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Inflation – “Food” for thought



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In a nutshell

- The push for subsidy rationalisation led to increases in fuel and sugar prices in July 2010. Further increases are likely on the cards as the government intensifies efforts to reduce dependency on subsidies and improve its financial position. The overall effort should be applauded as the across-the-board subsidies practised by Malaysia tend to benefit the higher-income group.
- However, the impact of the subsidy rationalisation on consumers' pockets should not be underestimated. While the impact of the rationalisation on the Consumer Price Index (CPI) was minuscule, past experience suggests that the effect on food prices – which has substantial implications for the low-income group – may not be insignificant. The fact is food prices tend to stay elevated even after prices of fuel decline.
- Recent developments in commodity prices may add to the upward price pressure if the situation does not improve in the near term. For instance, prices of wheat have soared, as evidenced by a surge in one-month futures prices by 75% compared with its lowest level in June. The global price of cocoa has surged by about 40% since its low in May 2009 while coffee prices leapt by 49% in July from its low in December 2008.
- Malaysia's food sufficiency levels have not improved tremendously in the past several years, according to the Ministry of Agriculture & Agro-Based Industry. The country's dependency on imported foodstuff is reflected in the growing trade deficits over the years. As such, supply shocks such as unfavourable weather conditions and tightness in global commodity supply chain will likely magnify the impact on food prices.
- We view positively the government's efforts to curb profiteering activities. The Price Control and Anti-Profiteering Bill 2010 which was tabled in the Parliament in July 2010 is meant to ensure that consumers are protected from profiteering, and will to some extent relieve consumers from the burden of high costs of living.
- However, Malaysia may wish to double its efforts to ensure the affordability of major foodstuff. According to the Asian Development Bank (ADB), countries like China, Indonesia and Korea have introduced more policies to strengthen food security through measures such as restricting exports of selected commodities, reducing import duties and raising imports levels by relaxing restrictions on imports into their countries.

Introduction

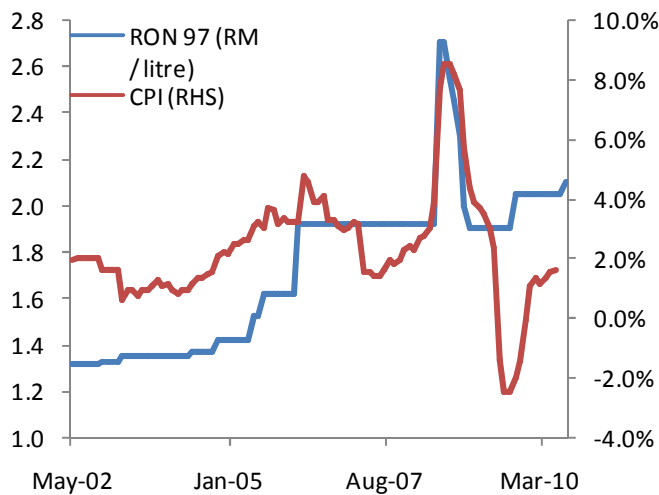
The government subsidy rationalisation was announced on July 16, 2010. Thus far, the quantum of price hikes on petroleum products such as RON97, RON95 and diesel have been relatively minimal compared to the adjustment proposed by the Performance Management and Delivery Unit (PEMANDU) during its open day on May 27 this year. However, the price of sugar was adjusted slightly higher at 25 sen per kilogram (kg) from 20 sen per kg initially proposed by PEMANDU. Based on the media reports, the impact from this decision is expected to be minimal in light of the assurance from food companies that they will not pass on the additional costs to consumers.

But skeptics, particularly people on the street, are still of the view that recent price adjustments will generally affect prices of many consumer goods more than what will be reflected in the CPI. This is based on past experiences that such increases ended up lifting food prices to levels that will not come down easily. Our findings suggest that prices of consumer goods and food in particular, which rise in response to hikes in fuel prices, tend to remain high even after the latter declines. Supply bottlenecks, hoarding and profiteering issues further lead to general prices remaining relatively high compared with their historical levels, adversely affecting consumers' disposable incomes and their spending patterns in the near term. Should the strength in private consumption erode following the expected increases in prices of essential items, the economic growth profile will be affected as consumer spending accounts for a large chunk of the economy. However, easy credit and the low interest rate environment may to some extent keep consumers spending but at the risk of higher household debt.

