



# **Economic Briefing To the Penang State Government**

## **ECONOMIC COMMENTARY for February '04**

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The recovery of the exports sector during the last quarter of 2003 marked a fresh round of economic buoyancy for Malaysia that has already showed up as a four year high in the KLSE composite index touching 875 points towards the end of February 2004.

During the last week of February 2004, Bank Negara announced Malaysia's 2003 growth at 5.2% with year-on-year growth figures for the four quarters in 2003 reading 4.6%, 4.5%, 5.2% and 6.4% roughly reflecting the seasonal effects experienced in a typical year. Given these performance figures, a projected annual growth near to 6% for 2004 would not be beyond the nation's reach. December 2003 figures showed the manufacturing sector to have increased by 20.8% from the same month a year before and registering growth of 10.9% for the year 2003. However, manufacturing will only contribute about 30% to the GDP leaving the bulk of about 54% to come from the services sector. Accompanying the rise in export sales, which is an important component of the current upbeat in the economy, was a marked rise in approved investments to RM29.1 billion in 2003, i.e., an increase by 62% over 2002 reported by MIDA. Of this amount, RM13.5 or 46% were domestic investments and RM15.6 or 54% were foreign direct investments. These figures also show a strong come back in investments during 2003 that have increased by 114% and 35% respectively between domestic and foreign sources from 2002.

The declining American dollar continues to be the current issue confronting the global economy. Undeniably, it has helped turned the U.S. economy around to show growth by 3.1% in 2003 and a forecast of between 4% and 5% for 2004. Although this appears to be welcomed news to Malaysian exporters, the American current account deficit fueled also by weak savings creates a potentially troublesome distorting effect on the world economy that will have to correct itself sometime in the future. Already part of this is showing up in Malaysian economic figures where Malaysia's foreign reserves has reached RM183.9 billion or US\$48.3 billion from which RM13.2 billion or US\$3.4 was added only during the first two months of 2004. The rise in the reserves indicates a capital outflow that is reflective of Malaysia's trade surplus. Basically, Malaysia is investing its surplus abroad. But if much of this is in American debt instruments as is traditionally the case and typical of most other economies in the world, the returns to such investments and its related risk is a matter of concern. China, Japan, South Korea and Taiwan have among themselves doubled their reserves over the past three years mostly the result of currency intervention by their respective central banks to hold their currencies down vis-à-vis the dollar. Their plan was to remain competitive in global market but in doing so, they help fund America's current account deficit.

What this means for Malaysia is that either one of two things will happen:

- (1) The continuing suppression of Asian currencies will result in low yields in American debt instruments which means to say that Malaysia will do worse with the returns from its foreign reserves compared with the returns from its domestic investments.

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This being the case more domestic investments will be warranted to remove Malaysia's surplus and hence capital outflow while building national capacity (the potential GDP) in the process. Thus in this connection, the 114% rise in domestic investment recorded in 2003 was a step in the right direction.

- (2) However, if a major correction occurs in response to the surging level of American debt, caused by high consumption/investments and low savings, the U.S. dollar would plunged but this will cause an offsetting effect by a proportionate surge in U.S. Treasury bond yields. This implies better than expected returns for Malaysia's sizable foreign reserves but because of the plunged dollar, such returns will amount to little in ringgit terms vis-à-vis the other currencies of the world.

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## Malaysian-China Business Relationship

China's ascension into the World Trade Organization in November 2001 marks a new phase in the economic patterns of this world. Traders, industrialist, investors are rushing into China to capitalize on this promising market. Economies around the world have been positively and negatively affected.

