

The Gold & Jewellery Industry in Penang

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The gold and jewellery industry in Penang is more than a hundred years old and is the main contributor to the Malaysian gold and jewellery industry. According to industry sources, approximately 75-80 percent or 48-52 tonnes of the gold and jewellery in Malaysia are manufactured or fabricated in Penang, followed by Johor Bahru and Kuala Lumpur.

There are about 300 registered companies engaged in the gold and jewellery industry of Penang, with activities ranging from manufacturing to import, export, retail and wholesale. Majority of the gold and jewellery manufacturers are located at Seberang Perai. However, there are four major gold & jewellery manufacturers on Penang Island, namely OE Design, Zenmax, Yikon and Zhulian. Penang is the major exporter of gold & jewellery in the South East Asian region. More than 70 percent of the gold & jewellery manufactured in Penang is for the export market.

With the Malaysian gold and jewellery exports being valued at RM3 billion or approximately 50 tonnes in 2004, the export value of the Penang gold and jewellery industry is about RM 2.25 billion.¹ For Malaysia as a nation, the major export markets are the Middle East at almost 90 percent, North & South America at 6 percent and European countries at 4 percent. Of the jewellery fabricated out of Penang, approximately 60 percent are headed for the Dubai market, with Hong Kong, Singapore and the European markets making up for the remaining 40 percent.

Apart from being an export-oriented jewellery fabrication centre, Penang has its fair share of retail outlets located mainly along Campbell Street, Jalan Masjid Kapitan, Lebuah Ah Quee, and Market Street. These retailers cater to the domestic market and international tourists, mainly from Indonesia (Medan & Aceh), Southern Thailand, India and Saudi Arabia. Some of these retailers are large dominant players who have their own manufacturing operations which cater to both the export and local markets, whilst some are small-medium operators who purchase the gold and jewellery from wholesalers purely for domestic retail sales.

The primary suppliers of raw materials for this trade are bullion banks and international private bullion houses. Amongst the bullion banks are UOB, RHB and Maybank. A dominant international private bullion house is MKS Precious Metal Switzerland. Its Malaysian office is a key local supplier for many of the jewellery fabricators and manufacturers. Some of the larger retail outlets also double up as secondary suppliers; buying from primary suppliers such as bullion houses and selling to smaller cottage fabricators.

The Chinese have been the major players of the gold & jewellery industry in Penang for years. Their experience encompasses manufacturing and trading of gold articles (bangles, necklace, bracelet, earrings, etc.) and gem setting (diamond & precious stones). Apart from the Chinese, there are smaller groups of Indian Muslim and Indian jewellers who are mainly involved in gem setting and are located around Jalan Masjid Kapitan and Market Street. The Indian Muslim and Indian jewellers mainly focus on retail, wholesale and a small portion of import and export. Most of them provide the design and specifications based on their customer's requirements to the Chinese goldsmiths and manufacturers for production.

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¹ The RM2.25 billion figure is extrapolated from the national export figures, being 75 percent of the nation's export value

There are five associations in Penang which cater for different groups within the gold & jewellery industry here, namely:

1. Penang Goldsmiths and Jewellers Association
2. The Penang Gold and Silver Merchants Association
3. Penang Chinese Heng Woh Goldsmiths Employees Union
4. Province Wellesley Gold and Silver Ornament Merchants Association
5. Muslim Jewellers and Money Changers Association

The gold & jewellery industry is a labour intensive industry. According to the various industry associations, this industry employs approximately 8,000 – 10,000 people in Penang. Majority of its labour force are locals as trustworthiness and security are important issues. The art of crafting fine jewellery is very much alive in Penang with the latest batch of traditional jewellery artisans currently in their 40's. It is estimated that these people can contribute to at least another 30 years of craftsmanship whilst training new apprentices. Over the past century, Penang has gained itself the reputation as possessing one of the finest gold-craftsmanship in the world.



What lies ahead?

- ***The 'Gold Bazaar' of Penang***

The Gold Bazaar was proposed by former Prime Minister Tun Mahathir Mohammad after a trip to Dubai and upon being told that the majority of the jewellery on display were from Penang, Malaysia. Having seen the vast market potential, it was then proposed that the areas of Jalan Kapitan Keling, Buckingham Street and Campbell Street² be gazetted as the Gold Bazaar of Penang. Approximately two years ago the Federal Government allocated RM6 million to start the project.

The proposed Gold Bazaar project aims to rejuvenate the surrounding areas of Jalan Masjid Kapitan Keling as a popular business centre for gold and jewellery in the region and to attract both local and foreign tourists. The development objectives are :

- To provide a unified landscape treatment by blending the various building units into a specific identity that ties to the main character of the prominent buildings of the area;
- To improve and protect the existing economic base by encouraging more potential shoppers into the area;
- To create a conducive ambience for commercial and shopping activities with aesthetically pleasing and adequate landscape facilities; and
- To serve as a venue for occasional cultural and religious festivals with appropriate landscape features that will highlight the Penang Historical Enclave while retaining and enhancing the sentimental value of the area.

The gold bazaar project comprises of two phases. Phase One involved repaving of the roads within the designated area. Phase Two comprises the repainting of building facades, installing new kiosks and stalls, close-circuit television cameras at strategic locations and advertisements boards, beautification of the streets, landscaping and the provision of other on the ground facilities.