General catalyst for rising prices

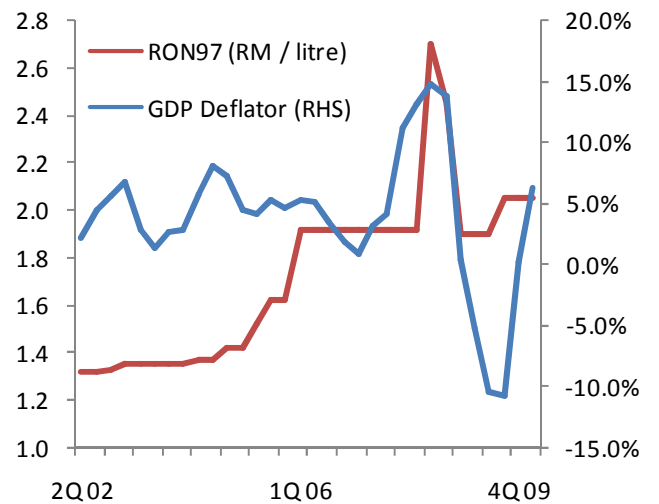
Looking at past trends, reductions in fuel subsidies were the common cause for the spikes in the CPI. For example, when prices of RON97, RON92 and diesel were raised by 30 sen in February 2006, the headline CPI rose 1.6 percentage points to 4.8% in the subsequent month. Breaking it down further, one can see that the transport sub-index bore the brunt, rising by a double-digit pace of 18.0% in March 2006, up from 8.0% in the earlier month. As expected, the 78 sen increase in petrol prices in June 2008 had resulted in a larger increase in the CPI to 8.5% in July 2008 following an exponential rise in the transport sub-index by 22.7% during the same month after remaining below 1% in the early part of 2008. As a result, the average CPI climbed by 5.4% in 2008, the highest since the Asian Financial Crisis in 1998.

Chart 1: RON97 vs. CPI y-o-y%



Source: CEIC

Chart 2: RON97 vs. GDP deflator y-o-y%



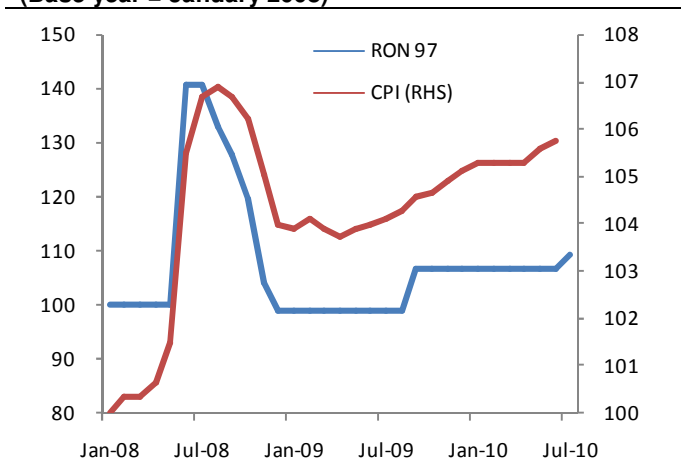
Source: CEIC

What about food prices?

The impact of fuel hikes on food prices cannot be underestimated. In 2008, apart from fuel hikes, a tight supply was another critical reason for the escalating food inflation. During that year, the food and beverage sub-index, which constituted 31.4% of total CPI, surged 11.5% at the end of the year from a mere 6.2% in 1H2008. The tight supply also led to rapid increases in prices of corn, soybean, dairy products, rice, and wheat. Consequently, food companies had no choice but to pass on the cost to consumers in light of the high prices of raw materials.

