

Penang GRP 2004

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In This Issue

Penang GRP 2004	1
Catchy Phrases: The Language about East Asian Currencies and East Asian Economic Integration	8
Forum: Understanding the Goods and Services Tax (GST): Treatment of Imports and Exports	13
International Headlines	15

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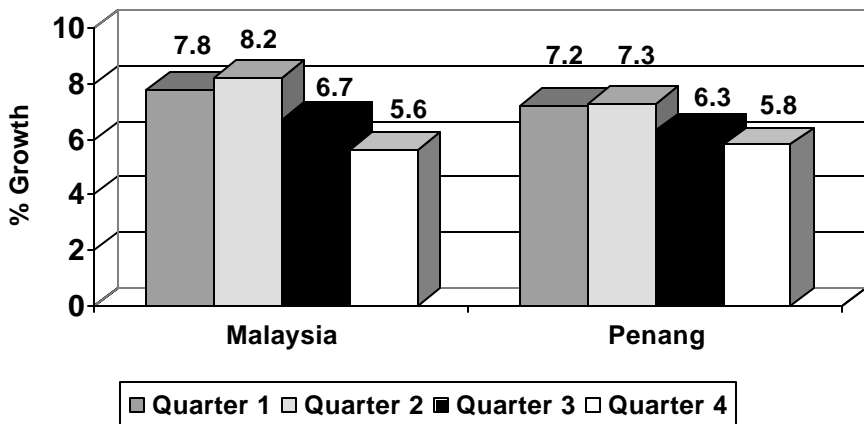
2004 was a relatively good year as both the nation and the state managed to rebound quite strongly from a tumultuous 2003. Both Malaysia and Penang recorded a remarkable 7.1 percent and 6.6 percent growth respectively, driven by strong external and domestic demands. The Penang economy experienced a very encouraging 5.8 percent growth in the last quarter of 2004. The growth slightly exceeds the 5.6 percent expansion of the Malaysian economy in the same period.

Table 1: Gross Domestic Product 2004: Malaysia vs. Penang

	Malaysia	Penang
Year 2004	7.1	6.6

Source: Department of Statistics, Malaysia & SERI

Chart 1: Gross Domestic Product (GDP): Q1- Q4 2004



Source: Department of Statistics, Malaysia & SERI

Table 2 highlights the value, sector share and rate of growth of the five main sectors from Q1 '04 to Q4 '04. Strong growth was recorded across all sectors in Q4 '04 with the exception of the mining & quarrying and construction sectors. The two contracted by 9.27 percent and 18.17 percent respectively.

Table 2: Penang's Gross Regional Product by Economic Sectors, 2004

Value (RM Million in 1987 Prices)	Q1	Q2	Q3	Q4	2004
Agriculture	76	77	78	78	309
Mining & Quarrying	47	46	43	43	179
Manufacturing	2,098	2,123	2,133	2,150	8,505
Construction	97	90	80	81	349
Tertiary	2,627	2,672	2,686	2,707	10,691
Overall GRP	4,945	5,008	5,020	5,059	20,032

Source: SERI

Table 3: Penang-Economic Sector Contribution and Growth Rate by Economic Sectors, 2004

% Share	Q1	Q2	Q3	Q4	2004
Agriculture	1.53%	1.54%	1.55%	1.55%	1.54%
Mining & Quarrying	0.95%	0.91%	0.85%	0.85%	0.89%
Manufacturing	42.42%	42.40%	42.50%	42.50%	42.46%
Construction	1.97%	1.80%	1.60%	1.60%	1.74%
Tertiary	53.13%	53.35%	53.50%	53.50%	53.37%
% Growth	Q1	Q2	Q3	Q4	2004
Agriculture	3.50%	3.97%	4.89%	5.70%	4.51%
Mining & Quarrying	-4.60%	-5.89%	-9.97%	-9.27%	-7.36%
Manufacturing	10.00%	10.15%	9.39%	8.74%	9.58%
Construction	0.50%	-7.90%	-18.80%	-18.17%	-11.10%
Tertiary	5.50%	6.02%	5.27%	4.66%	5.38%
Overall GRP	7.11%	7.28%	6.31%	5.75%	6.62%

Source: SERI

Manufacturing

The Penang economy continues to be driven by the manufacturing sector, which experienced a robust 9.58 percent overall growth in 2004. Value-added in the manufacturing sector grew by 8.74 percent in Q4 '04. Total investments into Penang increased from RM1.92 billion in 2003 to RM2.03 billion in 2004. Nevertheless, Penang's share of the total approved investments in Malaysia has shrunk to 13.1 percent, the lowest percentage share it has ever had since 1999.

For the first time in 6 years, manufacturing investments in Penang were driven by domestic investments. Data sources show that domestic investments, in the first 3 quarters of the year, went mainly into the electrical & electronic (E&E), plastic products, fabricated metal products and machinery manufacturing sub-sectors. Total domestic investment for 2004 escalated by a massive 117.1 percent from last year, while total FDI shrunk by 30.2 percent, further contracting from RM1.45 billion in 2003 to RM1.02 billion in 2004.

Table 4: Penang: Number of Approved Projects and Investments

	2003	2004	Y-o-Y Growth
Number of Projects Approved	137	144	5.1%
Potential Employment	9,890	9,235	-6.6%
Amount of Investment Approved (RM)	1,922,986,202	2,030,147,425	5.6%
Local	467,169,243	1,014,409,409	117.1%
Foreign	1,455,816,959	1,015,738,016	-30.2%

Source: MIDA

Out of the total of 144 projects this year, 60.4 percent of the projects involved foreign participation. The US remains as the main foreign investor with a total investment of RM459.4 million this year, followed by Japan and Singapore.