This project was greeted with much enthusiasm by gold traders as it promised grand visions of canopied sidewalks with lightings, pretty facades and designated tourist bus berths, complete with an information kiosk and appropriate signages and an archway at the Jalan Kapitan Keling mosque. Sentiments have since changed. Traders are unhappy and dissatisfied with the progress of the gold bazaar. Phase One was completed last year and the second phase which was originally scheduled to commence in September / October 2005 and to be completed by mid 2006 has only recently commenced.

Many traders in the area are unhappy and dissatisfied with the current condition of the gold bazaar. Business prior to the repaving works was reportedly much better than now. Many locals avoid the new road as it has been narrowed with parking facilities severely reduced, it is bumpy and has caused many punctured tires. As such the merchants have lost a considerable amount of business. Most frustrated traders have moved out of the area. Many

² Campbell Street and Buckingham Street is otherwise known as the Penang Gold Trail.

Chinese traders have chosen to set up shops at shopping complexes such as KOMTAR, Prangin Mall and Bukit Jambul Complex. The Indian Muslim jewellers remain where they are mostly because of the cheap rental. Their current premises are rented from the "Endowment Board" run by the Majlis Agama Islam and thus they are afforded a cheap rental of around 70 to 80 percent discount from the normal market rates. It is this significant cost savings which allow them to sustain their businesses.

- ***The Impending Goods & Services Tax (GST)***

The implementation of the GST in 2007 is expected to affect the gold and jewellery industry in two main ways; the first is the tightening cashflow on the companies and the second is the decrease in demand for gold and jewellery.

Although the GST is ultimately borne by the customers, the GST on input (gold) charged is a financial burden to the industry players. Presently, manufacturers and or fabricators of gold and jewellery products are already suffering tight financial conditions with the high price of gold. When the GST is imposed, this will add to the financial burden of the companies. Despite the fact that these companies can claim back on the GST paid on gold, there is lingering doubt regarding the efficiency of the "claim back" system given past experience with the claiming process for excess income tax paid. If these fears are realised, manufacturers and retailers alike will be put in an even more difficult financial situation. The companies will also face difficulty in expanding their businesses.

This has been proven in the mid-nineties when Malaysia imposed a ten percent tax on importation of gold. Within four months of imposition, the entire industry came to a standstill. It took a full 1½ years to remove the tax. In this period, gold smuggling was rampant and many bullion banks suffered as there was no demand for legal gold bars which were sold at a minimum of ten percent premium over the black market price.

Secondly, the GST makes the taxation on certain good more pronounced in that consumers are made to realise the exact amount of tax payable. This is expected to have a stronger effect on consumer psyche and may potentially deter the consumer from purchasing gold and jewellery if market conditions are bad. Industry sources are of the opinion that a GST rate above 5 percent will have a pronounced effect on consumer demand.

The cottage or smaller fabricators are calling out to the government to assist them in this matter. In this price elastic industry, they feel competitiveness will be eroded once the GST is implemented and the trade will die a slow death as has been proven in Singapore and Taiwan. The implementation of GST may force them to consider relocation options to China or Indonesia.

- ***China/Indonesia/Vietnam as an alternative fabrication center***

Relocating manufacturing operations to China, Indonesia or Vietnam is not an attractive option to many of these gold and jewelry fabricators. Despite the large pool of labour and vast market opportunities, many prefer to manufacture here for export to those markets. Relocation will only be considered if they have no other options. The gold and jewellery industry is a very sensitive industry which is easily affected by security concerns, available infrastructure, the level of "loss allowance" in the gold production process, the reluctance to hire "outsiders" or "foreigners" and the difficulty in obtaining financing from banks in an industry where the profit margins are low against the value of the raw material.

Penang currently possesses the necessary infrastructure to facilitate the transfer and shipment of gold bullions and gems and the export of completed gold and jewellery items. In countries like China, Indonesia or Vietnam, the allowance for gold losses would have to be much higher in view of security issues both within and outside of the fabrication centers.

The high cost of security in Malaysia has made personal movement in terms of product transfer in this industry very common. Gold shipment from Zurich to KLIA in Malaysia or from Zurich to Singapore costs around the same as gold shipment by private security companies from the Bayan Lepas area to the bullion banks in Penang. Thus personal movement is a much cheaper option. However, if and when these carriers get hit by theft, their insurance premiums escalate by approximately 20 to 30 percent, thereby wiping off the profit margin for the entire year.



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Therefore, only dire circumstances will push these manufacturers to consider the option of relocation and many have cited that the GST is definitely one of them.

- **A Hallmarking Centre - A Boon or a Bane?**

Hallmarking is a method of assessing the purity of gold by a competent & recognized authority. Hallmark on gold jewellery confirms that it has been evaluated, tested and certified that the gold jewellery conforms to national / international standards of fineness and purity.

The Ministry of Domestic Trade & Consumer Affairs has proposed compulsory hallmarking for precious metals and jewelry with the following aims:

- To prevent malpractices and to protect the interest of consumers (both locals and tourists) with respect to the quality of the precious metals and jewellery they purchase;
- To monitor and establish a legal platform for dissatisfied consumers, including tourists, in the event of under-carating fraud/complaints; and
- To ensure high standards in the precious metals and jewellery industry of the country.