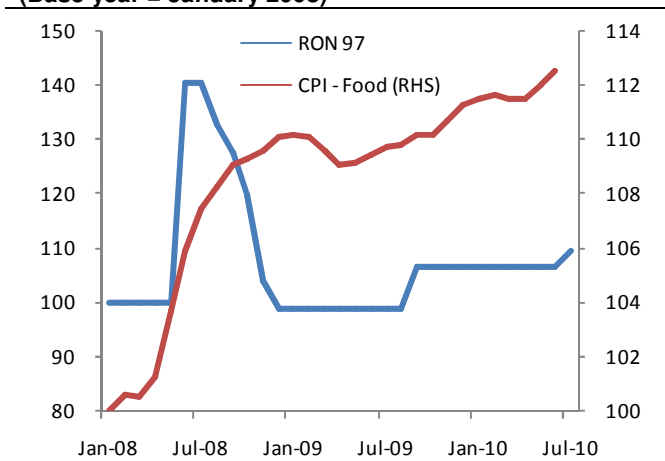
One important fact that cannot be ignored is that, based on past experience, food prices tend to remain high even after fuel prices decline. In 2008, when prices of fuel were reduced following a sharp decline in crude oil prices as a result of the global financial crisis, the CPI and food prices did not drop by the same amount. In fact, when fuel prices fell lower than their levels in July 2008, dropping by 73.1%, the CPI was still 7.2% higher than in the corresponding period. Similarly, food prices were 11.7% higher compared to their levels in July 2008. Even eyeballing Charts 3 and 4, one can see the general uptrend in the CPI and the food index during that period.

Chart 3: RON 97 & CPI rebased at 100 (Base year = January 2008)



Source: CEIC

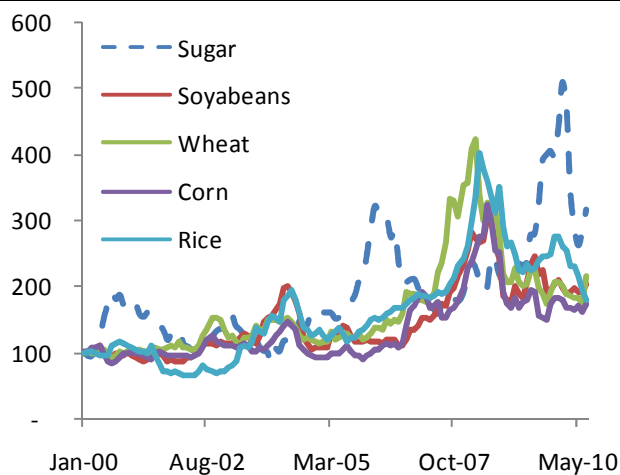
Chart 4: RON 97 & CPI – Food rebased at 100 (Base year = January 2008)



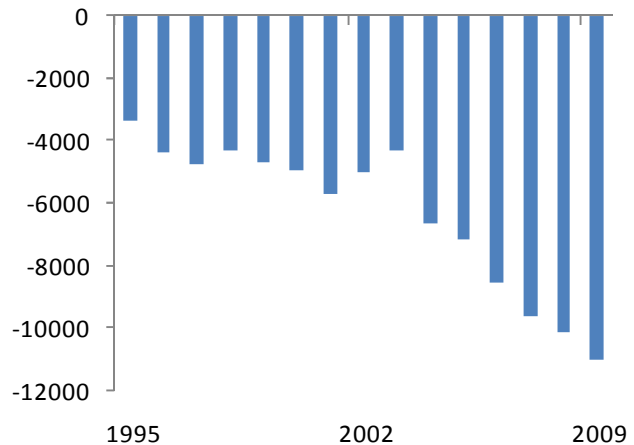
Source: CEIC

The situation was compounded by the fact that Malaysia is a net importer of food, leaving the country susceptible to international price gyrations. In 2009, Malaysia’s trade deficit in foodstuff ballooned to RM11.0 billion from RM4.9 billion in 2000. Items like cereals, vegetables and sugar were the key products that experienced large trade deficits in the past several years. This suggests the need for higher self-sufficiency levels for these products as they form important dietary components among Malaysians.

Being necessities, the demand for these goods is practically inelastic. The high marginal propensity to consume (MPC) among Malaysian consumers also means that the amount of purchases is not likely to be reduced even if prices continue to climb. As disposable incomes remain more or less unchanged, one can expect that consumers will forego other discretionary spending such as on durable goods and tourism. This raises an important question on whether Malaysia should be more aggressive in its efforts to become self-sufficient in certain food products by implementing various measures that have been undertaken in other Asian countries.