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Table 5: Projects Approved in Penang (2004) with Foreign Participation

Country	Number	Employment	Investment (RM)
Canada	2	155	50,820,000
France	1	185	19,500,000
Netherlands	4	536	80,949,728
Hong Kong	1	0	0
India	1	21	205,000
Italy	1	291	10,709
Japan	13	462	130,475,650
Korea, Rep.	1	10	3,830,400
Singapore	10	899	132,606,342
Taiwan	17	921	40,694,908
Thailand	1	95	1,700,000
United Kingdom	1	196	6,450,000
USA	9	1,349	459,355,351
F.R Germany	1	28	1,151,280
Finland	1	414	30,000,000
Cayman Islands	2	64	23,299,000
British Virgin Islands	3	291	1,946,657
Others	18	980	32,742,991
TOTAL	87	6,897	1,015,738,016



Source: MIDA

In the terms of total investments, Penang stands 5th in the country, trailing behind Selangor, Sarawak, Kedah and Johor. There was a huge surge of investments into Kedah whereby the Northern state leapfrogged from 9th place last year to 3rd place this year, overtaking both Johor and Penang this year.

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Table 6: Ranking of Approved Investments, 2003 & 2004

Position	Number of Projects		Total Capital Investment	
	2003	2004	2003	2004
1	<i>Selangor</i>	<i>Selangor</i>	<i>Sarawak</i>	<i>Selangor</i>
2	<i>Johor</i>	<i>Johor</i>	<i>Selangor</i>	<i>Sarawak</i>
3	<i>Penang</i>	<i>Penang</i>	<i>N. Sembilan</i>	<i>Kedah</i>
4	<i>Perak</i>	<i>Kedah</i>	<i>Perak</i>	<i>Johor</i>
5	<i>Kedah</i>	<i>Melaka</i>	<i>Johor</i>	<i>Penang</i>

Source: MIDA

Table 7: Penang: Approved Manufacturing Projects by Industry

Industry	Number of Projects		Total Investments (RM million)	
	2003	2004	2003	2004
Electrical & Electronics	57	54	1,385.4	1,258.6
Basic Metal Products	3	3	52.0	19.7
Chemicals & Chemical Products	1	7	4.1	129.7
Fabricated Metal Products	26	21	148.4	127.7
Food Manufacturing	4	6	42.6	137.9
Machinery Manufacturing	16	17	93.6	139.1
Non-Metallic Mineral Products	-	1	-	6.2
Others	-	2	-	4.8
Paper, Printing & Publishing	3	7	33.9	69.6
Petroleum & Petrochemical Products	-	1	-	16.1
Plastic Products	10	9	25.9	42.2
Rubber Products	3	2	9.8	10.9
Scientific & Measurement Equipment	7	5	96.8	31.3
Textile & Garment	2	-	9.1	-
Transport Equipment	3	5	7.7	2.4
Wood & Wood Products	-	1	-	7.1
Beverages & Tobacco	1	-	12.7	-
Furniture & Fixtures	1	2	1.0	18.3
Leather & Leather Products	n.a	1	-	8.5
TOTAL	137	144	1,923.0	2,030.1

Source: MIDA

There were no new or expansion of investments into the textile & garment and beverages & tobacco sub-sectors in 2004.

As can be seen from Table 7, the electrical and electronics industry continues to remain the leading industry in the manufacturing sector despite recording a drop in the number of projects and total amount of investments. The drop in the total investments in the E&E sub-sector was cushioned by growth in total investments of other sub-sectors, however. Among the industries that recorded positive growth in terms of total investments in new and expansion projects in the past year are: chemical & chemical products; food manufacturing; machinery manufacturing; paper, printing and publishing; and furniture & fixtures. There were no new or expansion of investments into the textile & garment and beverages & tobacco sub-sectors in 2004.

Tertiary

The tertiary sector continues to be the biggest contributor to Penang's GRP. The tertiary sector achieved a decent 4.66 percent growth in Q4 '04 and a 5.38 percent growth for the whole of 2004. The tourism industry is slowly regaining its position and travel confidence has returned strongly after strings of problems hit the industry in the past years. Visitor arrivals to Penang in the first half of 2004 increased by 20 percent¹ compared to the same period of last year. Hotel sources reported that they have registered better occupancy rates in Q4 '04 than Q4 '03. Foreign tourist arrivals were mostly from neighbouring countries. However, the industry was very much affected by the tsunami just before the end of the year. Due to the knee-jerk effect, the

¹ DCT Consultancy Sdn. Bhd.

average occupancy rate of hotels fell sharply as last minute cancellations and postponements resulted in substantial losses for the hotels. Amongst those hard-hit by the tragedy were hoteliers, travel agencies, tour guides, airlines, seafood restaurants and other travel trade operators. Nevertheless, the industry players believe that the impact will not have long-term repercussions for the tourism sector in Penang. However, the March 28 earthquake in Sumatra and the predictions of more to come may require a re-evaluation of the short to medium term prospects for the tourism industry.

Visitor arrivals to Penang in the first half of 2004 increased by 20 percent compared to the same period of last year.

Though the Penang tourism sector has shown signs of improvements this year, the true potential of tourism in the State has yet to be realised. Further collaboration between State authorities and industry players and the people of Penang is needed to further promote and enhance the charms of Penang. Aggressive marketing strategies will not work if there are no concrete products and packages to sell.