The impact of setting up a hallmarking center for the gold & jewellery industry of Malaysia is much debated. Many within the industry is of the opinion that compulsory hallmarking will negatively affect their business as the move will hike costs of production. Manufacturers will have to pay for their products to be graded, raising security concerns in terms of transporting the products from factory to hallmarking centre, and hence reducing the overall competitiveness of the industry. Moreover, many believe that this industry is self-regulating, as overseas buyers such as the Dubai and Asia based importers have stringent quality controls. Failure to meet the criteria will result in rejection of the entire shipment and, apart from costs incurred in the entire shipment process, will also lead to a loss in the credibility of the manufacturer. At the moment, both the industry and customers seem satisfied with the existing gold assaying services provided by Fedmas Assay Office, an approved & recognized gold assaying laboratory in operation in Penang since 1984.

On the other hand, hallmarked gold and jewellery items promote uniformity and prevent unscrupulous acts which are not rampant, but common these days, such as gold plated silver jewellery sold as pure white gold to unsuspecting buyers. It is also an effective form of consumer protection. Despite these, many players in the industry feel that the hall marking act will not eliminate these problems by a hundred percent. In fact, it may well encourage the burgeoning of a black market. All in all, the hallmarking act will further burden honest producers whilst unscrupulous producers hope to find loopholes within the system and continue to sell their products in the black market.

Industry sources have divulged that at the national level, more than 90 percent of gold and jewellery establishments are against the idea of a compulsory hallmarking act. This has led to a current review of the proposed hallmarking act, i.e. the need to be made compulsory versus voluntary. As the proposed Act is still at the drafting stage, no other details of the Act has been disclosed by the Ministry.

- **Lack of craftsmen**

While the art of gold craftsmanship is very much alive in Penang, it is feared that without formal apprenticeship programs, the traditional craft of gold making may not survive into the longer term. Today, many of the workers have been trained to be single purpose manual or machine operators as it is a cheaper alternative.

The setting up of a gold and jewellery training center as part of an existing education institute such as the Penang Skills Development Center or the Pusat Giat Mara would help to increase awareness and indirectly promote the potentials of this industry within the younger generation of school leavers. This will also provide a broader scope of job opportunities in Penang as those who are less academically inclined may choose the vocational path to be trained in a certain skill, such as designing or goldsmithing to fulfill the needs of the gold and jewelry industry.



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Conclusion

The gold and jewellery industry is unique to Penang in that it contributes to the economy both culturally and economically. Proper development and planning will ensure survival of this unique trade into the future. The tourism sector also stands to benefit. As it is, the gold bazaar is strategically located close to the Khoo Kongsi and the Kapitan Keling mosque - two major tourist attractions of Penang. At present inbound tour agencies do not include a visit to the gold bazaar as part of their itinerary; leaving tourists to drop in on the shops informally. The vision of a completed gold bazaar holds much promise for the industry. Thus, the Government can promote the industry further by:

- Speeding up the completion process of the Gold Bazaar.
- Increasing the level of security along the Gold Bazaar. The installation of CCTV's at the Gold Bazaar which is linked to the police station for closer monitoring will boost the confidence level of jewelers in displaying more ornate and elaborate items thus drawing more international and domestic customers.
- Encouraging inbound tour agencies to include a visit to the Gold Bazaar in their tour itineraries; provided that the Government hastens the completion process of the Gold Bazaar.
- Providing multi-storey parking facilities, adequate & clean public toilets, and more efficient public transport system to the Gold Bazaar.
- Having more frequent dialogues between the government and industry players to better to identify the current needs & challenges faced by the industry. This move is essential to encourage better understanding and cooperation amongst all parties involved.
- Hosting international gold & jewellery exhibition and scheduling them as State tourism events. The authorities could also look into inviting more international gold & jewellery houses to set up their regional office in Penang.
- Assisting in human resource development for this industry. The setting up of a gold & jewellery training school to cater for industry needs will address the issue of the shortage of skilled workers within the industry.

These initiatives are expected to further enhance and strengthen the status of Penang as a regional gold & jewellery centre.

This article is based on the preliminary findings of the Gold & Jewellery Survey 2005 commissioned to SERI by investPenang



The vision of a completed gold bazaar holds much promise for the industry.

Monetary Policy: The OPR and Its Effects On The Economy

Introduction

The government's justification for tweaking with the economy is so as to achieve stability and growth. While output levels, inflation, employment and income distribution are some of the main factors affecting a stable and growing economy, how these factors perform are not the result of government fiscal spending alone. For this reason, much of government intervention on the economy involves the attempt to influence consumption and investments among households and the private sector. There are a variety of policy instruments available but these tend to only have indirect effects by working through what are referred to as intermediate targets: money supply, exchange rate, interest rates, share prices that can potentially translate into output, inflation, employment and income levels.

When Nigel Lawson was the Chancellor of the Exchequer in Britain during the second half of the eighties, he subscribed to Waud's¹ argument for not setting targets since the targets will introduce an additional source of error to whatever actions that the government has chosen to do. Other managers of national economies, however, will tend to have some form of targets that prescribed monetary policies are aimed at. In many situations the targets are publicly announced but undisclosed targets are also often the case.

