Property Development in Penang

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The Penang Property Sector

It is common knowledge that the property development sector was amongst the worst hit by the Asian Financial Crisis, due to the nature of the business – high leverage and dependence on business cycles. In the years following the crisis, recovery was sluggish and many abandoned projects bear witness to the severity of the slump that the property sector went through.

In the last few years property developers, backed by a low interest rate regime and improving economic conditions, took the leap of faith and embarked once again on many projects ranging from residential to commercial, landed and non-landed properties across a wide spectrum of market areas from the island to the mainland as well as the revival of some abandoned projects.

Within Penang, two submarkets exist, one on the island and another on the mainland. There is stark contrast within these submarkets in terms of investment returns, property appreciation and prices. Properties on the island fetch higher rental returns than those on the mainland. However, the mainland is fast becoming the destination of choice for those who prefer landed property at a more modest cost. By rule of thumb, property prices on the mainland are approximately half the price of property on the island. Ever since the Asian Financial Crisis, prices for housing in the mainland have appreciated by 30 to 40 percent, whilst prices in the island have not fluctuated much. This reflects the vast potential that the mainland has to offer to developers. The concentration of SMIs in the mainland and the proximity of the FIZ to the Penang Bridge are key pull factors for the property market in Butterworth.

2004 was a particularly good year for the Penang property market. The state registered RM 5.65 billion in total property transactions.

The Rate of Development in Penang

Many developers are of the opinion that Penang has the potential to be an international real estate destination. The reasons behind this claim are many. Firstly, Penang is able to tap into both the international and local market. Despite recent criticisms of Penang losing its charm and appeal, the island is still the choice location for property investors; it is after all the Northern Hub for Malaysia. Secondly, many are confident that residential properties in Penang will sell as they are regarded as prime investments in a location where land cost is high and limited. The residential market has always been and still is the key driver of the Penang property market. Thirdly, innovation has not eluded this sector. Super condominiums are the perfect example – sea fronting condominiums priced at a premium, spanning approximately 3,000 square feet or more, with state of the art amenities. A new “super-condo” corridor has emerged in Penang along the Gurney Drive - Tanjong Bungah coastal road. Priced at a minimum of RM 1 million, these super-condos offer variety to the market segment of buyers which will traditionally opt for landed property in the more prestigious areas of Penang namely Jesselton Crescent and Tanjong Bungah. Following its success in the Klang Valley, gated-housing developments are also catching up fast.

Sceptics question if the property market in Penang will crash resulting in a burst in the asset bubble. They worry that developers may still be riding the wave of euphoria generated by the astonishing performance of the Penang property market in 2004. With a population of 1.4 million of which almost half reside on the mainland, one questions if these ambitious projects will create an oversupply in the market and in the longer term lead to more abandoned projects and white

elephants. Most developers are confident that as long as there is wealth creation, buyers and investors will always look to upgrading, whether for investment or dwelling purpose. The response rate for these "differentiated" projects have so far been encouraging, reflecting the evolution in buyer markets where buyers today take into consideration broader perspectives such as quality homes and the surrounding environment when considering property investment as opposed to the past where decisions were mainly price-driven.

Timing is essential to developers. Their ability to ride the upswing of the business cycle will determine the success of their projects and ultimately the profit margins. Most developers believe that each project has been differentiated to cater to a specific market and thus will sell well, provided they are able to operate within a supportive operational and legal framework.

Three important factors when considering the rate of property development and its sustainability are:

i. *the rate of growth of the Penang population*
From 1991 to 2000, the Penang population grew by 23.42%.
From 2000 to 2004, the Penang population grew by 9.85%.

ii. *the household to permanent stock ratio*
The island of Penang has more houses as compared to households, while the mainland has more households as compared to houses. This again highlights the potential of the Butterworth market. Nevertheless, many of the more affluent households in Butterworth own holiday homes and apartments on the island.

iii. *the rate of economic growth.*
The property sector is dependent on economic growth. Economic variables such as interest rates are a key propellant for this industry.

Penang as an international real estate market: the Issues & Challenges
To build Penang up as an international real estate market, several issues arise.

1. Redevelopment of urban areas

...developing projects in the city is a grey area in which developers are hesitant to venture because of the unclear guidelines and policies regarding inner city development.

The city of George Town has a rich history that goes as far back as 200 years, visible in the architecture of the buildings and culture of its people. It is this vibrant cultural tapestry that has prompted the State Government of Penang to propose and submit the city of George Town for UNESCO's World Heritage Listing as a living heritage site. In the bid to qualify and be accepted, rigid conservation plans have been imposed on the inner city. Separated into the core zone and buffer zone, stringent rules have been put in place to specify the types of developments that can take place to preserve the unique heritage of George Town.

It is thus most ironic that many areas within inner George Town are in a deplorable state with unoccupied pre-war shop houses and homes in disrepair. The victims of urban poverty have become the illegal dwellers of these vacant homes and shop lots. It may well be that the unique heritage of George Town will not be preserved apart from the immediate areas which house important monuments such as the Khoo Kongsi, the Syed Alatas Mansion and the Acheen Street Mosque.

One cannot help but notice that there is little development within inner George Town. Lack of land and space are not acceptable reasons for the sluggish pace of development in the inner city as there are existing rows of shop houses, residential homes and pockets of empty land available for sale. The truth of the matter is that developing projects in the city is a grey area in which developers are hesitant to venture because of the unclear guidelines and policies regarding inner city development. Moreover, at approximately RM 200 per square feet, land cost is relatively higher and after taking into consideration issues like setback allowance and plot ratio controls, projects often become cost ineffective. Compounding this issue is the perceived risks associated with inner city development. Unless there is a cohesive effort by both the Government and developers

for urban renewal in George Town whereby the city is systematically redeveloped in stages, there is no guarantee that redeveloping pockets of George Town will revive inner city living. Take for example the Rex Theatre and the row of shop houses along Kinta Lane which have been on the market for years. One can argue that there is potential for heritage development. However, investors will be unwilling to commit unless they can be guaranteed that the surrounding environment including existing infrastructure will be upgraded and improved.

...there is much room for economic development as a result of the conservation efforts.

Developers are willing to work on George Town if the government spearheads this effort through a master plan approach in which issues such as traffic planning, renewal of public infrastructure, plot ratio to control the scale of developments and architectural guidelines are imposed. As far as privately-owned properties are concerned, the authorities should consider working together with the owners to create and implement theme-based development zones based on the heritage and cultural characteristics of different parts of the city. Developers should also be encouraged to submit their ideas for city renewal. These will ensure the overall urban character remains largely intact and enhanced as residents will also benefit from the added conveniences and facilities generated from sustainable commercial activities.