Agriculture, Hunting, Forestry & Fishing

In the agriculture sector, Q4 '04 performance did not register much change from Q4 '03 both in terms of yield and land area. As Q4 is not a harvesting season for paddy, there were no paddy yields at this time of the year. Industry sources quoted that paddy production for the whole of 2004 has experienced a slight increase compared to 2003 as the yields in 2003 were affected by flood related problems. In terms of the palm oil sub-sector, the output of crude palm oil increased by 23.9 percent in Q4 '04 y-o-y. The total value of crude palm oil grew at a slower pace of 1.6 percent in the same period, however, as crude oil prices were much higher in the last quarter of 2003 compared to the same period of 2004. The fisheries sector was badly affected by the tsunami crisis but the full impact of the catastrophe on the economy could not be deduced from Q4 '04 figures as demands for December had mostly been fulfilled before the tragedy occurred.

Construction

The construction sector did not fare well in 2004. It achieved a minimal 0.5 percent growth in Q1 but went downhill for the ensuing 3 quarters. Although the property market picked up in the year 2004, majority of properties sold were overhang properties from previous years. Only towards the end of 2004 did the construction sector gain slight momentum with the building of several super-condominium complexes along the beachfronts stretching from Tanjung Bungah to the prestigious Jalan Sultan Ahmad Shah. Two recently completed super-condominium complexes are the Millenium Tower and Gurney Place, which at the moment have relatively low occupancy rates.

Table 8 highlights the increase of costs of building materials for all 4 quarters of the year 2004 using July 2002 prices as base price (with the specified months being the proxy for each of the quarters). Prices of building materials for the northern peninsular states continue to soar at nearly every work section, especially in Reinforced Concrete (RC) work piling, foundation works, RC structural works and plumbing works. Nonetheless, in comparison with the other states across the peninsula, prices in the northern region are still lower in most work sections. Amongst all the building materials, the price of steel and structural works has been rising the most rapidly. On the contrary, costs for finishing works only recorded a minimal rise since the base year.

Table 6: Building Materials Cost Index by Work Section and Region

Work Section	Period	REGION					
		A	B	C	D	E	F
		Pulau Pinang, Kedah, Perlis	Perak	Kuala Lumpur, Selangor, Negeri Sembilan, Melaka	Johor	Pahang	Kelantan, Terengganu
JULY 2002 = 100							
RC Piling Works	Mar 04	105.5	110.0	112.5	108.3	108.4	109.8
	Jun 04	125.6	128.0	129.4	124.8	128.2	129.4
	Sep 04	120.3	126.6	127.4	123.4	130.1	129.8
	Dec 04	120.1	127.5	125.7	123.9	130.2	129.6
Foundation Works	Mar 04	102.0	107.0	111.4	107.6	107.4	108.1
	Jun 04	117.6	122.1	125.2	121.4	123.7	124.4
	Sep 04	113.6	120.8	124.0	120.2	125.2	124.7
	Dec 04	113.6	121.6	122.5	120.6	125.3	124.1
RC Structural Works	Mar 04	103.0	108.5	112.2	108.5	108.2	108.9
	Jun 04	120.3	124.9	127.4	123.6	126.1	126.7
	Sep 04	116.0	123.4	125.9	122.2	127.6	126.9
	Dec 04	116.0	124.2	124.3	122.7	127.6	126.4
Steel and Structural Works	Mar 04	131.4	129.5	129.6	130.5	130.9	128.6
	Jun 04	138.6	136.3	136.4	137.7	137.9	136.6
	Sep 04	134.2	132.2	132.3	133.5	134.4	132.4
	Dec 04	135.3	133.4	133.7	135.4	135.5	133.4
Brickworks and Blockworks	Mar 04	105.0	99.6	108.8	105.2	105.9	110.2
	Jun 04	105.3	104.0	109.6	107.3	107.2	112.1
	Sep 04	105.0	105.0	110.2	107.0	107.3	112.1
	Dec 04	105.0	105.2	110.0	106.8	107.8	112.1
Roofing Works	Mar 04	110.7	110.4	110.9	115.3	112.7	110.9
	Jun 04	116.0	118.3	115.1	120.9	117.5	117.9
	Sep 04	114.1	117.0	113.8	119.9	117.9	117.7
	Dec 04	114.4	118.3	113.9	121.4	120.0	117.9
Doors and Windows Works	Mar 04	112.4	112.3	112.4	112.2	112.4	111.3
	Jun 04	113.7	113.4	113.6	113.6	113.7	114.7
	Sep 04	112.6	112.4	112.5	112.6	112.7	113.7
	Dec 04	112.7	112.6	112.8	113.3	112.9	114.5
Finishing Works	Mar 04	99.8	100.3	100.5	100.8	100.4	102.3
	Jun 04	100.7	100.5	100.8	101.1	100.6	103.7
	Sep 04	100.4	100.9	101.6	101.2	101.0	103.6
	Dec 04	100.5	100.9	101.5	101.8	101.4	103.5
Sanitary Fittings Works	Mar 04	100.6	101.3	100.2	100.3	100.0	99.6
	Jun 04	100.8	102.5	100.3	100.7	101.3	100.0
	Sep 04	100.8	102.2	100.3	100.6	102.7	100.2
	Dec 04	100.9	102.2	100.4	100.7	102.8	100.4
Plumbing Works	Mar 04	109.2	108.2	106.0	108.6	106.3	102.7
	Jun 04	114.9	115.1	110.9	113.7	109.6	107.7
	Sep 04	115.1	114.6	111.2	114.7	110.6	107.7
	Dec 04	117.1	117.5	112.4	116.5	115.3	108.0

Source of data: This index is compiled from data supplied by Department of Statistics

BNM Loans

The state continues to record a high increase of bank loans in the 4th quarter of 2004. Sectors which experienced high growth rates are mining and quarrying; wholesale, retail, restaurants & hotels; property, transport storage & communication; consumption credits; purchase of securities and purchase of transport vehicles.

The rise in the total amount of loans especially in the areas of private consumption and private investments signal a higher growth in consumer spending. This is in tandem with national trends where private consumption has been the main growth driver of the economy in 2004.