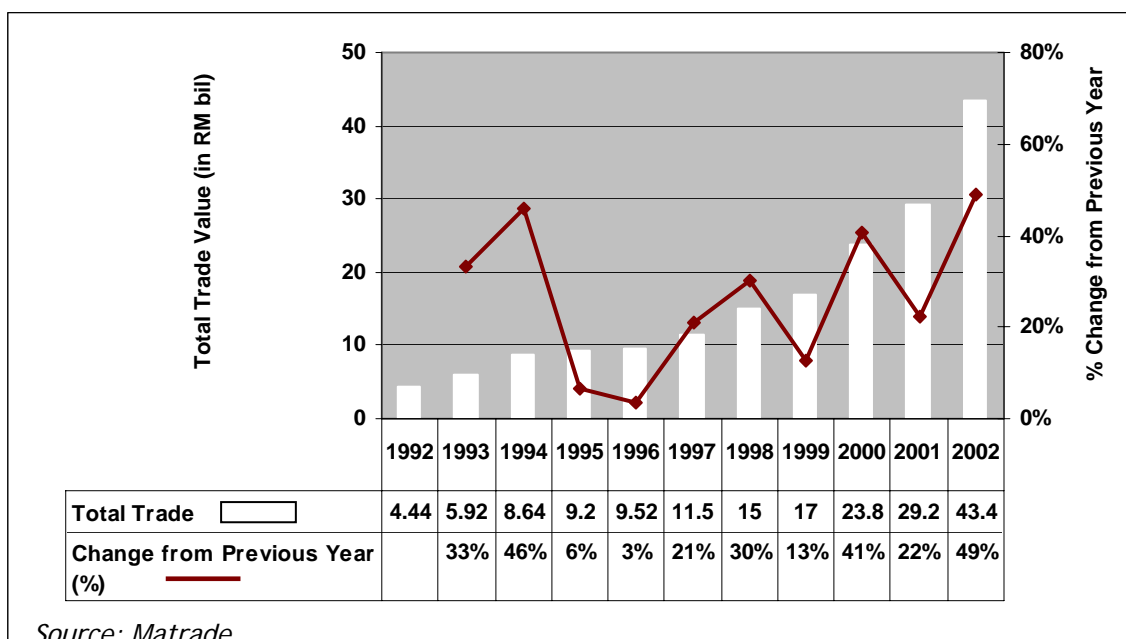
Is China a threat or is it an opportunity to South East Asian countries and to Malaysia in specific?

### Trading Relationship

China is an important trading partner for Malaysia. China is Malaysia's fourth largest trading partner and accounts for 6.6 per cent of Malaysia's global trade in 2002. In 2002, Malaysia's trade with China was worth RM43.4 billion, up from \$29.2 billion the year before (Figure 1). This represents a 49 per cent increase, the highest percentage increase recorded since 1992 (the next highest being 46 per cent increase in 1994).

Malaysia-China's bilateral trade is now ten-fold larger than 10 years ago when it was only RM4.44 billion. Statistically-speaking, the compound annual growth rate (CAGR) over ten years is 25.6 per cent. More notably, growth over last two years since 2000 has been phenomenal. Trade grew by 41% in 2000, 22% in 2001, and 49% in 2002. The increased trade not only signals a revival of the good economic relationship with China but also exceeded growths during the good times in the early 1990s.

Figure 1– Total Bilateral Trade Between China-Malaysia (in RM bil)



Along with unparalleled increase in trade, Malaysia has also recorded the largest ever trade deficit with China (RM3 billion) in 2002. In 2002, an explosion of imports from China, which grew at 62 per cent, accompanied by a much more modest increase in exports (36 per cent), pushed trade deficit into RM3.5 billion.

