplus, instead of a zero balance there remains a sizable positive balance of RM38.7 billion. There is a small errors adjustment resulting in an overall positive balance of RM39 billion, which when added to the amount of foreign reserves in 2002 of RM131.3 billion, gives us the 2003 foreign reserves amounting to RM170 billion.

So where is the predefined zero balance of payments that was frequently mentioned above? Each time the foreign reserves go up it means that the country holds more of a foreign currency. The reserves cannot be in ringgit, because technically if Malaysia wants more ringgit it can mint more ringgit on its own. It costs money to mint currency but the expense is well below the face value of the currency minted which can be used to purchase things, this difference between minting cost and the total face value of the issued currency is called seigniorage. But even if reserves are in a foreign currency they are not normally kept in liquid cash since reserves are not meant for immediate use. Thus the reserves are normally “parked” in a relatively low risk security (financial instrument). For a long time, U.S. treasury bills have been the favourite because it is regarded as a riskless asset and the U.S. dollar is an accepted international currency by most, if not all, nations of the world. Thus a rise in the foreign reserves meant a capital outflow by the same amount in return for an increase in Malaysian holding of a foreign debt instrument like the U.S. treasury. This means that the RM39 billion in the overall balance is regarded as an outflow as well and shows up as an increase in the following year’s foreign reserves.

In 2004, the situation looks even more complicated. The current account was RM56.5 billion in surplus. The capital outflow by way of Malaysian investments overseas (i.e. Malaysia’s (reverse) FDI abroad plus other investments were much lower than the capital inflow (FDI and portfolio investments) by foreigners into Malaysia. This resulted in a net capital inflow by RM15.4 billion when there should have been a net outflow as would be expected when the current account is in surplus. The net capital inflow when added to the surplus resulted in a total balance of RM71.9 billion. Strangely, 2004 also produced a sizable RM11 billion error, giving rise to an overall balance of RM83 billion that went into the country’s foreign reserves and increasing it from RM170 billion in 2003 to RM253 billion in 2004.

As an outside observer, there is no way that one might begin to imagine what strategy lies behind the building up of the current account surplus (which could be reduced by more domestic investments) or the lack of use of the funds from this surplus as investment outflows abroad. There are signs of the building up of reverse FDI by Malaysians abroad but the amount is still way below the funds available in the surplus. Meanwhile there are also capital inflows (FDI and portfolio investments) into Malaysia. The end result of this is the building up of the country’s foreign reserves. This makes little sense from the perspective of the rate of return (probably between 1 percent to 3 percent annually) of the financial instruments which the money that makes up the reserves are normally “parked” in, compared to the rate of return from say domestic investments, reverse FDI by Malaysians abroad or even other forms of investments abroad.

If one is asked to guess “what is the strategy behind Malaysia’s sizable foreign reserves?” it would probably be to give credibility to the minting of Malaysia’s ringgit under what would normally be seen as a risky fixed peg. The reserves to currency issue ratio for the ringgit, is rock solid even when judged by the tough currency board standards that a fixed exchange rate would require (even though the ringgits’s fixed rate is not on a currency board system). The other less apparent effect that the strong reserves might bring, particularly if a high proportion of the reserves remain in the form of U.S. treasuries, is that by helping the U.S. economy along, continued growth in Malaysia’s and other East Asian economies is better assured. The opposite scenario is that if the U.S. cannot meet its current account deficit with sufficient financial inflows, a likely new round of global recession will become a threat to Malaysia’s economy.

Conclusions

The two main concerns, whenever numbers about the country’s economy are reported, are performance (growth) and sustainability (economic health). Active participants in the economy such as the business community are keen on growth even if it is only for the short term but more conservative people worry about long-term stability that can be brought about by a sustainable economy. One without the other is no good because without growth there would not be improvements in welfare over time (i.e., in economic terms higher levels of utility). Without economic stability there would be more uncertainty, which would erode confidence and poor business investments leading to degrading production capacities, eventually bringing growth to a standstill.

...the central bank's primary function is to manage the country's economy and leave the concern over growth to both the country's public and private sectors.

The focus given here to the health of Malaysia's economy, as opposed to the more frequently talked about performance of the economy, was with the perspective that the central bank's primary function is to manage the country's economy and leave the concern over growth to both the country's public and private sectors. The global economy these days is fraught with uncertainties – America, a huge economy, faced with its twin deficits pushing the dollar downwards; China, another huge economy, with its renminbi pegged and moving downwards with the dollar and forcing upwards the euro, the currency of the only other sizable economy in the world; the conflicting signals that arise between market players that drive an enormous amount of global capital flows and governments trying to manage and milk growth out of their respective economies. Thus, Malaysia, consuming two-thirds and saving a third of its national income, investing a fifth of its income, maintaining trade balance positive by a quarter of its income, keeping the current account unusually high at around 15 percent of national income and foreign reserves a good six-tenths of national income, (equivalent to eight months of retained imports) – is exhibiting pretty solid economic numbers by any standards. Bank Negara has done well in the service of the nation and its people. ***§ Dr. Chan Huan Chiang***

FORUM

The article below is the 4th part of Prof. Dr Suresh Narayanan's series of articles on the Goods and Services Tax (GST) which is scheduled to be implemented in Malaysia in 2007. As the GST will affect each and every one of us, we invite you to put forward your comments via email at seripg@tm.net.my so that they can be taken cognizance of by the policy makers. Please note that the views reflected in this article represent the personal views of the writer and do not necessarily reflect the views of SERI.