Table 6: Growth Rates in Loans by Sector

Sectoral Loans	% Growth	
	Penang	Malaysia
Agriculture, hunting, forestry & fishing	-4.6%	2.2%
Mining & quarrying	14.4%	-20.9%
Manufacturing	-1.0%	3.4%
Utilities	-6.0%	-4.6%
Wholesale, retail, restaurants & hotels	4.9%	9.7%
Property (Construction, residential & non-residential property)	10.5%	11.1%
Finance, insurance, real estate & business services	-7.9%	1.5%
Transport, storage & communication	14.0%	-18.5%
Consumption credits (Personal use, credit card, consumer durable goods)	14.1%	14.2%
Purchase of securities	18.3%	-6.7%
Purchase of transport vehicles	15.3%	14.4%
Community, social & personal services	-1.6%	-1.5%
Sectors (non-economic related - n.e.c.)	-6.3%	-8.8%
Total Loans	7.5%	7.2%



Source: Bank Negara Malaysia

Conclusion

Based on the above sectoral analysis, we estimate that for the year 2004, Penang achieved GRP growth of **6.62 percent**. This is an upward revision from our forecasted growth rate of 6.5 percent as published in the *Penang Economic Report December 2004*. With regards to Q4 '04, a growth rate of **5.57 percent** was recorded. The Q4 '04 growth rate is slightly lower than the previous three quarters of the year because base figures recorded for Q4 '03 were much higher than the other quarters of 2003. This is due to the fact that the economy began to recover and gain momentum towards last quarter of 2003.

Moreover, in Q4 of 2004, retailers experienced sluggish sales despite the festivities. This could be attributable to lower levels of consumer confidence amidst the uncertainties of 2005 such as the potential impact of the higher cost of oil and the possibility of an increased interest rate environment. **§ Poh Heem Heem & Tan Yin Hooi**

NOTE:

As of 2003, the GRP projections by SERI are rightfully driven on the demand side and would therefore reflect business cycle effects. Before this, the GRP projections were calculated on the basis of potential output (labour input, land availability, capacity, etc.) by the various supply sectors (agriculture, manufacturing, mining & quarrying, construction and tertiary). Obviously, there will be an expected mismatch between the two projection methods largely because demand projections will be effected by business conditions and consumer sentiments whereas the supply side is affected by changing productive capacity. We have noticed that our supply side projections for 2003 have resulted in a shortfall by about 3% relative to the demand side.

About half of this shortfall results from stock changing conditions, which are similarly found in the national GDP figures. What this means is that output in any given year does not necessarily enter into the final demand categories (consumption, investment and trade) in the same year. Instead unsold output is carried on to the following year, which thus implies that demand in any year will also be met from output from the previous year. The net effect is registered in the national accounts as change in stock. The other half is caused by an underestimate of the productivity figures (such as output per unit land or output per unit labour etc.) used in the GRP projections.

To calculate the growth between 2003 (supply projection) and 2004 (demand projection), the supply side is normalized by rebasing it with a 1.03 (i.e. 3% factor) so that the real growth rate could be meaningfully

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Catchy Phrases: The Language about East Asian Currencies and East Asian Economic Integration

Introduction

Quantum physics makes bewildering reading, containing familiar everyday words like jet events, five, maybe as many as eight flavours and vibrating strings that have special meanings, which bear no connection with what we know. Exchange rate literature on how East Asian currencies interact among themselves and with the rest of the world has also evolved its own set of catchy phrases. But they form the language with which we might better understand how the economies of East Asia came into and recovered from financial crisis. They also help point towards those kinds of monetary policy that would be required and those that might be avoided in order that the world's financial architecture remain intact and that individual economies can continue to achieve the growth desired.

Original sin

Small economies in East Asia have never been able to borrow huge amounts of capital abroad using its own currency, mostly because the domestic capital market is underdeveloped. As a result, highly capitalised investment projects at home that produce returns in domestic currency are financed in a foreign currency. Small economies also have difficulty financing long-term debt because of uncertainties over the stability of domestic currency. Long-term investments therefore tended to be financed by short-term loans. *Original sin*¹ concerns either a currency mismatch or a maturity mismatch that contains the risk from changes in the exchange rate or changes in the interest rate differential between long-term and short-term financing. These changes affect the financing cost relative to expected returns and thus give rise to uncertainties.

Conflicted virtue

The simple notion that one can borrow when there is a shortfall and lend during times of surplus becomes complicated when different currencies are involved. Malaysia is currently in such a state of *conflicted virtue*², because like its East Asian counterparts it cannot lend in its own currency. Malaysia is "virtuous" because its current account surplus (partly caused by the country's high savings rate), which is valued in a foreign currency, runs into "conflict." If the ringgit follows a floating rate, the continued run of surplus years leads to a steady appreciation of the ringgit. Since the amount lent is in a foreign currency that has been steadily depreciating, the total amount of credit held from such lending has also steadily fallen in value relative to the ringgit amount first lent out.

¹ See Barry Eichengreen and Richardo Hausmann (1999), "Exchange rate and financial stability," NBER working paper No.7418

² See Ronald McKinnon and Gunther Schnabl (2004), "The return to soft dollar pegging in East Asia," *International Finance*.

If the ringgit is fixed against the dollar, as it is today, the amount lent does not depreciate but the *conflict* remains, because as the stock of dollar claims accumulates, speculation becomes rampant over how long such a fixed rate can sustain, failing which an impending currency appreciation will suddenly wipe out much of the value of the amount lent in dollars. This is exactly the situation that Malaysia faces right now. As at 28 February 2005, Malaysia's foreign exchange reserves amounted to RM272.9 billion, which is lent out in a foreign currency at the value of US\$71.8 billion. If the ringgit suddenly appreciates by say about 10 percent to RM3.4 to the dollar, the same US\$71.8 billion will only worth be RM244 billion, instantly wiping out RM28.7 billion from the net worth of the amount lent.