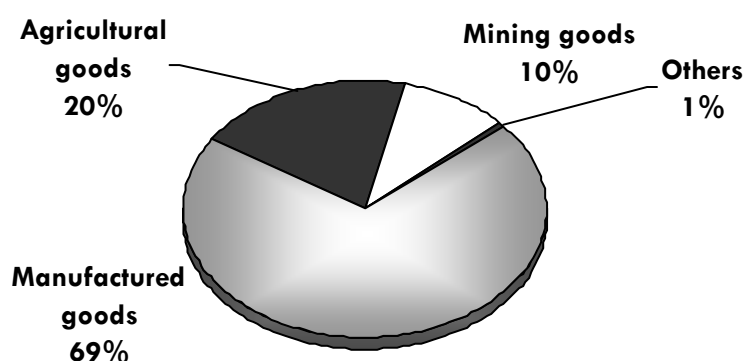
**Table 1 – Malaysia's Trade With China**

Year	Bal of Trade (RM Billion)	Total Exports (RM Billion)	Total Imports (RM Billion)	Exports Growth Rate	Imports Growth Rate
1998	0.51	7.77	7.26	48%	16%
1999	0.65	8.8	8.15	13%	12%
2000	-0.81	11.51	12.32	31%	51%
2001	0.21	14.68	14.47	28%	17%
2002	-3.51	19.97	23.47	36%	62%

Source: Matrade

Manufacturing goods takes the lead in exports to China (Figure 2). Manufactured goods accounts for 69% of exports or equivalent to RM14 billion, agriculture accounts for 19.6% (RM3.9 billion), mining goods 9.6% (RM1.9 billion), and others 0.6% (RM0.1 billion).

**Figure 2- Malaysian Export Sectors to China**



**Total Export = RM19.96 bil**

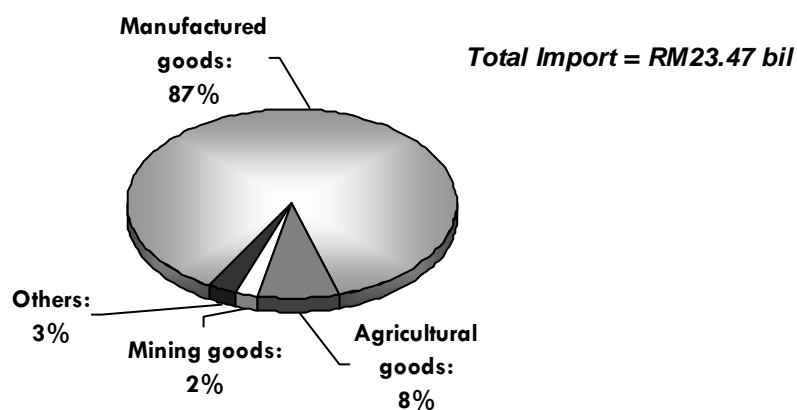
The export of electrical and electronics (E&E) products, under the “manufactured goods” category, make up 43% of total export to China (Table 2). E&E export by itself is even greater than the entire category of agricultural goods. At RM8.6 billion, “electrical and electronics” is approximately three-times the value of the next largest exports (i.e. palm oil, which is valued at RM2.9 billion) and four times the size of “chemicals and chemical products” export (valued at RM2.29 billion). Crude petroleum is the fourth largest export, with a value of RM1.3 billion.

**Table 2 - Top 5 Malaysian Exports To China in 2002 (in RM Million)**

Product Sectors	Value (in RM mil)	Share of Total Exports (%)	Annual Growth (2001-
Electrical & electronics (E&E)	8,619.80	43.2	21.1
Palm oil	2,911.20	14.6	100.7
Chemicals & chemical products	2,293.50	11.5	50
Crude petroleum	1,334.80	6.7	84.3
Machinery, appliances & parts	774.6	3.9	17.1

Source: Matrade

On the imports side, we see that manufactured goods takes up an even larger chunk of the share (87% of imports) compared to exports (69% of exports) (Figure 2). This amounts to RM 20.39 billion in 2002 (Figure 2). Agricultural goods consist of 8% of imports, mining goods 2%, and others 3%. The large chunk of imported manufactured goods is partly attributed to the imports of E&E products, as evident in Table 3. In 2002, Malaysia imported RM13 billion worth of E&E products from China. In contrast, Malaysia only exported RM8.6 billion to China.