For a city like George Town there is much room for economic development as a result of the conservation efforts. The ability to encapsulate the surrounding areas as they were in their prime years ago would be a major tourist attraction especially if Penangites could be drawn to live in them again. The first step towards achieving this is clearing the misconception that conservation is inimical to economic growth and development.

2. Overcoming the limited land bank available in Penang

Property on the island has traditionally been more sought after as opposed to the mainland as land is limited and the island being the more urbanized centre between the two. The geographic topology of the island limits development to the coastal areas of the island. Land reclamation and hillside developments have taken place in a bid to overcome the limited land bank issue. These efforts however come at great cost to the environment and society. Not only does land reclamation affect the shoreline and quality of the beaches, it affects the livelihood of fishermen and compromises the economic potential of our tourism, aquaculture and fisheries sector. Clearing the hills for development should also be strictly enforced and regulated. Guidelines for hillside development need to be constantly reviewed to ensure that they are suitable for present day conditions. The authorities should ensure that all other viable options have been exhausted before agreeing to open the hills for a particular type of development. Effective enforcement will ensure an evenly developed state in terms of housing and infrastructure. Also, opportunities for urban renewal in inner George Town will lessen the pressure for more land banks in Penang.

3. Tapping into the expatriate markets

The authorities should ensure that all other viable options have been exhausted before agreeing to open the hills for a particular type of development.

Projects such as ***Malaysia My Second Home*** are an important growth source for the property sector as it draws in the expatriate market. Under this programme, the state of Penang attracts the most number of applicants as compared to other Malaysian states. Penang holds special appeal to markets such as the United Kingdom, Indonesia, Hong Kong, Taiwan and Singapore. Cultural similarity and proximity are major pull factors for investors from Asian markets, whilst the idyllic lifestyle and historical ties make Penang a favourite amongst the British. In general, expatriates are drawn to the laid back culture of the people of Penang, the lower cost of living as opposed to Kuala Lumpur and Johor Bahru and the modern facilities provided.

Prior to the Asian Financial Crisis, it was the strong performance of our manufacturing industries that attracted the larger bulk of foreign investments into the Penang property market. Today, the property sector has decoupled from the manufacturing sector and has created an identity of its own as one of the most sought after investment options where capital appreciation for landed property is almost guaranteed within selected areas and

selected categories of housing. Although foreigners form a small segment of property investors in Penang, the level of interest shown is very high. The state should capitalise on this and lobby for more relaxed regulations to encourage more foreign participation within the property sector.

The ability of the state government with the cooperation of the private sector and citizens, to continuously upgrade the overall quality of Penang in terms of lifestyle and amenities will enable the state to further attract expatriates to live in Penang. There is much to benefit from a state with a healthy number of expatriates as it indirectly increases the number of tourists, enhances the local culture, encourages cultural diversity, facilitates skills transfer and contributes to the Penang economy. Bearing testament to these are the economies of Singapore and Hong Kong.

Moreover, by knowing that there is an easily accessible expatriate market, developers will have the incentive to continuously raise the standards of their products thereby benefiting the entire industry.

...a healthy number of expatriates indirectly increases the number of tourists… facilitates skills transfer and contributes to the Penang economy

4. Policing developers, contractors and professionals

A case like the Majestic Heights project in Paya Terubong should never have happened and should never be allowed to happen again. Misappropriation of management fees in apartments, condominiums and commercial complexes are rife in the industry. This is especially so if the respective strata titles have not been obtained. The state government either directly or through the councils has an important role to play in policing the industry to ensure buyer rights and healthy development of the property sector. In a small state like Penang, unscrupulous professionals, developers and contractors can easily tarnish the reputation of the property sector. The relevant authorities can build confidence in the market by sticking to a firm unwavering policy when it comes to quality standards in construction and completion of projects. A mere slap on the wrist for offending parties is insufficient especially when it is hard to monitor and control any cross-holdings that one contractor, developer or architect may have with other similar companies. Harsher penalties should be considered and implemented to prevent misappropriation of funds and investor abuse. Speedier strata title processing will also lessen the tendency for misappropriation of common funds. On the other hand, there is also a need to educate residents to respect rules and regulations aimed at enhancing living conditions.

5. Feasibility Studies and Data Collation

The Property Market Report published annually by the Valuation and Property Services Department of the Ministry of Finance Malaysia provides a comprehensive review of market trends and transactions, property prices and property value. There is however, lack of current data available at the state level to support feasibility studies. Feasibility studies are important in that they address the issues of demand and supply. In this case, the basic fundamentals of economics, i.e. the rule of demand and supply cannot be expected to ensure the optimal level of development given a host of other influencing factors such as vested interest, profit margins, sales targets and competition which are in play here.

Feasibility studies are important in that they address the issues of demand and supply.

With an objective and independent feasibility study, one can gauge the number of super-condo's, shopping malls, housing developments and commercial complexes that the Penang economy can sustain. A fair and objective feasibility study based on current and available data and statistics from an objective and unbiased source – in this case, the government or a government affiliated company, will benefit the industry in many ways. Firstly, it makes it easier for the relevant authorities to reject applications and submissions for new developments which they deem unviable. Secondly, it facilitates growth within the industry (especially for the retail and commercial sector) in terms of additional investments (local and foreign) as investors expect to be well-informed of their potential investments.

Thus the importance of feasibility studies and accessibility to current data is very much needed to ensure healthy growth of this industry.

6. The need for a supportive operational framework

The importance of a supportive operational framework cannot be underestimated in this industry where success hinges upon economic cycles. Developers incur immensely high holding costs, with interest being charged on land targeted for development from the very minute it has been purchased. The turn-around time at which plans are submitted and approved by relevant authorities is a critical success factor. In addition to that, developers need consistency and competency in planning policies and guidelines. The lack of a supportive environment may drive out many developers, resulting in a few key players dominating the market. A market dominated by a few key players is not in the best interest of the community and economy and should be avoided at all costs.

The future of the Penang property sector

The weakness of the Penang property sector may be unstructured development if there is no forward planning in land usage and if future projects are not streamlined and redirected towards the inner city centre.

The current policy that enables 20 percent of a residential area to be commercialised needs looking into if inner George Town is to be revived.

Penang property ranks as one of the choice investments in Malaysia. A conscious effort should be made to ensure that further developments enhance and not compromise our reputation. Forward planning is needed to ensure that property within the state develops at a sustainable pace and that the types of property approved are suitable for the surrounding environment. One such example is the location of a light industrial area to the left of the Jelutong Expressway when travelling towards the city. It is a pity that prime land along the main gateway to Penang has not been optimised to create a more welcoming and pleasing environment.