Mundell I and II³

Original sin and *conflicted virtue* thus appear to be two sides from the same coin, depending on the hazards of having to use foreign currency for borrowing or lending because of the relative weakness of the capital market for domestic currency. But there is also another issue with domestic currency, which is the invoicing for goods and service resulting from international trade. With the minting of the euro, much of these problems have been solved among the member countries. Consequently, there would obviously be considerations about the possibility of a similar currency union among East Asian economies.⁴ A common currency brings several advantages: price stability among traded goods, convenience in goods invoicing and both exchange rate and money supply stabilities without requiring active interventions by the central bank.



Such notions about the advantage of adopting a common currency had perhaps prompted Robert Mundell to suggest in 1961 that different countries within a small area and are more homogenous might form an optimal currency area.⁵ Before free-floating, that would only come into effect a decade later, Keynesian-type government intervention was thought to smooth over shocks in the economy, causing the exchange rate to depreciate when the central bank pursued easy money and appreciate when money supply is tightened. Thus it makes sense for homogenous economies facing the same economic conditions to be on the same exchange rate.

However, after the onset of free floating exchange rates, Mundell himself, in 1973, contradicted his original theory and instead argued that a common currency area should span over a wide area and best be comprised of diverse economies that are heterogeneous – quite the opposite from his original idea.⁶ In a heterogeneous region particular economies might suffer a recession, which leads to income losses as currency is drawn down. Under a flexible exchange rate, the currency depreciates along with the recession further amplifying the loss of income as the purchasing power for imports declines. But had the economy been on a common currency, any tendency to depreciate is shared and thus cushioned by all the heterogeneous economies sharing the same currency. This does not spare recession at home but with a more stable exchange rate, it at least helps mitigate loss of purchasing power for imports.

Most people are skeptical about the likelihood that East Asian currencies will come into alignment because of the obvious diversity among the economies that make up

³ See Ronald McKinnon (2004), "Mundell I versus Mundell II" *Journal of Common Market Studies*.

⁴ An example of such an analysis is Srinivasa Madhur (2002), *Cost and Benefit of a Common ASEAN Currency* ERD Working Paper No.12 Asian Development Bank, Manila.

⁵ Robert A Mundell (1961), "A theory of optimum currency areas." *American Economic Review*, 51, pp.509-517

⁶ Robert A Mundell (1973), "Uncommon arguments for common currencies." in Johnson HG and Swoboda AK, *The Economics of Common Currencies*, Allen and Unwin, pp.114-132.

the region. In principal, East Asian currencies are free to float in response to market forces without intervention by the central banks. But the small volumes in the issuing of most of these currencies make each floating independently a practical impossibility. Thus in practice, the market has always fixed each currency against a nominal anchor, namely the U.S. dollar such that the floating rate becomes one, which either strengthens or weakens relative to the dollar.⁷

Fear of floating

Despite the fact that each East Asian currency is free to float against a nominal anchor currency such as the U.S.'s, prior to the 1997 crisis, *fear of floating*⁸ helped give rise to an Asian currency standard even though this was not a declared monetary policy by the respective central banks.⁹ Except for Japan, most East Asian economies keyed their currencies to the dollar by ways we come to call managed float, independent float, currency board hard fixed rate or loose basket peg. Although currency interventions leave currencies prone to speculative attacks, prior to the crisis, it has been observed that the various currencies from these economies were generally aligned in terms of purchasing power parities against one another as well as with the U.S.¹⁰ The central banks in East Asia tended to “dollar-peg” their currencies when times are good in an effort to avoid loss of export competitiveness across a diverse spectrum of goods – the so-called “Dutch disease”. Dollar-pegging also helps offset the tendency towards currency collapse during adverse economic conditions along the lines of the Mundell II argument discussed above.

Loose cannon

The East Asian currency alignment would have continued to work well had the Japanese yen been similar pegged against the dollar. As Ronald McKinnon had pointed out, for many years prior to the 1997 crisis, the cyclical swings and short run volatility in the yen-dollar rate was a destabilizing factor. Not only had such swings been altering the competitiveness positions of dollar pegged countries they also led to abrupt changes to the pattern of Japanese foreign direct investments abroad. In other words, the turbulent shifts to the yen-dollar rate made the Japanese currency a destabilizing *loose cannon* among the East Asian currencies.¹¹

Beggar thy neighbour

The very open East Asian economies, in which the value of trade is often as much as the GDP, mostly invoice their trade using dollars. Thus instead of acting like *loose cannons*, the different East Asian currencies kept within narrow bands of the dollar will not only help stabilise domestic price levels (an important monetary policy objective) but it will also help prevent competitive devaluations to keep export prices

⁷ Ronald McKinnon explains this in his 1979 book *Money in International Exchange* (Oxford University Press). If there are 150 currencies in the world there would be 11175 possible foreign exchange quotes. It will be too expensive to manage this. Thus if one currency is used as a nominal anchor, there need only be 149 foreign exchange quotes relative to this anchor.

⁸ Guillermo Calvo and Carmen Reinhart (2002), “Fear of floating.” *Quarterly Journal of Economics*. 117.

⁹ McKinnon cited Kehnichi Ohno (1999), “Exchange rate management in developing Asia: a reassessment of the pre-crisis soft dollar zone.” *Asian Development Bank Institute Working Paper, Tokyo*, who regressed daily logarithmic changes of each of 10 Asian currency relative to an arbitrarily chosen European currency as the dependent variable against changes of the dollar relative to the same European currency and changes of the yen to that European currency as independent variables. Ohno found that the coefficient for the dollar variable is close to one but only a weak coefficient value was found for the yen variable. This means that Asian currencies and the dollar move closely in tandem with one another but not with the yen, thus indicating exchange rate alignments between the 10 Asian currencies tested and the dollar.