**Figure 3 - Malaysian Imports From China****Table 3 - Top 5 Malaysian Imports from China in 2002 (in RM Million)**

Product Sectors	Value (in RM mil)	Share of Total Exports (%)	Annual Growth (2001-2002)
Electrical & electronics	13,019.70	55.5	70.6
Machinery, appliances & parts	1,831.30	7.8	78.7
Cereal	988.7	4.2	139.1
Textiles & clothing	962.9	4.1	46.5
Other manufactures	952.8	4.1	71

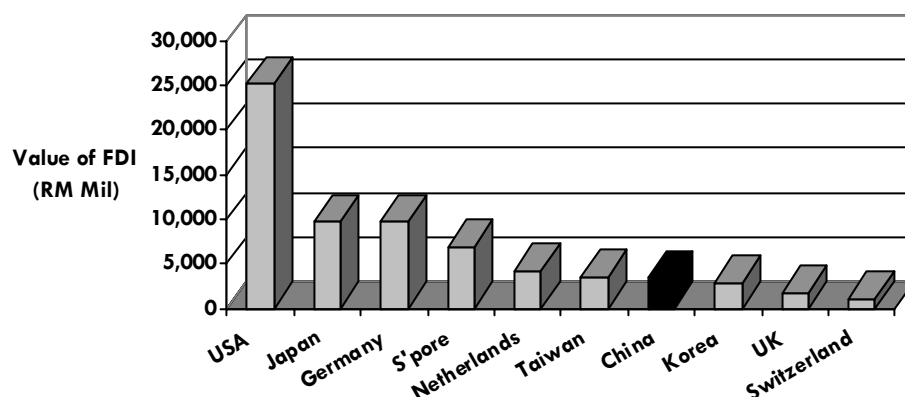
The demarcation of production according to competitive advantage between both countries has clearly caused large inflows and outflows of E&E products. By and large, many of the components and products used for assembly and testing in Malaysia are imported from China as they are cheaper to manufacture in China. In other words, intermediate and capital goods are the most common imported items from China. Availability of skilled workers is a shortage in China, so Malaysia is able to take part in the E&E supply chain by acting as a value-added manufacturer and designer, in certain cases. This complementary trade is mutually beneficial as it keeps cost down for Malaysian's E&E finished products at the same time that it "forces" Malaysian manufacturers to move up the value chain.

Apart from E&E, other sectors with significant trade deficits are machinery appliances and parts, cereals (food), as well as textile and garments. With the abolishment of Multifibre Agreement (MFA) under the WTO rules in 2005, imports of textiles and clothing will only grow exponentially as China's textile will no longer be subjected to quotas. On the flip side, palm oil, chemical and chemical products, and crude petroleum are large money earners for Malaysia. Each of these respective sectors have trade surplus of RM1 billion and above.

### Investment Relationship

According to statistics published by Malaysian Industrial Development Authority (MIDA), China is the 7<sup>th</sup> largest foreign investor in Malaysia between 1998 - 2002. The amount of investment stood just below Taiwan and surpassed investments from the Republic of Korea, United Kingdom, and Switzerland. From 1998 - 2002, Chinese investors invested RM3.38 billion into Malaysia.

**Figure 4 – FDI from Foreign Sources, 1998 - 2002 (in RM Mil)**



**Table 4 – Top Sources of FDI in Approved Projects in Malaysia (RM Mil)**

Rank	Country	1998	1999	2000	2001	2002	1998 - 2002
1	USA	6,433	5,159	7,492	3,412	2,668	25,164
2	Japan	1,868	1,006	2,881	3,366	587	9,708
3	Germany	152	187	1,656	2,603	5,055	9,654
4	Singapore	968	902	1,778	2,228	1,019	6,896
5	Netherlands	628	772	2,175	69	607	4,251
6	Taiwan	1,001	267	916	1,140	252	3,576
<b>7</b>	<b>China</b>	<b>361</b>	<b>12</b>	<b>34</b>	<b>2,923</b>	<b>55</b>	<b>3,384</b>
8	Korea, Rep.	76	35	723	1,703	369	2,907
9	UK	479	192	772	123	168	1,734
10	Switzerland	142	708	91	85	25	1,050