Authorities concerned should seek to clear the misconception regarding development in inner city Georgetown where more often that not, developers are intimidated by the conservation approaches and techniques expected of them when they venture into the city centre for development projects. These conservation techniques which include specifying the types of raw materials to be used are only applicable to certain buildings, many of which have already been splendidly restored by their respective trustees.

For a project like boutique heritage houses to take off, the onus is on the government to provide the necessary incentives and concessions for city dwellers and developers. The authorities need to assure the public that areas gazetted for heritage housing will not be affected by over commercialisation.

The current policy that enables 20 percent of a residential area to be commercialised needs looking into if inner George Town is to be revived. This policy presents businesses with an option to operate out of the inner city. At this rate, businesses seem more likely to move out of the inner city rather than an influx into the inner city given the traffic congestion, poor parking facilities and narrow roadways of the inner city. This will eventually give rise to a situation whereby the low occupancy rate of inner George Town does not warrant and justify government spending to upgrade existing infrastructure; giving people all the more reason to avoid inner city living.

Outdated policies and by-laws regarding inner city development should be reviewed but not compromised...

There is no need for massive land reclamation projects and extensive hill clearing when one looks carefully at the potential that the inner city holds in terms of development. With a clear master plan for inner city renewal, the government can persuade developers to venture into this market. Outdated policies and by-laws regarding inner city development should be reviewed but not compromised, to reflect the changing needs of the present day. Faster approval of plans with more approving authorities "on the ground" to be able to monitor and address feasibility issues will further project the commitment of the government to this cause. ***§ Poh Heem Heem***

Box Article: Development within the Retail Sector

There are currently three new proposed mega-retail projects for Penang – the Penang Times Square along Jalan Dato Kramat by Ivory Properties Bhd, Mutiara Bay near Shangri-La-Hotel by Belleview Group and the recent acquisition of prime land along Gurney Drive by Hunza Properties. These new projects by these reputable and leading developers in Penang promise to change the concept of shopping in Penang. These projects however, have to compete with existing players such as the front runners Gurney Plaza and Prangin Mall, and others being Island Plaza, One-Stop Center, Bukit Jambul Complex, Komtar and Megamall.

The question is if Penang, with its approximate population of 1.4 million is able to sustain these many malls. Although the Penang retail market is able to capture consumers from the Northern region, the propensity to spend is still weak, as many of the Northerners window shop more than they buy. A good case in point is the One-Stop Shopping Complex in Pulau Tikus. What was once a thriving shopping mall in 1996 has now slumped - its business affected by the opening of Gurney Plaza and further worsened by its gradual state of disrepair.

We can then surmise that to thrive, the Penang retail sector needs tourists in addition to its local population to support the industry. This leads to the inevitable relationship between tourism and shopping. While we are able to gauge how much a tourist spends on accommodation and food, it is difficult to gauge the amount he can potentially spend on shopping. The propensity to spend while shopping within the right environment is limitless, given current day credit facilities such as credit cards.

As far as the shopping environment is concerned, shopping malls in Penang are a far cry in comparison to its peers in KL and Singapore. This is especially so in terms of tenant mix and aesthetics - two very important factors in attracting tourists and creating the right ambience to encourage spending. Two main reasons lie behind this. Firstly most shopping complexes in Penang are Strata Complexes with the exception of Gurney Plaza and Island Plaza. With a Strata Complex, developers build and sell units individually and are responsible for management of the building until strata title is obtained. The build and sell principle gives rise to individual ownership hence developers or the management lose control over the tenant mix. Individual ownership also leads to division of opinion and a lack of unity in terms of maintenance decisions.

It is also difficult for Penang to compare with Kuala Lumpur and Singapore in terms of attracting international brands into our market. Firstly, Penangites being more prudent spenders pose a different buyer market from Kuala Lumpur and Singapore. Secondly, when renowned international brands seek entry into the Asian market, they target Hong Kong and or Singapore. When they seek entry into the Malaysian market, they target Kuala Lumpur. Thus unless the Penang market develops a similar appetite Penang will always trail behind. On its own, Penang lacks the critical mass of Kuala Lumpur. Bringing in tourists will help build the critical mass and create a larger appetite for consumer goods.

Going forward, developers have a major role to play in ensuring the success of Penang's retail scene. Today, most investors reject strata complexes for obvious reasons. In Penang today, there is visible difference in Gurney Plaza and Island Plaza from the other retail centres. There is control over the tenant mix and the maintenance of the centre. If developers spend more detail on maintenance and aesthetics the retail scene in Penang would be given a boost. Improving the façade and interior of shopping complexes will benefit the entire industry as it will raise the profile of Penang as a shopping hub.

On the other hand, authorities have a major role to play in ensuring that there is no oversupply of retail complexes. Feasibility studies should be commissioned and data analysed before approving further shopping malls and complexes. Issues such as the close proximity of malls must be considered in a relatively small market like Penang to avoid market cannibalisation and avoid further stress on already deteriorating traffic conditions in Penang.

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From Pegged to Managed Float: The Ringgit, Government Objectives and Market Forces

Introduction

Releasing the ringgit from its hard peg of 3.8:1 against the dollar in July 2005 has been anticipated for a number of years because many feel that the peg has long outlasted its designated role in Malaysia's economy recovery from the 1997 East Asian financial crisis. Yet the peg stood firm and unwavering. This time round, however, the peg was finally removed, amidst mixed signals: on the one hand that the ringgit is on solid footing relative to the size of Malaysia's foreign reserves, yet on the other, recent international developments are not putting the peg in a favourable light. Nonetheless releasing the peg at a point in time least expected is the best time to have done so.

But what are the reasons? Market pressure? Interest rates? Capital flows? The renminbi? Multilateral obligations? Our aim is to explore these issues with the hope of discovering whether the release of the peg was indeed forced upon by events or that the peg could instead continue on without serious implications, in which case, the release of the peg was a policy decision to finally end its designated role independent of current economic circumstances.

Market pressure, interest rates and capital flows?

For years, many analysts have considered the ringgit peg untenable because of the widening discrepancy between the pegged rate and what is deemed as fair value for the ringgit. Unfortunately, because the ringgit is not traded, whether the ringgit has been over or undervalued is difficult to ascertain.

On the point of market pressure, what this actually means is that the exchange rate is subjected to the impossible trinity (also called the monetary policy trilemma) of three policy objectives: i) unimpeded capital flows, ii) control over the exchange rate and iii) control over domestic interest rates (see Penang Economic Monthly, July 2005). Any central bank can achieve only any two but not all three of these. During the course of the peg, Bank Negara had also pursued an independent interest rate target, initially using the three month invention rate and, since April 2004, the overnight policy rate (OPR). There was capital control and thus objective i) of the impossible trinity could not be achieved.