¹⁰ Ronald McKinnon (2004), “The East Asia dollar standard,” *ANEPR conference Asia in Search of a New Order, Tokyo*.

¹¹ Ronald McKinnon (1999), “The East Asian dollar standard, life after death?” *Workshop on Rethinking the East Asian Miracle, Economic Development Institute and World Bank, San Francisco*.

down and gain market share against neighbours whose currencies are on the rise. While over the recent decades, many could envisage an Asian economic bloc evolving with Japan in the center, during more recent years many are beginning to see the centre¹² migrating towards China.

Professor McKinnon saw China's *renminbi* peg of 8.3 yen to the dollar that was instituted in 1994 as an important stabilizing factor among the East Asian economies. In the wake of the 1997 financial crisis most currencies of the rest of East Asia tumbled. Despite losing competitiveness, China did not devalue its currency and instead shifted production towards its domestic sector. This prevented widespread *beggar-thy-neighbour* devaluations across East Asian currencies, similar to what was experienced among countries affected by the depression during the 1930s. Japan could have done better in bringing the yen in-line with the dollar, which would, in textbook fashion, also bring about interest rate alignment. This in effect would lead to price stability throughout the region as well as moderate unnecessary speculative cross-boundary capital movements.



Snake in the tunnel

Whether an attempt to fix currencies instead of allowing them to float freely is to be regarded a *virtue* or a *sin* will continue to be debated for some time. However, after the Bretton Woods system for fixing exchange rates using the dollar as a nominal anchor came to an end in 1971, the EEC countries devised a mechanism, referred to as the *snake in the tunnel*, to manage the various European currencies (the *snake*) within a narrow band against the dollar (the *tunnel*) in order to continue the currency stability that had previously been enjoyed. The 70s were a time of global slowdown, which most people saw as a result of supply shocks in response to which the floating exchange rate coincidentally brought by the end of the Bretton Woods system would work better. Despite the attempt to fix, the *snake* was seen at the end to have escaped from the *tunnel* such that by 1977, the German mark was the only currency left in it. By 1977, the *snake and tunnel* was replaced by the *exchange rate mechanism* or the ERM, the precursor to today's euro. Economists like McKinnon and Mundell would have liked for the snakes not to have escaped, because they saw the 70's slowdown as having been caused by global monetary instability brought by the breakdown of the Bretton Woods system that led to supply shocks, these being the result rather than the cause of the 70s slowdown.

Conclusions

The ASEAN free trade agreement or AFTA and its plan to become AFTA+3 to include China, Korea and Japan is receiving keen interest because the current years form the period during which systematic reductions in trade tariffs come into effect across participating countries via the common effective preferential tariff (CEPT) mechanism. The East Asian economies are highly open in trade and financial flows and are therefore susceptible to risks from exchange rate volatility.¹³ As mentioned, the East Asian economies have implicitly followed an Asian currency standard due to *fear of floating*. Many economists¹⁴ have attributed part of the success over recent decades of the East Asian economies (when compared against Latin American ones) to such commitments in pegging currencies to a common nominal anchor, namely the dollar that also results in price stability especially wages that in turn motivated economic growth.

Unfortunately, during the 1997 crisis, the majority of the East Asian currencies could not be defended but in the years that followed, the different economies gradually returned to some form of soft dollar pegging. China, which did not suffer from the

¹² Takatoshi Ito (1994) "On the possibility of a yen bloc" in Reuven Glick and Michael M Hutchison *Exchange rate policy and interdependence: perspectives from the Pacific basin*. Cambridge University Press.

¹³ See footnote 2.

¹⁴ Barry Eichengreen, Douglas Irwin, Jeffery Frankel, Andrew Rose, Ronald Mackinnon, Jefferey Sachs

crisis continued to hold on to its 1994 instituted, 0.5:1 peg against the dollar for the *renminbi* and thus prevented the *beggar-thy-neighbour* competitive devaluations across the rest of East Asia. To help overcome issues like *original sin* and *conflicted virtue*, an attempt was made by the Japanese government with pledges from Hong Kong, Taiwan and Singapore to assemble an Asian Monetary Fund in September 1997 for the purpose of helping crisis countries to meet balance of payment shortfalls. This never came about, because a couple of months later, following objections by both the U.S. and IMF, the Manila Framework Group was formed instead under APEC for the purpose of instituting IMF's Article IV (concerning exchange rate obligations) surveillance and technical assistance over financial regulation. The sentiment was that an Asian fund would allow crisis countries to avoid having to institute the necessary prudence from strict financial supervision as mandated by IMF's Article IV.

In 1999, at the Asian Summit in Singapore, then prime minister, Mahathir Mohamad, unsuccessfully attempted to revive the Asian fund. However, at the December 2000 ASEAN meeting in Chiang Mai, a bilateral Asian swap agreement was announced under which all ten ASEAN country members as well as Japan, China and South Korea (i.e., ASEAN+3) would participate. Called the Chiang Mai initiative, the new swap arrangement is a development of an earlier facility that was established in 1977 that involved only the original five founding members of ASEAN. The key difference is that the new facility allows collateral in local currency instead of the traditional use of U.S. treasury bonds. For small and short-term drawings of funds, an IMF agreement can be bypassed but subsequent or prolonged drawings will require the usual supervisory conditions by the IMF to be met.¹⁵ Thus, the swap arrangement was able to circumvent the objections that had been raised by the U.S. and the IMF over the Asian fund. Going entirely Asian will require containing an Asian *snake inside some tunnel*. The Europeans have finally overcome this problem today with the euro, since all member countries are on the same currency. The same is not true in the ASEAN+3 swap system, in which unless a more formal currency parity arrangement is devised, *original sin* or *conflicted virtue* problems cannot be fully avoided.