In terms of Malaysian investment in China, we refer to the special survey report by Deloitte KassimChan, entitled "*Malaysian Investment into China Fitness Survey*" conducted in 2003. Following are the key results of the survey, out of 160 respondents representing diverse sectors in Malaysia:

- 21% already have operation in China
- 43% intend to make their first investment in China within next five years
- 58% of respondents planning to enter or expand in China anticipate that it will take at least three years for their Chinese business to become profitable

In terms of location, Malaysian investors predominantly choose coastal cities because of their better infrastructure and better prospect for return on investment. Their development is a reflection of China's history of liberalisation, deregulation, and government support. Shanghai is the biggest draw of all – 30% of respondents with operation in China are located there. Up next are Tianjin, Guangdong, Jiangsu, and Beijing.

### **Why Malaysians Invest In and Trade With China?**

With a thriving economy that has been growing on an average of 7% to 9% for the past 23 years, it is not difficult to understand why China is attracting more investors and traders than ever before. With a near 1.3 billion population, China represents a huge market opportunity. Before the recent Western craze about China, Malaysians have, for the last three decades, identified China as an important trading nation. Hence they were willing to go to great lengths to penetrate the country by bypassing restrictions through ports in Hong Kong and Singapore.

The urge to follow the market trend is yet another factor for Malaysians to go to China. Fear of losing out to other competitors keeps them on their toes. A simple but common Malaysian wisdom goes as follows: "If you go to China, you'll die. If not, you'll die too."

The choice to go or not to go to China is not always an option. Several local manufacturing companies, especially those serving multinational corporations (MNCs), have been compelled to enter China to service their existing customers in this new location. To quote one of our respondents, "Many MNCs are moving to China. So in order to continue to serve our MNC customers, we must be there. We weren't intending to do so if it wasn't because of the MNCs." Unfortunately for them, since competition is so intense, their customers may not even end up choosing them as the outsourcing supplier in China.

Without doubt, cost of materials and cost of labour in China are motivational factors. This would be most applicable for cost-sensitive manufacturers and other labour-intensive industries. Cost is a tricky issue, though. Inflation in China, though still low, has jumped into positive territory after being in the negative in 2002. As China improves its living standard, cost savings will be increasingly less relevant.

Domestic limitation also forces Malaysian businessmen to move to China. Not only is the Malaysian market small, its population is also not wealthy and sophisticated enough to afford high-priced items that local manufacturers make.

### **The Penang Perspective**

China's influence has reached Penang's shores. Over the last few years, MNCs and SMLs (small- and medium-sized industries) alike started to shift their operations out of the Penang and into China. Many are worried that the exodus of the MNCs and other investors to China would devastate the Penang economy.

It would be a lie to say that there is no cause for concern with the emancipation of the Chinese economy. More foreign direct investment (FDI) is now being channeled into China, taking up as much as 60% of the FDI to Asia, replacing Southeast Asia in importance to foreign investors. Some businessmen in Penang claim that China is "killing off" the industry. Many small companies and producers find that their survival is at risk because the products that are imported into Malaysia from China are far cheaper than the local ones. On the other hand, consumers benefit from the inflow of cheap products. Cost competition can also spur the local companies to improve on its productivity and efficiency to lower the cost of their products.

As mentioned in the "Trading" section earlier in this article, Penang and Malaysia are exporting many products into China. Penang's exports are mainly derived from the electrical-and-electronics (E&E) sector. Most of our exports are semi-processed commodities, which are easily replaced. Once importers find a replacement for the products at a lower cost, they will divert and import from the cheaper source instead, regardless of the years of business relationship that has been established between the two companies.

In terms of the labour force in Penang, the technically-educated workforce may seek to move to China if the knowledge job market continues to be uninspiring. Penang also stands to lose many of its knowledge workers if R&D does not continue to grow here.