Thus when Bank Negara liberalised much of the capital controls that came into effect on April 1 2005 and the put OPR in place, it follows that objective ii) exchange rate control has to be somewhat relaxed. So says the textbook. In real life, things are not so clear-cut. In fact, despite government policies and regulatory measures, the market appears to have the resilience to circumvent some of the rules. Both capital controls and the ringgit peg are designed to prevent speculation altogether, thereby offering the business community a solid currency so stable that hedging becomes unnecessary. In the early years of the peg, everyone was happy and the stability paved the way towards a rapid recovery that astonished even those that thought that having the peg alongside capital controls would be a serious policy mistake.

Non-Deliverable Forward

However, economic circumstances in more recent years are far different from those of 1997 and 1998. Although Bank Negara has time and again reiterated its commitment to the peg for the sake of stability, the business community is less convinced. If both the peg and capital controls can be so tightly regulated, the market would have been totally impotent. This is not the case. True, the ringgit is not actually traded in the forex but it remains possible to engage

in offshore speculation on ringgit derivatives totally beyond the control of any regulatory device. The instrument is generally referred to as non-deliverable forward or NDF, which is designed to facilitate hedging against exchange rate risks of “exotic” currencies – those issued by emerging economies that have limited convertibility, subject to regulatory changes, risks due to economic and political events or when hedging vehicles are limited. The NDF involves two parties agreeing on a fixed currency rate at a predetermined future date (say 90 days). After 90 days, the difference between the prevailing spot rate of the currency and the pre-agreed fixing rate is settled using an international currency say U.S. dollars. The NDF can be executed anywhere in the world, totally beyond the reach of any central bank.

Consider a hypothetical example involving the ringgit for which the market quotes one-year forward rates as shown in Figure 1. Forward ringgit to be settled one year from the time of contract has strengthened during the closing months of 2004 and stabilized around RM3.72 to the dollar prior to the release of the peg in July 2005. Before the peg was released, an American importer with an order from Malaysia is expecting to take delivery around the middle of 2006. If the importer has complete faith in Bank Negara’s commitment to the peg, as has been frequently announced in the media, there is would have been no concern about a shift in the ringgit’s exchange rate in 2006. However, economic events and numbers suggest that the ringgit’s peg is untenable but there are few avenues to hedge against such a risk. With the one-year forward quoted at RM3.72 to the dollar, the ringgit is expensive relative to the peg rate of RM3.80. However, rumours have it that a five percent or ten percent revaluation is in the offing that will put the ringgit in the RM3.60 to RM3.40 range, significantly adding on to his import costs and putting his profit margin in jeopardy. If RM3.72 can be assured, this will lock in his import cost thereby protect the profit margin. The importer thus enters into an NDF contract to notionally (i.e., not actually) buy ringgit in a year’s time at RM3.72.

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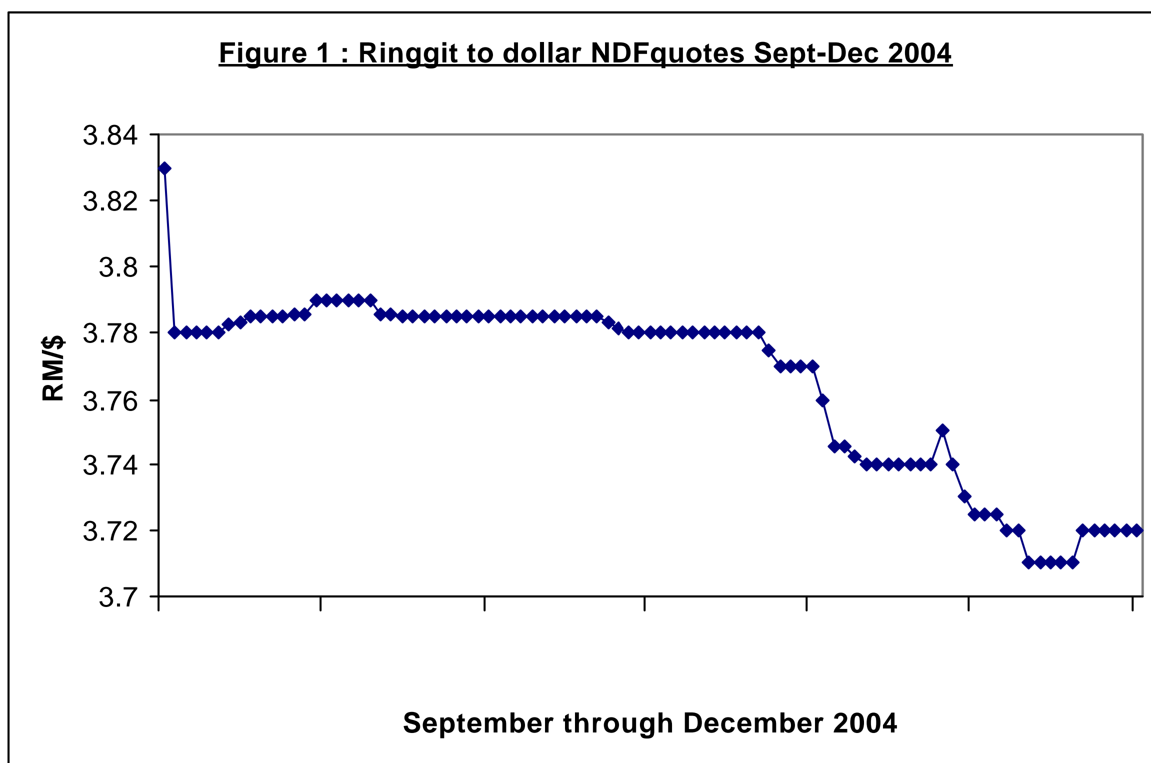

Figure 1 : Ringgit to dollar NDFquotes Sept-Dec 2004

Source: UOB Economics—Treasury Research

If the peg had not been released, the ringgit will stay at RM3.80 through 2006. The speculator with whom the importer had a contract would stands to gain as he buys ringgit (notionally) cheaply at RM3.80 and sells (notionally) to the importer at RM3.72. The settlement is done in U.S. dollars, based on the notional ringgit rates and amounts and thus this deal is beyond the control of Bank Negara. At RM3.80, the actual import of goods remains cheap in 2006, even though the importer lost money in the NDF market. Regardless, his profit margin has been factored in at RM3.72 to the dollar. On the other hand, had the ringgit strengthened to RM3.65, the speculator stands to lose, but this is calculated risk. The importer is able to get a settlement gain from the NDF contract, which will cover his losses due to higher actual import cost at RM3.65 to the dollar, thus keeping his profit margin intact.