Chart 5: Prices of grains (2000 = 100) in Chicago Board of Trades (CBOT)

Source: CEIC

Chart 6: Malaysia's foodstuff trade balance (RM Million)

Source: CEIC

Table 1: Trade balance in foodstuff

MYR mn	1995	2000	2005	2006	2007	2008	2009
Trade balance	(3,369)	(4,919)	(7,115)	(8,517)	(9,583)	(10,098)	(10,969)
Live Animals	412	195	243	185	283	349	294
Meat and Meat Preparations	(310)	(707)	(962)	(894)	(1,083)	(1,159)	(1,275)
Daily Products & Birds' Eggs	(706)	(766)	(1,107)	(1,019)	(1,420)	(1,187)	(663)
Fish, Crustaceans & Molluscs & Preparations Thereof	52	196	394	253	388	679	(40)
Cereals and Cereal Preparations	(1,685)	(2,153)	(2,719)	(2,976)	(3,942)	(5,961)	(4,584)
Vegetables and Fruits	(632)	(796)	(1,392)	(1,577)	(1,751)	(1,688)	(2,290)
Sugars, Sugar Preparations and Honey	(653)	(731)	(870)	(1,186)	(1,180)	(1,250)	(1,921)
Coffee, Tea, Cocoa, Spices & Manufactures thereof	373	341	142	(946)	(838)	(1,203)	(100)
Feeding Stuffs for Animals excludes Unmilled Cereals	(257)	(574)	(965)	(822)	(712)	(1,157)	(1,886)
Miscellaneous Edible Products & Preparations	39	76	121	466	672	2,478	1,496

Source: CEIC

Something amiss

The agricultural sector's share of GDP has been on a declining trend following Malaysia's development process since the late 1980s. The sector's share of GDP fell from more than 20% in the 1970s to 7.7% in 2009 as the country focused on the development of the manufacturing and services sectors. With the continuing focus on expanding the services sector to become a major driver of the economy, the share of the agriculture sector is anticipated to decline further, raising concerns on Malaysia's sufficiency levels of foodstuff at a time of rapidly rising global commodity prices. Malaysia's agricultural sector is dominated by oil palm, accounting for 43% of total agricultural output in 2009, followed by forestry (14%), food crop (11%) and paddy (2%).

Rising commodity prices and tight supplies in the domestic market have raised concerns among policymakers who in the past few years have mooted the idea of stockpiling essential goods to ensure that prices will not rise excessively. According to the news flow, the stockpile of essential goods such as rice and cooking oil is meant to prevent irregularities like hoarding and panic-buying, which will in turn minimize the impact of rising prices on the cost of living and the decline in purchasing power. Other measures that have been implemented by the government to control prices of food include price controls and subsidies (refer to Table 2).

Table 2: Policy responses on food security in developing member countries

REGION / DMC	REDUCE IMPORT DUTIES	INCREASE SUPPLY USING RESERVES	BUILD RESERVES/ STOCKPILES	INCREASE IMPORTS/ RELAX RESTRICTIONS	RAISE EXPORT DUTIES	EXPORT RESTRICTIONS	PRICE CONTROLS/ CONSUMER SUBSIDIES	MINIMUM SUPPORT PRICES	MINIMUM EXPORT PRICES	ASSISTANCE/ SUBSIDY TO FARMERS	PROMOTE SELF-SUFFICIENCY	ACTIONS AGAINST/ APPEALS TO PROFITEERS	CASH TRANSFER	FOOD RATION/ STAMP
EAST ASIA														
Cambodia		✓	✓			✓	✓					✓		
PRC	✓	✓			✓	✓	✓	✓		✓	✓	✓		
Indonesia	✓	✓		✓		✓	✓							✓
Korea	✓	✓					✓				✓			
Malaysia			✓				✓				✓			
Mongolia	✓			✓										
Myanmar											✓			
Philippines			✓	✓			✓	✓		✓	✓	✓		✓
Singapore			✓										✓	
Taipei, China	✓													
Thailand		✓	✓	✓			✓					✓		
Viet Nam			✓	✓		✓			✓					
CENTRAL ASIA														
Kazakhstan						✓	✓							
Kyrgyz Rep							✓							
Tajikistan	✓													
SOUTH ASIA														
Afghanistan	✓						✓	✓						
Bangladesh		✓	✓	✓			✓	✓		✓	✓			✓
India	✓		✓	✓	✓	✓	✓		✓			✓		✓
Nepal				✓										
Pakistan			✓		✓	✓		✓						
Sri Lanka	✓		✓	✓								✓		
PACIFIC														
Fiji											✓			✓
FSM											✓			
PNG											✓			
Samoa							✓							
Solomon Islands	✓													
Tonga							✓							