In Malaysia, Bank Negara Malaysia has shown considerable restraint by not tugging heavily at the nation's economy, electing instead to let policies already in place remain. Bank Negara has, on many occasions, ridden out predictions of policy changes by market analysts or public reactions to market events. When policy changes did occur, it could be observed that such changes were introduced when the market was least likely to react. For example, the switch from the three-month intervention rate to the overnight policy rate in April 2004 was a major change in the choice of monetary policy instrument but it was no market event. The policy set overnight money at 2.7 percent, which was then the prevailing market rate and this rate was kept locked until the upward revision to 3 percent late November 30 last year. In the case of capital controls, which were introduced in 1998 in conjunction with the pegged ringgit, this was released on April 1 2005 without simultaneously releasing the ringgit's dollar peg and thus not allowing the market to react to the policy change. When the peg was finally taken off towards the end of July 2005, there was no sudden revaluation. Today, after half a year, the ringgit has been trading in the 3.7 to the dollar range, in other words, only 2.6 percent off the eight-year long pegged rate.

The Overnight Policy Rate at 3 percent

Bank Negara, revising upwards the OPR from 2.7 percent to 3 percent has an intended policy effect. The idea is to very gently squeeze liquidity in the banking system by making daily cash shortfalls more expensive for the banks, which they are meant to avoid by not lending out as much². To keep their previous revenue margins intact, banks will have to also revise upwards their base lending rates so that as much revenue can be earned with lesser amounts of lending. The increased borrowing cost in the economy will supposedly curb spending and investments thus help to slow down inflation.

When the ringgit was pegged to the dollar and even today, when the ringgit still keeps within very narrow bounds with the dollar, interest rate differentials between the U.S. economy and Malaysia attracts a keen interest among market analyst. Since capital controls have been released, money can technically flow without much restriction to arbitrage (take advantage of) any difference in investment returns between the interest rates in Malaysia and in the U.S. When the overnight rate was 2.7 percent in Malaysia, the rate in the U.S. used to be only 1 percent. But since June 2004, The U.S. Federal reserve has nudged up overnight rates in the U.S. 13 times by a quarter percent each time. This has resulted in a fairly wide interest rate differential – the U.S. overnight of 4.25 percent compared to Malaysia's overnight of 3 percent

¹ Waud R N (1973), "Proximate Targets and Monetary Policy," *Economic Journal*, Vol. 83:1.

² While upward revisions of the overnight policy rate suggests that the Bank Negara is attempting to tighten liquidity, the 30 basis points would be considered too little an increase to have an effect, because the revised OPR is currently 125 basis points below the Fed's overnight rate. The large interest rate differential, suggests that borrowing will not slow down, which is what the upward revision is meant to do.

(i.e., 125 basis points). Analysts are anticipating yet another quarter-point rise of the Fed rate to 4.5 percent, when the Federal Reserve meets at the end of January, which will also be the time when Alan Greenspan retires from the chair, which he had held since 1987. What this means is that while the Fed has been busy tightening up the U.S. economy, Bank Negara has kept liquidity in Malaysia fairly loose. It is like trying to balance a tight rope – 30 basis points up to curb inflation but keeping money still loose so that brakes are not put on the local economy.

Looking at Bond Yields to Gauge Policy Effects

After the monetary authorities have taken a policy action, how do we tell whether such an action is taking effect on the economy? How do we know if there is a corresponding reaction by households and businesses? A popular “crystal ball” that market analysts like to gaze into is the yield curve formed by plotting the rate of returns on bonds expected by investors for various periods of maturity.³ Investors tend to expect higher compensation for bond purchases with longer maturity periods long for two reasons. First, they are denied access to their monies that will be locked up for the long period of maturity. Second, it is general perception that with inflation, the invested money will likely buy less in the future when the bond matures. Thus the expected compensation for a bond, which takes many years to mature, will have these two elements: the real interest rate (to compensate for the loss of use of the money) and the perceived inflation rate (to compensate for loss of purchasing power over the period of maturity).⁴



Thus a normal healthy economy that happily chugs along will reveal a yield curve that slopes gently upwards from left to right to indicate lower yields for short-term loans on the left to higher yields as the period of maturity increases towards the right. Any departure from this pattern in the yield curve therefore signals caution attracting curiosity and attention as to why investors are not behaving intuitively vis-à-vis expected returns and length of investments.

One must, of course, realize that policy intervention on the part of Bank Negara such as the 30 basis point increase, in the overnight policy rate is directed, like a precise surgical instrument, only at influencing the rate of overnight money. The yields of everything else, Bank Negara's Band 1 bonds (up to 21 days maturity), the Band 4 bonds (between 68 days and 91 days maturity), Band 7 bonds (172 days to 211 days maturity), Band 10 bonds (312 to 364 days maturity) or the longer maturing Malaysian Government Securities (MGS) that have maturities 1 through 10 years, 15 and 20 years, will depend on market response and changing economic conditions.

How the market interprets policy-influenced overnight rates will supposedly show up in the yield curve. Analysts make inferences about how the economy is performing by looking at how the yield curve responds. One simplistic way of analyzing the yield curve is to see if the yield curve is flattening following the rise in the short-term interest rate. This happens when the short-term rate rises on the left side of the curve but this rise has only little or no response on the long-term rates towards the right side of the curve. The result is then a flattened version of what used to be a steeper yield curve rising from left to right.