Such hedging via the NDF used to be available only outside Malaysia when capital controls were in place since it would be difficult to settle when the contract expires. However, with liberalization on capital controls in effect since April 1 2005, NDF hedging has become possible between Malaysia and countries abroad. In the March 23 2005 Bank Negara announcement, the central bank said that "to facilitate better and more efficient risk management of currency exposure, rules on hedging are also liberalized further to allow residents as well as non-residents to enter into hedging arrangements with licensed onshore banks".[1]This is a policy contradiction since a hard peg ringgit committed to by the government would have no need for hedging, but the liberalization was made to extend ringgit hedging, that used to be available only offshore, to Malaysian residents as well.

This tendency for the market to see a different value for the ringgit beyond the official 3.8:1 peg rate also leads to speculative capital movements so long as there is an NDF market for the ringgit. In June 2005, one-year Malaysian government securities (MGS) were being transacted at around 2.35% yield in Kuala Lumpur. Abroad, U.S. dollar funds could be obtained at the London interbank offer rate (LIBOR) of 3.7%. It really makes little sense to borrow at 3.7% for a return of 2.35%, but because there is an NDF at RM3.72 to the dollar, the speculator can still find room for making money. For example, LIBOR funds of US$100 million is borrowed and converted to RM380 million to buy the one-year MGS. At the same time the lock-in rate of RM3.72 NDF deal is made. After a year, the MGS would be sold at RM388.93 million (i.e. at 2.35% yield). With the NDF in place, the RM388.93 million can be notionally converted to US$104.55 million at 3.72:1. Meanwhile, LIBOR being 3.7% means the funding cost for one year, plus the principal borrowed, amounts to US$103.7 million. Thus the speculator receives a fairly risk-free gain of US$104.55 less US$103.7 or US$0.85 million.

The same trick of buying relatively risk-free government securities with LIBOR funding is more difficult to do in Singapore. As a matter of publicly announced policy, the Singapore Monetary Authority does not interfere with domestic interest rates.[2] Thus securing a more stable rate on the government security vis-à-vis NDF quotes at a desirable level is harder to obtain because, void of government intervention, market arbitrage would have ironed out discrepancies.

What we see here is the workings of the impossible trinity. As long as there is freedom of capital controls for foreign capital to buy in on MGS at domestic interest rates and there is some room for speculative maneuvering of the ringgit's exchange rate (albeit only notionally) by the NDF market, something has to give. Capital movement has to be blocked even though free capital movements are desired in order to boost capital availability for the domestic money market. If not, domestic interest rates are allowed to adjust against international rates or the ringgit's exchange rate is allowed to move more freely, because it is the combinations of these numbers that will determine whether capital flows will move in or out or stay still.

The renminbi and Malaysia's multilateral obligations to trading partners

Academic literature, unlike market talk, has been looking at exchange rate movements not merely through analysis of economic fundamentals, relative inflation and interest rates or purchasing power parities. Instead, much of the exchange rate effects have been the result of government intervention or non-intervention that follows from the policy choices of the various governments. Whether policy intervention on the exchange rates takes place or not depends on the choice to either protect and thus stimulate capital market investments, in which case a floating exchange rate is preferred, or to protect industries in which case more stable exchange rate regimes would be preferred. In the case of Malaysia, this choice is more difficult. The country's capital market is fairly well developed and expanding. The government thus has to take the back seat, allowing the market to find its own equilibrium. Yet, Malaysia is an exporting nation and therefore, the need to achieve price stability among its trading partners also becomes a necessary policy issue.

To better understand the combined, though contradictory, effects between market forces and government policies on exchange rate movements, one merely needs to plot all these on a chart through a fairly long passage of time. Figure 2 shows exchange rate movements among

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[1] See < www.bnm.com.my/index.php?ch=8&pg=14&ac=994 >
[2] Singapore's Exchange Rate Policy, Monetary Authority of Singapore, February 2001.

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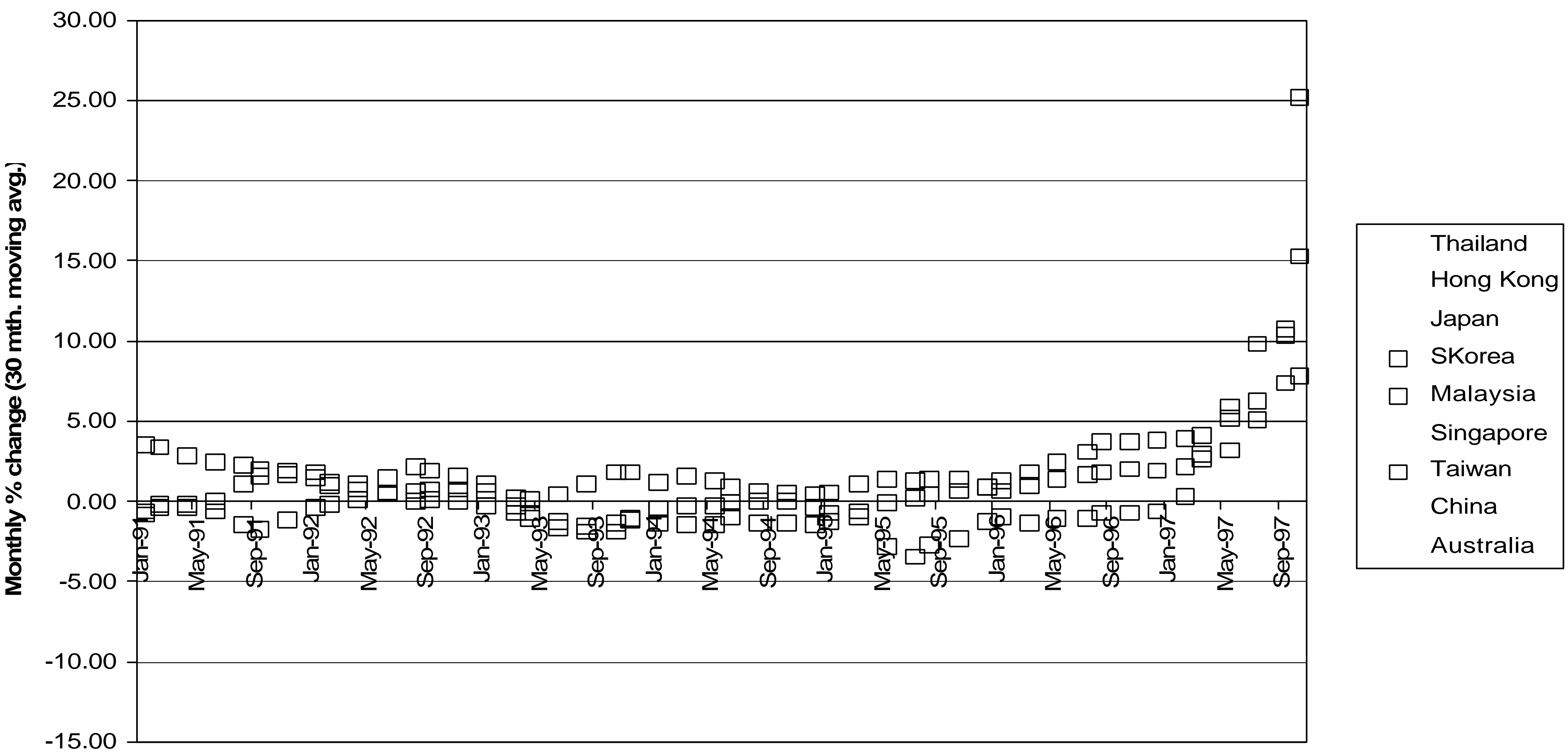
Figure 2: Currency trends 1991-1997



Source: Federal Reserve Bank of St. Louis

Figure 3: Currency trends 1998-2005

Monthly % change (30 mth. moving avg.)