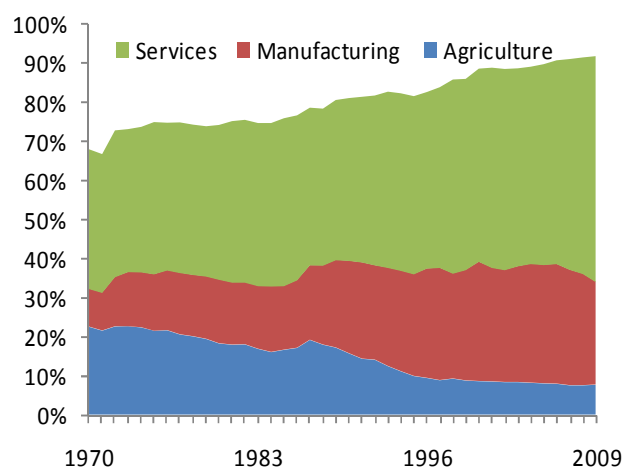
Source: ADB

The upward pressure on food prices has also been magnified by the declining trend in the level of self-sufficiency of food products (refer to Table 3). For instance, the self-sufficiency level of the staple food for the majority of Malaysians – rice – has declined to 68.7% in 2009 from 74.4% in 2004. Similarly, the self-sufficiency level for vegetables has been almost unchanged while the sufficiency level for milk has remained very low in the past five years.

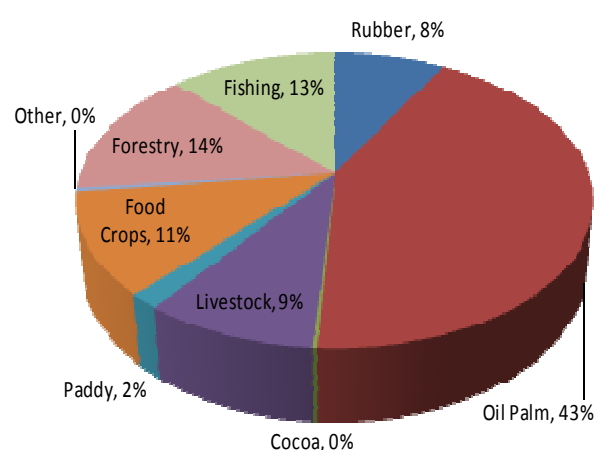
Table 3: Food self-sufficiency level (%)

	2004	2005	2006	2007	2008	2009
Rice	74.4	72.0	62.5	74.5	69.1	68.7
Vegetables	47.4	46.4	43.1	45.3	50.1	47.5
Meat	17.9	21.1	21.8	23.5	25.4	27.0
Milk	3.0	4.6	4.7	4.7	4.8	4.8

Source: Ministry of Agriculture & Agro-Based Industry

Chart 7: Services, manufacturing & agriculture % of GDP

Source: CEIC

Chart 8: Agricultural output (% of total)

Source: CEIC

A peculiar trend was also seen in public sector spending where expenditure on the agriculture sector continued to decline to 1.6% of total public spending between 2000 and 2004 from 7.2% in 1975. On a relative basis, Malaysia's ratio of public spending on the agriculture sector is the lowest among the People's Republic of China (PRC), Indonesia, Philippines and Thailand, suggesting that the sector has taken a backseat when it comes to the government's allocation of resources in recent years.

Table 4: Public sector spending on agriculture (% of total public spending)

	1975	1980	1985	1990	1993	1998	2000-04
PRC	12.1	12.2	7.7	10.0	9.5	10.7	6.5
Indonesia	9.8	9.6	6.8	7.6	6.6	7.2	5.9
Philippines	9.0	5.3	5.7	6.0	7.3	6.0	3.7
Thailand	5.9	8.1	11.7	10.4	10.4	7.5	7.3
Malaysia	7.2	6.5	4.6	3.6	3.0	1.5	1.6

Sources: ADB & CEIC

Judging from past experience, we believe that the issue of food inflation should be continuously addressed in order to ensure that the disposable incomes of Malaysians will not be adversely affected if prices were to go up in the future. Re-energising the agricultural sector through higher public expenditure will help raise self-sufficiency levels of essential food products while stockpiling will help ease the burden for the low- and middle-income groups. Measures to address the problem of supply bottlenecks (through lower import duties, prevention of smuggling) will also help alleviate the upward pressure on food and general prices in the economy. By doing this, policymakers will not have to resort to monetary policy responses (i.e. raising interest rates) that are used by other countries to help tame inflationary pressure in the economy.

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