Yield Curve Drama in Malaysia

The yield curve for none or low risk government security issues (Bank Negara Bonds at different bands and MGS of different maturities, listed above), is shown in Figure 1 for the years 2001, 2003, 2005 and 2006.⁵ It could be noticed that there is some drama in the long-term yields between 2001 and 2003 and from then through to the present time. It appears that the returns for risk-free long-term lending (15 year maturity government bonds) to the government expected by Malaysia's general public is shy of 5 percent per year, as could be seen for 2001 and for 2005.⁶ This suggests that if people generally believe the official inflation

³ For brief reviews of how to interpret changes in yield curves, see, Joseph G Haubrich (2004), “Interest rates, yield curves and monetary regime.” *Economic Commentary*, Federal Reserve Bank of Cleveland, and Tao Wu (2003), “What makes the yield curve move?” *FRBSF Economic Newsletter*, Federal Reserve Bank of San Francisco.

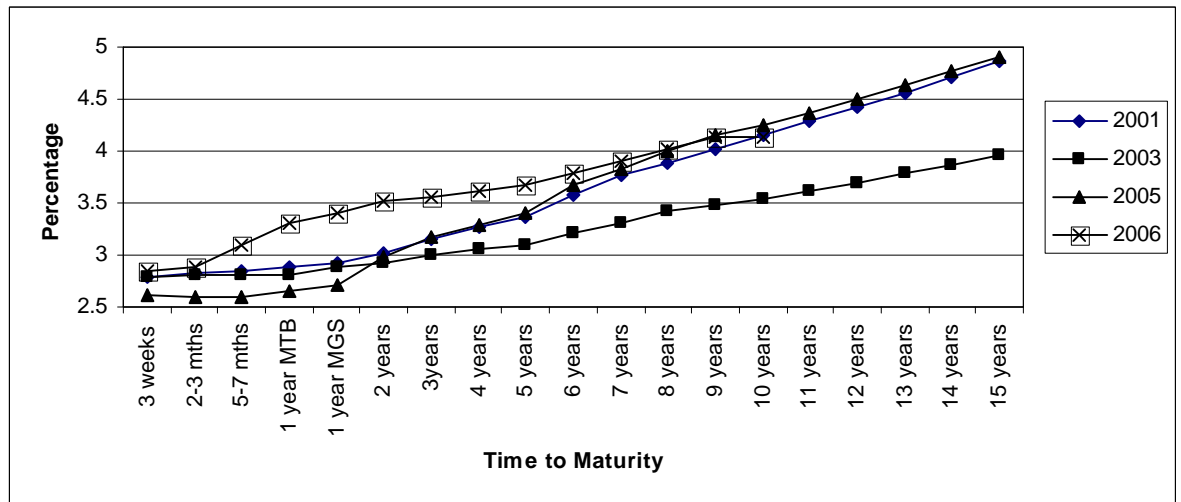
⁴ This perception of how investors expect compensation for their investments is known as the Fisher Effect, named after Irving Fisher (1896), “Appreciation and Interest” *American Economics Association*.

⁵ The yields for 2001, 2003 and 2005 are obtained from Bank Negara's indicative yield to maturity tables (<http://rmbond.bnm.gov.my/wwwbis/>). This, however, has been updated only to the middle of 2005. The 2006 yields are based on quotes for benchmark bonds obtained from the same source in the Bank Negara homepage. The yields for government securities with maturity periods not found among the benchmark bonds were interpolated to complete the curve for the 2006 yield curve.

⁶ Private bond issues have higher yields since they carry more risks. In 2005, the 3-year MGS yield was 3.17 percent while a 3-year AAA-rated private bond has a yield of 3.71 percent. These rates can be compared to 9.44 percent for a 3-year BBB rated private bond and as high as 11.80 percent for considerably more risky bonds rated BB and below.

figures of between 2 percent and 3 percent, then the compensation expected for loss of use of their money over this long-term period is a real interest rate of also between 2 percent and 3 percent. In other words, using the *Fisher Effect* notion, Malaysians appear to generally divide nominal yields roughly half and half between loss of use of their monies, locked up over the period of maturity, and loss of purchasing power of their monies from inflation.

Figure.1: Yield Curves for Malaysian Government Bonds



Source: Bank Negara Malaysia

Example 1: Long-term response to economic circumstance without policy input

But between 2001 and 2003, there was an erosion of nearly one percent (100 basis points) in the long-term yield from 4.85 percent down to 3.95 percent over this period while the short-term rate from 2.78 percent to 2.79 percent moved by only a miniscule 1 basis point. This phenomenon is drama because policy changes on overnight interest rates has only an indirect effect on long term movements in the interest rate. Reduced inflation in the short-term might moderate long-term price rise. But, since the economy is expected to go through many business cycles before the bond even matures, current reductions to inflation rates will not easily translate into smaller inflation in the future.