20.00
15.00
10.00
5.00
0.00
-5.00
-10.00
-15.00
-20.00

Jul-97 Nov-97 Mar-98 Jul-98 Nov-98 Mar-99 Jul-99 Nov-99 Mar-00 Jul-00 Nov-00 Mar-01 Jul-01 Nov-01 Mar-02 Jul-02 Nov-02 Mar-03 Jul-03 Nov-03 Mar-04 Jul-04 Nov-04 Mar-05

Thailand
Hong Kong
Japan
SKorea
Malaysia
Singapore
Taiwan
China
Australia
Euro

Source: Federal Reserve Bank of St. Louis

selected currencies against the U.S. dollar through the nineties up until the time of the 1997 recession. To make currencies comparable, the chart shows monthly percentage change as a 30 month moving average. This is to smoothen out shorter-term volatility and assuming, business cycles lasting around two and a half years, the moving average will show patterns in currency trends among the selected countries. Notice that the smaller East Asian economies tend to trend together including China after it instituted its renminbi peg in 1994. The Australian and Japanese currencies tended to deviate farther as there is no active intervention. Singapore's currency performed better but its exchange rate targets allow it to trend in the same pattern as the other actively intervened currencies.

Come 1997, and the somewhat coordinated movements among currencies fell apart and weakened extensively. Figure 3 shows the same information for the period after the 1997 crisis through to early 2005. There was an initial period of turbulence, but the chart shows that through various economic recovery strategies, either IMF mandated or not, the trading nation partners began to consolidate their exchange rate targets and began trending in tandem with each other once again. The euro was only issued in 1999, and along with the Australian dollar, the two currencies make wide arcs around the dollar entirely driven by market forces. The interesting difference between the currency patterns of the pre and post 1997 crisis is the Japanese yen. The yen used to be a wild card among the East Asian trading partners but as the chart shows, the yen has been moving along the same paths since the beginning of the new millennium. The Hong Kong dollar, Malaysian ringgit and China's renminbi were of course hard-pegged against the dollar during this period.

So what does all these mean in relation to Bank Negara's change of heart to move from the hard-peg to the managed float? In fact the market has not been as sensitive to the currency movements that our chart shows. True, the non-deliverable forward (NDF) rates have been more volatile reflecting that there are signs of currencies abandoning their dollar alignments. On the contrary, the long-term (business cycle smoothen) trend shows currencies consolidating on the dollar when data for the beginning months of 2005 are included.

Policy implications

From the above assessment, the policy implications of a pegged or unpegged ringgit become clear. First, regardless of speculative capital flows brought about by NDF markets, the nominal exchange rate of 3.8:1 can continue to be held tightly. The longer this is held, it will make a stronger NDF rate untenable since speculators for a stronger ringgit will lose money. With Malaysia's huge foreign reserves, the peg can be maintained indefinitely so long as the country continues to maintain its export surplus. In fact, even though ringgit NDF trade has, during recent months become more active, volume remains small relative to NDFs on other currencies. Furthermore, the spot to forward rate differential for the ringgit is only very small (3.80-3.72). This suggests that the ringgit NDF market is unexciting. NDF quotes given by Bloomberg for the renminbi and ringgit soon after the two currencies were released from their former pegs are shown in Table 1.

Table 1: Non deliverable forward (NDF) quotes

Settlement Date	Renminbi per U.S. dollar	Ringgit per U.S. dollar
2 Aug.2005 (1 week)	8.10675	3.79330
26 Aug. 2005 (1 month)	8.06000	3.79100
26 Sept.2005 (2 months)	7.97800	3.78500
26 Oct.2005 (3 months)	8.03000	3.77500
28 Nov.2005 (4 months)	7.90775	3.76833
27 Dec.2005 (5 months)	7.85125	3.76167
26 Jan.2006 (6 months)	7.82250	3.75500
26 April 2006 (9 months)	7.84030	3.72750
26 July 2006 (1 year)	7.78000	3.70000

Source: Bloomberg, Affin Securities

Second, capital outflows to take advantage of the interest rate differential between Malaysia's domestic money market and those abroad are not really an issue. Even though this amounts to capital flight, the higher rate of return from investing abroad accrues to Malaysian nationals and hence will help to narrow the current gap between Malaysia's gross national product and the gross domestic product.[3] Regardless, Bank Negara statistics have shown massive capital inflows rather than outflows. Capital inflows as illustrated by our example above are desirable as they amount to capital for the money market at relatively cheap rate (2.35%), while such inflows further build up on the already sizable foreign reserves. Arbitrage profits via the NDF is settled abroad using a foreign currency and hence has no effect on Malaysia. U.S. dollar LIBOR rates used to be much lower at around 1.6% during the middle of 2004 which would make better arbitrage vis-à-vis Malaysian money market rates, but LIBOR rates have strengthened considerably since, eroding away potential for arbitrage.

Third, despite inferences made by some analysts that Asian currencies have begun decoupling from their former dollar alignments, such inferences have been based on notional NDF forward rates rather than actual spot rates.[4] On the contrary, the business-cycle-smoothened currency trends, in Figure 3, show a consolidation towards the dollar. The preceding analysis therefore shows that Malaysia's release of the peg has not been the result of either market or trade related pressures.