COMPARING THE GOODS AND SERVICES TAX (GST) WITH A RETAIL SALES TAX (RST): Strengths of the RST *by Prof. Dr. Suresh Narayanan*

Introduction

Over the past few issues we have tried to understand the basic concepts and operations of the Goods and Services Tax (GST) that the government proposes to introduce by 2007. As we have indicated before, the GST is in effect a consumption based value added tax (VAT). Additionally, it was also argued that the VAT is analytically equivalent to a single stage sales tax levied on final or retail sales, better known as a Retail Sales Tax (RST). Since both a RST and VAT of the same rate and imposed on the same base will generate identical revenues, the logical question that follows is why opt for the administratively cumbersome VAT when the RST offers a simpler alternative?

It will be recalled that the VAT is a tax collected from many stages along the value added chain while the RST collects the same revenue from a single point—that is, retail sales. In fact, when tax reform was a hot issue in the US some years ago, the VAT and RST were serious contenders in the debate regarding the form the US national sales tax should take. Eventually, it was the VAT that was rejected!

The VAT and RST have some shared advantages: they do not discriminate between domestic and imported goods; neither provides incentives to enterprises to shift functions upstream or downstream to reduce their tax burdens; both avoid tax pyramiding and, of course, exports can be completely relieved of tax under both regimes. However, despite their theoretical equivalence and shared advantages, the two differ considerably in terms of administration and operational effects and the choice between the two is often determined on these grounds.

In this article, we will review the basic advantages that the RST enjoys over the VAT. They are largely in the form of familiarity, administrative simplicity, and lower compliance requirements (or costs).

The Strengths of the RST

Familiarity

The biggest advantage the RST has over the VAT in the Malaysian context is 'familiarity' because the RST would merely be an extension of the existing sales tax from the present manufacturers' level to the retail level. Both its operation and administration are already familiar to businesspersons and tax administrators making the transition from the current regime to the RST that much smoother. In contrast, the VAT is a new concept and its operations and effects will require more time to understand and be familiar with.

Administrative Simplicity

The RST is also administratively simpler since it requires the participation of only the final (or retail) sellers, unlike the VAT that needs the registration and participation of very many enterprises at the manufacturing, wholesale and retail stages.

Providing a commodity complete relief from tax is also very easily accomplished under an RST through a simple act of ‘exemption’ as the term is commonly understood. All exemptions take effect at the final stage –therefore exempted commodities are completely freed from tax. As explained before, under the VAT, ‘exemption” will not provide complete relief from tax— only zero-rating achieves the intended effect.

Lower Compliance Costs

Under the RST only final sellers have to keep records of their sales. In sharp contrast, the VAT requires more paperwork since all sellers and buyers within the VAT framework must keep records of taxes paid on purchases and taxes due on sales. These records provide the credit trail that is touted as the inherent ‘strength’ of this tax regime and are an essential requirement for its efficient functioning.

As stated previously, there is no necessity to draw a distinction between tax ‘exemption’ and ‘zero-rating’ under the RST. Exemption conveys the widely understood meaning of freeing a good from tax. Thus, ‘zero-rating’, as a separate exercise, is unnecessary and does not arise under the RST. Under the VAT, on the other hand, there is likely to be a confusion regarding the actual effects of an ‘exemption’, relative to ‘zero-rating’. More importantly, these distinctions call for more complicated record keeping by the taxpayer. Records of purchases of tax-exempt goods, that receive no tax credit, must be kept separate from purchases of zero-rated commodities, which qualify for tax credit. These distinctions become more difficult to make in the case of joint-inputs and firms dealing with several categories of commodities. Such ‘grey areas’ present firms with wider avenues for tax evasion, which, in turn, requires more stringent auditing on the part of the tax authorities.

In sum, the main strengths of the RST lie in its familiarity, administrative simplicity and its ease of compliance. What then is the attraction of the VAT that has made it so popular worldwide? We will attempt to answer this question in the next article.

INTERNATIONAL HEADLINES

OPEC output hike possible, says chief
April 10, 2005, Reuters

OPEC may boost oil supplies by a further 500,000 barrels per day next month to help meet an anticipated demand surge in the second half of the year, according to the cartel's president. The Organisation of the Petroleum Exporting Countries raised output limits by 500,000 bpd last month to 27.5 million bpd in a bid to cool prices. It left room for a second 500,000 bpd increase before a June meeting if prices fail to drop below US$55. But oil price has retreated 9 percent since last week, with U.S. crude closing at US$53.32 on April 8, 2005, down from highs above US$58.