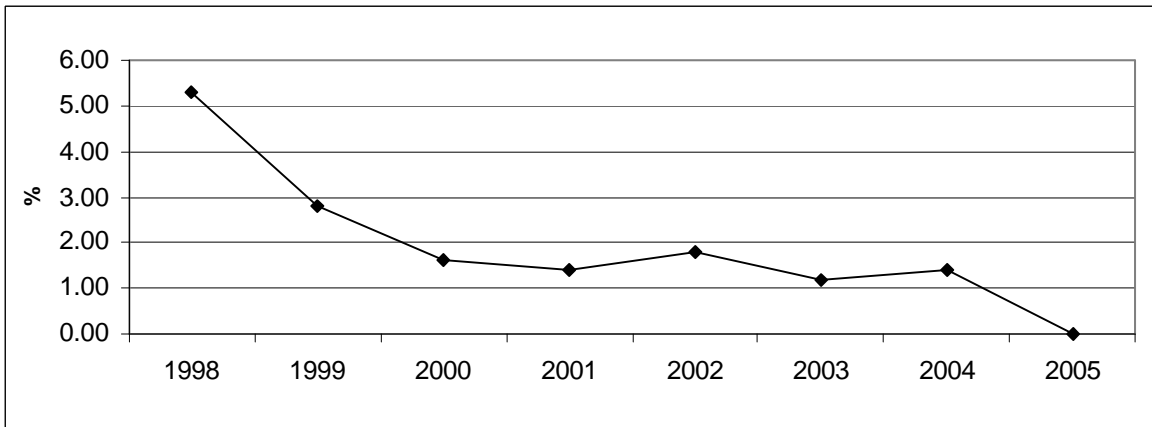
It is possible that the fall in long-term yields in 2003 may have occurred independent of policy. Consider the official announcement of the change to the consumer price index, shown in Figure 2. In 1998, during the height of the financial crisis, the CPI change from the year before was more than 5 percent. But in the years that followed, the annual rate of change to the CPI declined steeply to only between 1 and 2 percent points. This was the time when both Japan and the U.S. suffered deflationary effects – falling prices as opposed to the scenario of rising prices that we are more accustomed to.

Inflation might scare many people, but deflation is actually more frightening. The rate by which the nominal gross domestic product (nominal GDP), which is the real GDP plus and element of inflation, grows, generally describes the rate of return to business investment ventures. Since, interest rates have to be above zero (otherwise people will not save), but below the nominal rate of return to business (otherwise investors will not borrow) a relatively high nominal GDP rate gives room for packaging interest rates and monetary policy targeting. When the nominal GDP falls (following an economic downtrend accompanied by a tendency for falling prices) and heads closer and closer to zero, the margin for setting interest rates above zero but below the rate of return to business becomes smaller and smaller. During episodes of inflation, monetary policy can set interest rates as high as need be. In contrast when deflation occurs, there will be little or no room for monetary policy to play in the space between zero and the nominal GDP rate.

The fall by one percent in the 2003 long-term yield in Malaysia, therefore, is an indication of the changed perception among bond investors. Prices, as shown in Figure 2, appeared to be rising at a slower and slower rate for several years fueling fears of a possible deflation scenario. Understanding that this has a falling nominal GDP effect and indicative of an ensuing falling interest rate trend, long-term investor began to lock in their long-term yields

albeit at a lower rate and still enjoy a bit of real interest rate for their investments. Since 2003, however, prices have begun their upward climb again. The American and Japanese economies had also begun to recover. By 2005, the long-term yield is back at their former levels.

Figure 2: Rate of CPI Change



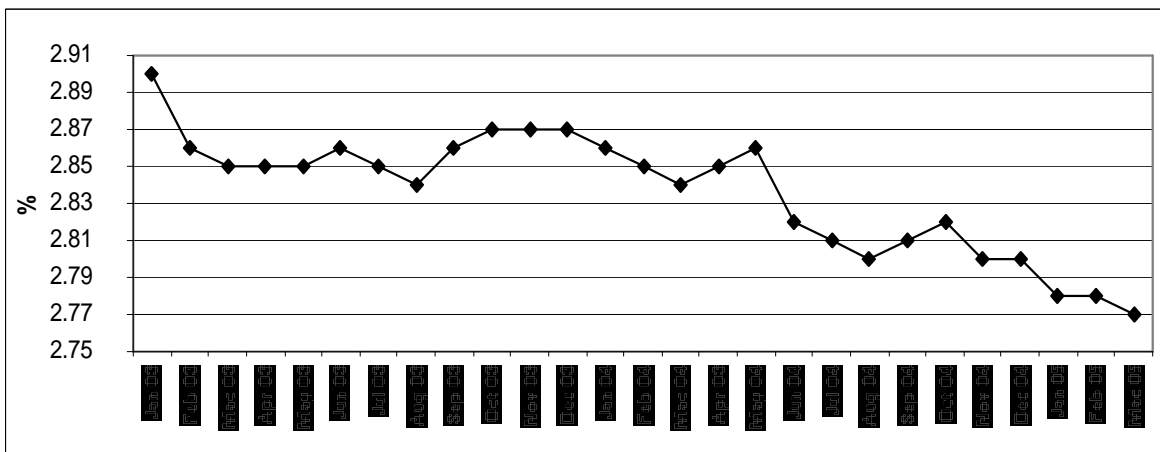
Source: Bank Negara Malaysia



Example 2: Policy input without inducing unintentional long-term investor response

Between 2003 and the beginning of 2005, the 3-month inter-bank borrowing rate has been on the decline as shown in Figure 3. As discussed in the previous example, inflation has been slowing down fueling fears of the fall in nominal GDP growth – an indication of falling returns to business investment. Accordingly, the lowered rate of interest is reflected in the 2005 yield curve found on Figure 1. By design, business and policy response that are aimed at addressing prevailing economic circumstances in the short-term are not meant to induce long-term response. Thus while a rise in the short term rate tends to flatten the yield curve, a fall in short-term rates will cause the yield curve to become steeper as could be seen in the 2005 yield curve. Such behaviour, by way of response among investors to short-term circumstance and policy intervention, is indicative of economic resilience. It shows that the public in general understands that prevailing economic circumstance might require some tweaking but sees government intervention as one of the many idiosyncrasies of business cycles that should have little to do with economic outcomes during the long-term.