Most of Penang's manufacturing companies are still stuck in the OEM (Original Equipment Manufacturer) stage, that is at the bottom of the value-creation chain. Some local enterprises are just starting to venture into ODM (Original Design Manufacturer, the next stage) whereas only a handful has passed that stage. While some MNCs and a few advanced local companies are technologically-advanced, they are not truly reflective of the actual state of Penang's manufacturing standard. For Penang to survive, it must move up towards the design and development (D&D) and R&D level. Assembly and labour intensive activities are not viable for a medium-cost country like Malaysia.

Although China poses many threats to us, China should be viewed as an ally in business rather than an enemy. Instead of challenging or competing with China in the area of cost, we should seek to complement them in the areas in which they have yet to stamp their superiority.

### **What Has We Got to Offer to China?**

Relying on trading of raw and processed commodities as well as E&E products is one possible scenario. The making of oleochemical products (chemicals derived from natural fats and oils) is a lucrative avenue. Malaysia's resource based products, such as furniture and steels, are also promising given Malaysia's abundant supply of natural resources and China's voracity for them.

In infrastructure building, opportunities exist in areas such as ports, roads, highways, resorts and hotels buildings as well as oil and gas exploration. To capitalize on Beijing's host status for the Beijing Olympics 2008, Malaysians could bid on projects involving architectural design of sport and related facilities, engineering services and infrastructure construction that meet the requirements of modern sports facilities.

In launching the 2003 Islamic Economic Development Week on December, Prime Minister Datuk Seri Abdullah Ahmad Badawi, spoke about his aspiration to make Malaysia a regional halal hub. China has an estimated 150 to 200 million Muslim population. Malaysia, established in its knowledge of the requirements of halal food processing, could supply halal food to the Muslim population. More encouragingly, the Department of Islamic Development Malaysia (JAKIM) has been issuing halal certificates since 1974.

Penang and Malaysia could also position itself as a regional education centre in Asia, ala Singapore. developing Malaysia as the education center regionally. Malaysia could become the regional English centre of education as it is one of the few Asian country where English features prominently. Malaysia could also provide quality study abroad opportunity to those who cannot afford to study at high-cost nations such as the United States, European countries, or Australia

### **Conclusion**

Only time will tell how China will transform Penang.

As much as Penang is losing its stature as a low-cost, labour intensive manufacturing/ assembly hub in Asia, Penang can strive to become the focal point for technology and development. More high technology activities should be encouraged instead of labour-intensive activities. Penang has the ability to offer sub-contracting services, tooling, equipment development and so forth. Penang also has stricter Intellectual Property (IP) protection compared to China. According to the MNCs, most of them are keen to shift their labour intensive operations to China but to keep high-end development activities in Malaysia. The local industries, meanwhile, should look towards value-added

activities, R&D, design capabilities, and branding to keep up with the rest of the world.

Training and development especially in the areas of design and development, ICT, management, engineering and automation should be given priority. Many industry players are still reluctant to train their workers, afraid of mental concerns such as employees leaving their company once they obtain the extra knowledge and training. Such mentality will only dent the development process for the companies involved.

Penang can also encourage more foreign investors including the Chinese to invest in Penang by making itself for penetration into other South East Asia countries. Both Penang and Malaysia are politically stable and we are blessed with a geographical location that is free from natural disasters.

The practice of dependency on the Government to protect the local industry must be stopped. But ceasing to protect the local industries does not mean the Government should watch its own people sink. The Government can help through other, non-protective methods such as faster documentation procedures, less stringent foreign labour policies, and tax incentives.

Finally, Penang should make full use of its sister city relationship with Xiamen. It is a great opportunity to encourage more Chinese investors to come and invest in Penang.

To escape China is to escape the inevitable. Like it or not, industry players must adapt to the new challenges. It is a tall order for Penang to compete against the most populous country in the world, but nevertheless, we can excel in the areas in which we have the forte.

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