*Comment: In view of the projected slowdown in global economic growth this year, oil price is expected to slide to a more **sustainable level of between US$40-US$45/ barrel in 2005**. Malaysia, being a net exporter of crude oil, would undoubtedly benefit from higher export earnings, but on the other hand, overall economic growth could be dampened by higher cost (heightened inflationary pressure) and indirect impact from slower global growth if oil prices sustain a prolonged hike.*

World Bank: Growth 'peaked' but steady
April 20, 2005, MSN Money

According to the World Bank, global growth momentum has peaked but buoyant economic and financial conditions in most developing countries should continue. Developing economies are expected to expand by a 5.7 percent in 2005, whilst GDP growth of wealthy countries is expected to slow down to around 2.5 percent. Led by rapid growth in China, India and Russia, developing countries easily outgrew wealthy countries in 2004, with aggregate GDP rising by a record 6.6 percent. The World Bank also warned that the large U.S. current account deficit could trigger abrupt interest rate and disorderly exchange rate movements, causing a deeper-than expected global slowdown, which could undercut growth in developing countries. The Bank predicts that the price of a barrel of oil would average about US$42 in 2005, with an expectation of oil prices easing in the second half of the year.

China Economy Grows by 9.5 Percent in 1Q
April 20, 2005, MSN Money

China's economy grew by an unexpectedly rapid 9.5 percent in the first three months of this year, exceeding the expectations of analysts who had expected efforts by Beijing over the past year to slow growth would have a bigger impact. The government warned that it needed to tighten controls on surging investment in new factories and real estate as surging growth could ignite inflation and harm China's fragile banks. The economy also grew by 9.5 percent in the fourth quarter of 2004. The government's official target for growth is 8percent a year. Leading the first-quarter surge was a 22.8 percent jump in investment in factories, construction and other "fixed assets," to 1.1 trillion yuan (US$133 billion). Manufacturing and consumer spending also registered double-digit growth. Industrial output was up 16.2 percent at 1.4 trillion yuan (US$169 billion). Retail sales rose 13.7 percent to 1.5 trillion yuan (US$182 billion). Inflation was moderate, with the consumer price index up 2.8 percent from the same period last year.

Japan's jobless rate fell to 4.5 percent
April 25, 2005 MSN Money

Japan's jobless rate fell to 4.5 percent in March from 4.7 percent in February. Japan's unemployment rate has been improving along with the nation's rebounding economy, but has fluctuated over the past year. The rate was 4.5 percent in January, 4.4 percent in December, and 4.5 percent in November. The government said that the labour market is "improving" even though conditions are severe in some sectors. Data issued by the Ministry of Public Management showed that the total number of jobless fell year on year for the 22nd month in a row to 3.13 million, down by 200,000 from the same month a year earlier.

Comment: Although Japan's jobless rate has fallen, growth in labour demand is slowing and overall labor market conditions remain patchy. Japan has faced consistently declining prices, or deflation, which deadens economic activity by pushing down wages and profits. In addition, trade surplus shrank 0.2 percent y-o-y in March. We remain certain of a slowdown in the overall economic condition in the world's second largest economy.

Earnings reports may portend trouble ahead for Japan Inc
April 28, 2005, Asian Wall Street Journal

After three years of vigorous profit growth, Japanese companies are facing deterioration in their business environment, suggesting export trouble is brewing in the world's second biggest economy. The strong yen doesn't help, making exports less competitive and profitable, and production costs are climbing with the prices of oil, metal and other materials in the global markets. Export dependent companies such as auto makers are likely to take the biggest hit while outlook may be brighter for domestic-oriented companies in financial services, real estate and construction. In addition, the recently displayed animosity of some Chinese towards Japan also could dampen sales of Japanese products in China, Japan's biggest trading partner. Meanwhile, the Japanese economy is still in deflation - Tokyo's core consumer prices declined 0.5 percent in April from a year earlier, extending the deflation that started in the late 1990s.

US economy grows at the slowest pace in 2 years
April 28, 2005, AP

The US's gross domestic product rose at an annual rate of 3.1 percent in the January-to-March period, down from a 3.8 percent pace in the prior quarter, due to high energy prices as well as decline in consumer and businesses spending. Just a few weeks ago, economists were predicting the economy would expand at a pace of 4 percent or better in the first quarter. But they lowered the forecast to a 3.5 percent growth rate as a spate of recent economic reports suggested the economy had hit another "soft patch." Employers added just 110,000 new jobs in March, the fewest in eight months. Meanwhile CPI; excluding food and energy; rose by 2.2 percent in the first quarter. That was up from a 1.7 percent rate in the previous quarter and marked the fastest pace since the final quarter of 2001.

Note: On May 3, 2005, the Fed raised short-term interest rates to 3 percent, a one-quarter percentage point boost, the eighth increase of that size since last June.

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