Figure 3: 3-Month Rate



Source: Bank Negara Malaysia

Example 3: Policy induced flattening of the yield curve without long-term response

It could also be seen on Figure 1 that the 2006 yield curve, has flattened as a result of the rise in short-term rates. To begin with there is the 30 basis point increase to the OPR announced by Bank Negara at the end of November, 2005, but on the whole, yields on government short-term securities have also been creeping upwards for some time. The important thing is, like the fall in short-term rates in 2005, the rise in short-term rates in 2006 have not led to big changes in the long-term yield.

The popular perception is that rising short-term interest rates in Malaysia is an outcome of the steady climb of short-term rates in the U.S. economy. It might be less of an issue when the ringgit was pegged thereby cutting-off the effects of interest rates on the ringgit's exchange rate against the dollar (except for derivative, non-deliverable forward speculation on the ringgit-dollar rate on offshore market). But with the ringgit now un-pegged, interest rate differentials between Malaysia's and the U.S. economy have, once again, become important. However, there are many critically important differences between Malaysia's and the U.S. economy – which also means that the ringgit coming off its dollar peg has been a wise move as this will allow some room to play in matters like interest rates and exchange rates between the two economies in response to prevailing and changing economic circumstances.

There is currently talk about American yield curves heading for an “inversion”, that is when short-term yield become higher than long-term ones.⁷ The American yield curve has been flattening for some time and if circumstances in the short-term do not change for the better, the result is the short-term rate is going to shoot past the long-term rates, the way it is beginning to happen for the U.S. economy. Past episodes of American recession have always had such an indication by the yield curve, which thus begs the question whether the time has come for another recession in the U.S. economy. However, analysts have observed an important distinction between the current episode of the flattened yield curve in the U.S. economy and past ones.

Past episodes of yield curve being flattened was the result of abnormally low long-term rates – similar to the one observed in Malaysia's yield curve in 2003. When the long-term rate to the right is low, the yield curve will appear flat in relation to short-term rates on the left. Remember that monetary policy is based on intervening only the very short-term overnight rate. What happens in the long-term, however, is dependent on market perceptions. Thus, how long-term rates look like on the yield curve reveals the underlying mood of the economy, that is, whether optimistically upbeat or cautiously wearied. The current episode of the flattening yield curve in the U.S. economy does not show that long-term rates have come down. Instead, despite that the Fed-rate has moved up by 325 basis points from 1 percent to 4.25 percent, ten-year Treasuries (the U.S. equivalent of Malaysia's 10 year MGS) remain at the 4 percent—4.5 percent level.

The same might be said for Malaysia's 2006 yield curve, where rising short-term rates responding to current economic circumstance and policy intervention is not accompanied by lowering long-term yields. The ability by policy makers to raise interest rates should be seen with some degree of optimism. As mentioned, interest rates cannot outpace the growth rate of nominal GDP (indicative of the rate of return to business investments) and if long-term yields remain at that normal levels, there is indication that rates of returns over the long-term is considered by the market will be sustained.

Conclusions

Yield curves that take on a normal shape, that is, rising from left to right, are indicative of a healthy economy. Furthermore, when movements in short-term yields do not also affect long-term yields, it is a sign that the market sees such short-term movements as only cyclical adjustments and thus does not revise its expectations on long-term portfolio returns. This means the market has a relatively high level of confidence on the economy and of the monetary authority managing it.

The question then, is what might we expect next? Since the differential between Malaysia's interest rate and the U.S.'s will likely widen further, Bank Negara might nudge Malaysia's OPR upwards as a corrective step in conjunction with its managed float policy on the ringgit. Since long-term yields are not adjusting, there will be further flattening of Malaysia's yield curve causing it to begin losing its normal shape, in other words, leaning towards the possibility of inversion – short term rates shooting past long term yields, which is a sign of recession. Bank Negara is thus understandably cautious, carefully moderating the rise of the OPR. Formula-1 races at Sepang are indeed a high-paced action sport to watch. But the slowly unfolding drama of how the economy changes from within and without and how both Bank Negara and the Fed attempt to respond by pulling at the wires can be equally gripping as well. **§ Dr. Chan Huan Chiang**

⁷ See “Economic focus: the long and short of it” *The Economist*, January 17 2006.

INTERNATIONAL HEADLINES

Japan Steelmakers to Invest in Facilities

January 3, 2006 AP

Japan's top four steelmakers will invest a combined 600 billion yen (US\$5.13 billion) in facilities to boost high-quality steel materials for automobiles and energy-related use over the next four years. An investment to be made by the four steelmakers- Nippon Steel Corp., JFE Holdings Inc., Sumitomo Metal Industries Ltd. and Kobe Steel Ltd.- would be the first such a large-scale one since the collapse of Japan's "bubble economy" in early 1990s and suggests that they are recovering after nearly a decade-long slump. Under the plans, Nippon Steel, Japan's largest steelmaker and the world's third-largest crude steel producer, will spend 220 billion yen (US\$1.88 billion), to increase its No. 1 blast furnace's capacity at its Oita plant in southwestern Japan, while setting up a new converter to make higher strength of steel by controlling the contents of pig iron at its Nagoya factory.