Implications of the renminbi's hard then crawling peg

There has been widespread discussions that compares Malaysia's hard peg with China's and therefore it should follow that once China bows down to international pressures and releases its hard peg, Malaysia has no choice but to do the same. Both are not the same. International pressure on the renminbi does not amount to a similar pressure on the ringgit. There used to be a time when much of international interest rates follow the monetary policy of the U.S. Federal Reserve as a benchmark. However, since China hard pegged the renminbi in 1994 alongside years of trade surplus, the renminbi not being allowed to revalue meant that heavy intervention had to be undertaken to maintain its peg. As a result, China's accumulation of foreign reserves ends up as American treasury bonds, pushing up prices and keeping interest rates low. This means that the Fed in the U.S. becomes ineffective in its attempt to drive up interest rates whenever this is desired policy. Because both the U.S. and China are huge economies, low interest rates also means overall global liquidity, that is in turn renders monetary policies elsewhere less effective as well. Such is the international pressure on China to depeg the renminbi. Although Malaysia too has been stocking up on American treasuries, the small size of Malaysia's economy has relatively little effect on the globe.

The renminbi today has moved into a crawling peg, even though in the official announcement, the renminbi is under a managed float system. The difference between the two is whether the direction of currency movement is, so to speak, pre-announced as an exchange rate target.[5] In the case of the ringgit and the Singapore dollar, short-term spot rate movements can be in either direction in response to an undisclosed basket of currencies. The crawling peg on the other hand is to allow for small currency adjustments towards a targeted peg. Accordingly, the contents of the currency basket to which the renminbi are targeted, was revealed by Zhou Xiaochuan, governor of China's central bank on August 10 2005. The US dollar, the euro, Japanese yen and South Korean won formed the dominant currencies in the basket. Singapore dollar, pound sterling, Malaysian ringgit, Russian rouble, Australian dollar, Thai baht and Canadian dollars are also taken into account in the target.[6]

However, the intended effects of the renminbi being released from its more than a decade long peg may not be achieved. Foreign investments in China looking forward to a high rate of returns are also expecting icing on top by way of stronger renminbi at the time of exit.

[3] The gross national product is the gross domestic product less net factor flows between nationals and non-nationals (i.e., payments to wages, interest, profits and rents). Returns on investments by Malaysian nationals from investments abroad adds to Malaysia's gross national product.

[4] Corrine Ho, Guonan Ma and Ronald N McCaully, (2005) "Trading Asian currencies." Bank of International Settlements Quarterly Review; Corrine Ho, Guonan Ma and Ronald N McCaully, (2004) "The market for non-deliverable forwards in Asian currencies." Bank of International Settlements Quarterly Review;

[5] For a discussion of various currency systems, see Peter Bofinger and Timo Wollmershauser (2001), "Managed floating: understanding the new international order." Wurzburg Economic Papers Universitat Wurzburg.

[6] See "Chinese basket of currencies revealed," Dai an and Vincent Lam, China Daily, < http: // www.asianewsnet.net/level3_template1.php?l3sec=2&news_id=43886>

Investors would want to rush in to catch renminbi rates before they crawl up too far. Such capital inflows will result in further accumulation of China's foreign reserves, forcing China to buy more U.S. treasuries that will in turn keep interest rates in the U.S. and elsewhere in the world low. This means that China must begin to diversify its foreign reserves with other currencies if U.S. treasury yields are to be allowed to rise in respond to Fed policies. But such an intended effect will also make it tricky for the world economy, because the U.S. continues to face its twin (budget and current account) deficits. With less ability to sell its treasury bonds, the U.S. would be forced into a balance of payment shortfall that would result in the devaluation of the dollar. This spells danger for an already fragile global economy.

Implications of the managed floated ringgit

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The issue is not that the ringgit has to align to the dollar, which the peg would guarantee. Instead, the issue is that the ringgit has to trend more closely with its trade partners. Table 2 shows the distribution of Malaysia's total exports and imports across trading partners. The release of the peg is not so that Malaysia becomes a capital account nation. By freeing capital flows, returns on capital investments can achieve their market values. On the contrary, the ringgit has not been freely floated but managed floated vis-à-vis an undisclosed currency basket so that better trending alongside Malaysia's major trading partners could be achieved. In other words, the ringgit can move out of the straight line and follow the winding paths taken by the other currencies about the U.S. dollar rate.

Table 2. Malaysia's trade partners (percentage of total, 2004)

	Exports	Imports
U.S.A.	18.76	14.47
Singapore	15.01	11.12
EU	12.56	12.01
Japan	10.10	15.93
China	6.69	9.82
Hong Kong	5.97	2.71
Thailand	4.77	5.50
Korea	3.50	4.97
Australia	3.28	1.70
Taiwan	3.28	5.41
Indonesia	2.43	3.98
India	2.37	1.22
Phillippines	1.53	2.68
Vietnam	0.90	0.55
Canada	0.63	0.44
Russia	0.32	0.45
Brunei	0.25	0.01
Total	92.36	92.96

Source: Bank Negara Malaysia

Fixed pegging has never been favourably viewed internationally and therefore coming off the fixed peg would put Malaysia in a more favourable position. Watch out for Malaysia's country rating moving up a notch or two.

Conclusion

The reason why countries have central banks is so that monetary policies can be wielded in pursuit of sovereign objectives. But the world becoming increasingly seamless with free movements of capital does exert considerable amounts of market pressure. What results is a tug-of-war between government policy and market forces. For several years now, the market has asserted that the ringgit peg is untenable. Our study here suggests otherwise. No, finally releasing the ringgit from its years of hard peg was not the result of yielding to market pressure but a policy position. ***§ Dr. Chan Huan Chiang***

Please note that this month's forum on the Goods & Services Tax has been held over and will be published in the next issue of the Penang Economic Monthly.

Headline Economic Indicators of Asian Countries

The following tables provide comparative data of nine Asian countries in terms of gross domestic product, consumer price index, industrial production index, unemployment rate, exports, imports, interest rates and foreign reserves.

GDP (percentage y-o-y)

	2002	2003	2004	Q2 '04	Q3 '04	Q4 '04	Q1 '05	Q2 '05
China	8.3	9.5	9.5	9.6	9.1	9.5	9.4	9.5
Hong Kong	1.9	3.2	8.1	12.0	6.6	7.1	6.0	na
Indonesia	4.4	4.9	5.1	4.4	5.1	6.7	6.4	na
Malaysia	4.1	5.3	7.1	8.4	6.7	5.8	5.7	na
Philippines	4.3	3.6	6.1	6.4	6.3	5.4	4.6	na
Singapore	3.2	1.4	8.4	12.3	7.2	6.5	2.8	3.9
South Korea	7.0	3.1	4.6	5.5	4.7	3.3	2.7	3.3
Taiwan	3.9	3.3	5.7	7.9	5.3	3.3	2.5	na
Thailand	5.3	6.9	6.1	6.4	6.1	5.3	3.3	na

CPI (percentage y-o-y)