The issues raised here are intended at demonstrating that money is indeed a fragile instrument, because of the volatility that comes with its value. The total amount of seigniorage currencies issued by small economies, like those in much of East Asia, are insignificant within the total international financial capital. As a result, their exchange rates can only be measured relative to some nominal anchor. The key question is thus what is the articulated exchange rate policy of the respective nations that issue their own currencies? So far, few have a clear exchange rate policy, except perhaps China, that has held its peg for more than a decade, Hong Kong that adopts a currency board fixed rate and Malaysia, which despite rampant speculations have similarly held on to its announced peg. The rest of East Asia are considered to be floaters even though given the various issues raised above found it useful or even necessary to return to some form of "soft" peg adopted prior to the 1997 crisis. Because the policy initiative in East Asia is towards economic integration, from the lessons we learnt, pegging or floating and how such currency regimes are to be managed, cannot be done unilaterally. Financial markets are powerful but they can only play within the rules set by the government that issues currencies. Make the rules clear and the game goes on smoothly – and please, never change the rules while the game is still in play. **§ Dr. Chan Huan Chiang**

¹⁵ Malaysia managed to independently arrange a bilateral support with Japan that amounted to 117b. yen (equivalent to US\$1.5b.) under the Miyazawa Initiative to fund the Danaharta asset management plan as part of Malaysia's economic recovery programme, which did not have to comply with the stated IMF conditions contained in the Chiang Mai initiative. Many of the apprehensions that were raised in connection with such latitude that Malaysia enjoyed did not come to pass, because of the clear success towards economic recovery that would have been more painful had IMF conditions been imposed.

FORUM

The article below is the 3^d 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.

UNDERSTANDING THE SALES AND SERVICES TAX (GST) : Treatment of Imports and Exports *by Prof. Dr. Suresh Narayanan*

Introduction

In the second article, we examined the various methods of preferential treatment under the GST—generically known as the value-added tax (VAT)—and their consequences. In this article, we shall look at how exports and imports fare under the VAT.



Exports

Under a consumption based, credit type VAT, exports deserve special care. Final exports must not only be relieved from tax but must not be burdened by taxes imbedded in the intermediate stages. This is to ensure that it can compete in world markets without being disadvantaged by domestically imposed taxes. The way to ensure this is by zero-rating exports.

Table 3 below uses the notational form relied upon previously (see Table 2 of the second article) to demonstrate the impact of affording various types of treatment to exports and imports under the VAT.

Table 3: The Treatment of Exports and Imports under the VAT

Case	Exporting Nation		Importing Nation		Total VAT
	Manufacturer (2)	Exporter (3)	Importer (4)	Retailer (5)	
1. Zero-rate exports Imports consumed directly	$tP_m - 0$	$0 - tP_m$	$tP_i - 0$	Skipped	tP_i
2. Zero-rate exports Imports taxed at point of entry and not consumed directly	$tP_m - 0$	$0 - tP_m$	$tP_i - 0$	$tP_r - tP_i$	tP_r
3. Zero-rate exports Imports not taxed at point of entry and not consumed directly	$tP_m - 0$	$0 - tP_m$	0	$tP_r - 0$	tP_r

Note: Uniform tax rates assumed in exporting and importing countries

We assume there is an exporting and importing country and that there are two stages within each of them. The values of the output of the manufacturer, importer and retailer are identified by P_m , P_i and P_r , respectively.

Let us look at the exporting nation (columns 2 and 3 only). It is assumed, as previously, that the manufacturer of the export good purchases no inputs. Furthermore, we assume that the manufacturer does not export directly—preferring to use the services of an exporter.

Case 1 shows the effect of zero-rating the export commodity at the stage of the exporter. First, the exporter incurs no VAT on the export, yielding a zero tax liability in column 3. Second, the exporter gets credit for all taxes on inputs incurred in the prior stage (equal to tP_m). Clearly, this procedure allows the export commodity to leave the country completely free of tax. Zero-rating is therefore needed to make sure that the exports are not disadvantaged under the destination principle that requires goods be taxed only at their final destination (or where they are finally consumed), not in the country where the goods are produced.¹ It is not a subsidy; neither is it any form of a favoured treatment being given to exports.

Imports

On the import side, the destination principle requires that imports be taxed in the importing country. To ensure that neither imports nor domestically produced goods are accorded a favoured treatment, an equal rate of VAT is obligatory on both. Columns 4 and 5 show the treatment of imports in the importing country.

Again, a two-stage process has been assumed, though imports could be directly consumed at the importer's stage or be channeled through a further stage (retail, in our example) before reaching the consumer.

The treatment of imports would have to be varied, depending on whether it is consumed at the import stage or passes through further stages before final consumption.

If imports are consumed directly or immediately, without going through further stages in the importing nation (Case 1), it is essential to tax them at the point of importation. Failure to do so leads to a permanent loss of revenue. However, if imports go through at least one more taxable transaction, it becomes immaterial whether or not they are taxed at the point of entry. This is obvious from comparing columns 4 and 5 of cases 2 and 3.

Case 2 assumes imports are taxed at the point of entry and that they go through another taxed stage before being consumed. Case 3, on the other hand, assumes that imports are *not* taxed at the point of entry but also passes through a taxed stage subsequently. The net VAT collected in both cases are the same (tP_r) because if an imported commodity is not taxed at the point of entry, the first taxed transaction will capture all the value added at previous stages since there are no credits to be claimed.