Middle Eastern Investors Flock to Asian Real Estate

January 11, 2006; WSJ, Asia

Investors from the Persian Gulf also are finding a more welcome reception in Asia than in the West, post Sept. 11, and are discovering that property prices in some Asia' nations have managed to avoid the sharp appreciation elsewhere in the globe. For places like Malaysia and Singapore, the influx of investment is an early signal that years of effort to attract Middle Eastern investment are starting to pay off. Singapore has signed free-trade agreements with two countries in the Middle East and is negotiating four others. Malaysia, a majority-Muslim nation, has marketed itself aggressively in recent years as an ideal tourism destination for Arab travelers. The number of Middle Eastern tourists visiting Malaysia has surged from 126,050 in 2004 to 130,190 in the first nine months of 2005. In 2004, the number grew by 57 percent y-o-y. Growing interest in Southeast Asian property could prove a new engine of growth for the luxury market in developed cities like Kuala Lumpur and Singapore.

Are You Being Served?

January 12, 2006, The Economist

Last month's official revision of China's gross domestic product revealed an economy worth 16 trillion yuan (US\$1.9 trillion) in 2004, 17percent more than previously thought. Some 93 percent of the increase was ascribed to the services sector. As a result, services' share of the economy has jumped by nine percentage points, to 41 percent, compared with 46 percent for manufacturing and 13 percent for primary industries (mainly agriculture and mining). According to China's National Bureau of Statistics, most of the newly unearthed GDP comes from three categories - wholesale, retail and catering; transport, storage, post and telecommunications; and real estate. Recent years have also seen a surge in media and technology services, including the internet; in financial services such as leasing; and in education and leisure.

EU Expects Economy to Grow Strongly in 2Q

January 13, 2006, AP

The European Union executive expects gross domestic product to grow 0.4 to 0.8 percent for the fourth quarter of 2005 and the first quarter of this year, in a forecast based on business and economic data from all euro-area countries by the European Commission. For 2005, the Commission expects the euro zone to grow 1.3 percent and the entire EU to expand by 1.5 percent. In 2006, the Commission predicted that the euro-zone economy would grow 1.9 percent in 2006 with the entire EU economy expanding by 2.1 percent. Finland put in the strongest performance in the third quarter with growth of 2.9 percent, followed by Estonia at 2.6 percent and Lithuania at 2.4 percent. Only the Portuguese economy contracted, by 0.9 percent. The European Central Bank raised key interest rate from 2 percent to 2.25 percent in December, 2005 - the first upward swing in five years amidst concerns about price stability.

China's FDI Falls For the First Time Since 1999

January 16, 2006, OSK Securities

Foreign direct investment in China fell for the first time since 1999. The Ministry of Commerce said China's actual FDI dipped 0.5 percent to USD60.3bn. Actual investment from the U.S. dropped 22 percent while investment from E.U. rose 22.5 percent. China has attracted a total of US\$220bn of investment since its 2001 WTO accession and the decline could be an early indication that the pace of investment is beginning to slowdown.

China's FX Reserves Jump, May Fuel Yuan Rise Debate

January 14, 2006, REUTERS

China's foreign exchange reserves jumped by US\$209 billion (34.3 percent) in 2005 compared to US\$207 billion in 2004, a leap that could intensify pressure on Beijing to let the yuan rise more quickly. Only Japan, with US\$846.9 billion, has a larger stockpile. China's reserves have ballooned in recent years as the central bank, in order to hold down the yuan, has bought most of the dollars generated by a growing trade surplus, inflows of foreign direct investment and speculative capital. Although Beijing has vowed to gradually let market forces drive the yuan's exchange rate, but since China revalued the yuan by 2.1 percent against the dollar in July and adopted a managed float, it has let the currency rise just a further 0.52 percent against the dollar. Some U.S. senators are threatening to slap a 27.5 percent tariff on Chinese imports unless Beijing revalues substantially, and such protectionism would grow if the U.S. economy started to slow.



India's Factories Are Booming, But Not Enough

January 17, 2006, REUTERS

India's booming manufacturing sector is a major engine of growth for one of the world's fastest growing economies but still has to pick up dramatically to hit the country's 10 percent growth target and take on rival China. Unless manufacturing grows faster, India's economic growth will be stuck at about 8 percent, a rate to be envied by many but not fast enough to fight poverty and to create jobs for a workforce growing by 3 percent or 12 million people. Over 60 percent of Indians still rely on farming. As more workers move off farms without the skills and education to join the information technology boom, factories and production lines become important to soak up the excess as well as the new jobseekers. Manufacturing accounts for about 16-17 percent of Asia's third-largest economy, not far behind the developed nation average of 20 percent, but less than half of China's 40 percent. In South Korea, Thailand and Malaysia, manufacturing accounts for about a third of gross domestic product.

Consumer Confidence Higher Than Expected

January 31, 2006, AP

Americans became more optimistic about the economy in January as indicated by its consumer confidence index which rose to 106.3, the highest level since June 2002, when the reading was also 106.3. The increase was driven solely by consumers' assessment of current economic conditions, especially their more positive view of the job market. However, while consumers rate current conditions more favorably, the improvement has not translated into greater optimism about the six-month outlook. Those expecting business conditions to worsen in the next six-month increased to 10.5 percent from 9.1 percent. Consumer spending accounts for two-thirds of all U.S. economic activity, hence the importance in tracking consumer confidence.