	2002	2003	2004	Q2 '04	Q3 '04	Q4 '04	Q1 '05	Q2 '05
China	-0.4	3.2	2.4	5.0	5.2	2.4	2.7	1.6
Hong Kong	-3.0	-2.6	-0.4	-0.9	0.8	0.2	0.4	0.8
Indonesia	11.9	6.8	6.1	6.4	6.7	6.3	7.8	7.7
Malaysia	1.8	1.2	1.4	1.2	1.5	2.3	2.4	3.0
Philippines	2.9	3.5	6.0	4.7	6.9	8.1	8.5	8.2
Singapore	-0.4	0.5	1.7	1.9	1.9	1.7	0.3	0.1
South Korea	2.8	3.5	3.6	3.4	4.3	3.4	3.1	3.0
Taiwan	-0.2	-0.3	1.6	1.2	2.9	1.8	1.6	2.1
Thailand	0.6	1.8	2.7	2.7	3.3	3.2	2.8	3.7

IPI (percentage y-o-y)

	2002	2003	2004	Q2 '04	Q3 '04	Q4 '04	Q1 '05	Q2 '05
China*	17.4	28.4	27.6	31.0	29.9	27.6	25.3	27.1
Hong Kong	-9.7	-9.2	2.9	1.0	3.3	5.1	-0.6	na
Indonesia**	-7.1	4.0	4.0	2.0	3.3	8.2	7.3	na
Malaysia	4.6	9.3	11.3	13.3	10.5	7.6	5.2	2.4
Philippines	-6.1	0.0	1.0	-0.7	1.3	7.6	1.0	na
Singapore	8.4	3.0	13.9	20.1	11.1	14.4	3.4	5.9
South Korea	8.0	5.0	10.4	12.7	11.5	6.8	4.0	4.1
Taiwan	7.9	7.1	9.8	15.3	8.7	2.6	-0.4	0.3
Thailand**	8.9	13.9	11.1	9.4	12.6	9.1	3.8	7.7

**as IPI figure is unavailable, Fixed Asset Investment is used instead*
*** IPI for manufacturing sector only*

Unemploment Rate (percentage)

	2002	2003	2004	Q2 '04	Q3 '04	Q4 '04	Q1 '05	Q2 '05
China	4.0	4.3	4.2	na	na	na	na	na
Hong Kong	7.2	7.3	6.5	6.9	6.8	6.5	6.1	5.7
Indonesia	9.1	9.5	9.9	na	na	na	na	na
Malaysia	3.5	3.6	3.5	3.7	3.4	3.3	na	na
Philippines	11.5	11.5	11.9	11.7	10.9	11.3	12.9	na
Singapore	5.2	5.4	4.0	5.3	3.1	3.9	3.3	na
South Korea	3.1	3.4	3.5	3.4	3.6	3.4	4.2	3.6
Taiwan	5.2	5.0	4.4	4.4	4.6	4.2	4.2	na
Thailand	2.4	2.2	2.1	2.5	1.6	1.5	2.6	2.1

Export (percentage y-o-y)

	2002	2003	2004	Q2 '04	Q3 '04	Q4 '04	Q1 '05	Q2 '05
China	22.1	34.6	35.4	37.1	34.7	35.6	34.7	30.9
Hong Kong	5.4	11.6	15.8	17.7	17.7	15.3	10.5	12.5
Indonesia	1.5	6.8	17.2	9.7	27.7	32.1	32.2	23.3
Malaysia	6.9	11.3	20.8	21.8	26.9	16.1	13.7	11.0
Philippines	9.5	2.9	9.3	10.8	8.5	11.5	3.6	na
Singapore	2.7	12.2	20.9	25.7	25.2	17.5	10.5	10.5
South Korea	8.0	19.3	31.0	38.9	28.9	21.2	12.6	9.0
Taiwan	8.9	9.9	17.5	23.6	20.2	9.2	1.5	-0.2
Thailand	5.4	16.4	21.8	23.1	25.0	20.0	12.4	11.6

Import (percentage y-o-y)

	2002	2003	2004	Q2 '04	Q3 '04	Q4 '04	Q1 '05	Q2 '05
China	21.2	39.9	35.8	42.9	30.1	30.4	12.2	16.0
Hong Kong	3.3	11.6	16.8	21.9	18.2	11.7	8.1	10.1
Indonesia	1.1	4.0	42.9	40.8	55.8	53.5	33.1	37.5
Malaysia	8.2	1.4	30.1	32.2	29.9	18.4	10.1	8.0
Philippines	7.2	5.8	7.5	7.8	9.7	6.0	-3.7	na
Singapore	0.3	7.0	24.0	27.5	30.7	18.9	11.9	11.3
South Korea	7.8	17.6	25.5	32.5	27.3	23.6	14.6	14.9
Taiwan	7.6	12.6	28.4	34.2	30.4	23.0	6.1	4.1
Thailand	4.0	16.7	26.6	35.0	29.9	17.3	28.6	34.0

Interest rates

	2002	2003	2004	Q2 '04	Q3 '04	Q4 '04	Q1 '05	Q2 '05
China	5.31	5.31	5.58	5.31	5.31	5.58	5.58	5.58
Hong Kong	2.75	2.50	3.75	2.50	3.25	3.75	4.25	4.50
Indonesia	14.37	10.11	7.06	7.12	6.97	6.46	5.94	6.21
Malaysia	2.73	2.74	2.70	2.71	2.70	2.69	2.70	2.70
Philippines	6.48	7.42	7.28	7.20	6.82	6.90	6.18	na
Singapore	0.62	0.43	0.62	0.34	0.83	0.91	1.36	1.64
South Korea	4.25	3.75	3.25	3.75	3.50	3.25	3.25	3.25
Taiwan	1.54	1.02	1.21	1.02	1.10	1.21	1.27	1.26
Thailand	1.87	1.35	1.25	1.03	1.22	1.69	1.90	2.30

Foreign reserves (USD billion)

	2002	2003	2004	Q2 '04	Q3 '04	Q4 '04	Q1 '05	Q2 '05
China	286.4	403.3	609.9	470.6	514.5	609.9	659.1	711.0
Hong Kong	111.9	118.4	123.6	120.8	118.4	123.6	122.4	122.0
Indonesia	32.0	36.3	36.3	34.9	34.8	36.3	36.0	36.0
Malaysia	34.6	44.9	66.7	53.9	56.9	66.7	72.4	75.2
Philippines	12.8	13.9	14.4	13.9	14.0	14.4	15.4	na
Singapore	82.3	96.3	112.8	101.6	102.7	112.8	113.0	na
South Korea	121.4	155.4	199.1	167.0	174.4	199.1	205.4	205.0
Taiwan	161.7	206.6	241.7	230.1	233.0	241.7	251.1	253.6
Thailand	38.9	42.1	49.8	43.3	44.8	49.8	48.7	48.4

The above tables were compiled from the following sources: CIMB, CEIC, IMF

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