To summarize the discussion, under the credit-type VAT, an imported commodity taxed at the point of entry can be subjected to the tax at subsequent stages, without adding to the tax burden of the consumer. Similarly, evasion of tax at the point of entry will not affect tax receipts so long as the commodity is taxed at any subsequent stage.

Interestingly, under-declaring the value of imports will have no net impact on tax revenue because the credit for taxes paid would be correspondingly lower at a subsequent stage.

The greatest danger of distortions in international trade arises in cases when countries use exemptions—even if only in a limited number of cases. To the extent that exempted goods and services carry concealed taxes, these taxes are imbedded in exports. Since these hidden tax elements cannot be removed fully, the export commodity enters the world market compromised by concealed taxes.

In the next article we shall review the strengths and weaknesses of the VAT, relative to the (apparently) simpler retail sales tax (RST).

¹ Experts agree that the **origin-principle** that requires exports (and imports) to be taxed in the country of origin is incompatible with a credit type VAT.

INTERNATIONAL HEADLINES

Australia's central bank raised interest rates by 25bps as expected

March 03, 2005, OSK

For the first time in 15 months, Reserve Bank of Australia raised its interest rates by a quarter of a percentage point to 5.5 percent as a 28-year low unemployment rate sparked concern that wages and inflation may rise. The bank said higher rates are "warranted in order to reduce the risk of an unacceptable rise in inflation." Annual inflation may accelerate to 3 percent by the end of 2006, the top of the bank's target range for price increases. He warned that even this forecast may be too optimistic.

More reform needed

March 03, 2005, The Economist

The unemployment rate in Germany rose again, to 11.7 percent in February; 5.2m people are now out of work. The OECD, in a report on economic development in rich countries, urged Germany to reduce its payroll taxes, among the highest in Europe, as a means of stimulating jobs. Meanwhile, the IMF cut its 2005 growth forecast for Germany to 0.8 percent (from 1.8 percent last autumn).



Thai Economy Grew 6.1% in 2004

March 08, 2005, Dow Jones Newswires

The Thai economy grew 6.1 percent last year, despite the fourth quarter's slightly slower 5.1 percent year-to-year expansion, the National Economic and Social Development Board said. Thailand's gross domestic product (GDP) grew 1.8 percent quarter-to-quarter in the three months ended December. Despite high oil prices, widespread drought and rising interest rates, the government is maintaining its forecast that GDP will grow between 5.5 percent and 6.5 percent this year, since the decline in tourism is smaller than expected following the massive tsunami in December that killed more than 5,300 people in Thailand alone. The Government's planned infrastructure projects, 50 billion baht supplementary budget and reconstruction in areas devastated by the tsunami would help offset losses from tourism.

Fuel's gold

March 10, 2005, The Economist

Crude-oil prices flirted with a new high this week. West Texas Intermediate (WTI) reached \$55.65 a barrel, on March 9, just shy of the record, \$55.67, set last October. The price rose on a blast of cold weather in Europe and America, which has boosted oil demand. This underlines the fact that oil prices have been driven higher largely by an increase in global demand, especially in China and America, rather than by a supply shock, as happened in the past. China could decide the fate of the oil price over the next year. It has accounted for one-third of the rise in global oil demand since 2001. If China's economy continues to boom, its energy demand will keep on surging. But if China stumbles, expect oil prices to tumble in turn.

China's growth to exceed forecasts

March 21, 2005, Reuters

China's economy will grow at an average annual rate of 8 percent from 2006 to 2010, according to a top think-tank whose forecast exceeds a well established official view that long-term growth would average 7 percent. The new forecast from the cabinet's Development Research Centre (DRC), reported by state media on Monday, follows the government's decision not to repeat for 2005 the 7 percent growth forecast which it had routinely issued for previous years and which the economy had routinely exceeded. Instead it is forecasting 8 percent growth for 2005, and the think-tank

Japan's jobless rate rises

March 29, 2005, Reuters

Japan's jobless rate rose in February while household spending fell, government data showed on Tuesday, highlighting an unstable recovery from last year's economic recession. But analysts and government officials said there was no need to be too pessimistic, since employment conditions were still in a long-term recovery trend and spending figures were skewed by last year's being a leap year. The seasonally adjusted unemployment rate rose to 4.7 percent from January's 4.5 percent. The market's median forecast had been for no change. The jobs-to-applicants ratio for February stayed unchanged at 0.91, meaning 91 jobs were available per 100 applicants.



China's apparel exports surge into U.S., Europe

March 29, 2005, The Asian Wall Street Journal,

China's apparel exports surged into the U.S. and Europe in February, the second month after the end of global quotas – a result that likely will add fuel to efforts by U. S. and European trade groups to impose new limits on the goods. In February, apparel exported into the U.S. rose to \$650 million, a 147 percent increase from February 2004, according to China's General Administration of Customs. Apparel exported into Europe rose to \$783 million, a 188 percent increase, according to the customs administration. The jump was particularly pronounced in product categories where China had little U.S. market share before this year. These include cotton knit shirts, which increased 603 percent to \$1.6 million; cotton pants, which rose 548 percent to \$60 million; and fiber shirts, which leapt 283 percent to \$15 million. For Europe, the totals were similar. Analysts say these figures make it increasingly likely that fresh curbs – called safeguard quotas – will be placed on China-made garments by the first half of this year.

ERRATA:

*In our previous issue of the Penang Economic Monthly (K-ECONOMY: DOES PENANG HAVE THE NEEDED INFRASTRUCTURE?), we mentioned that Malaysia's growth expenditure of R&D was only 5 percent of GDP for 2000. It should read as **0.5 percent** of the GDP. We regret the error made.*