

CITIES, PEOPLE & THE ECONOMY A STUDY ON POSITIONING PENANG

Homi Kharas, Albert Zeufack & Hamdan Majeed



A collaborative research between

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Foreword

This book is an output of the “Positioning Penang” study, a collaborative research project between Khazanah Nasional Berhad and The World Bank, identified by the Economic Planning Unit (EPU) as one of the inputs to the 10th Malaysia Plan. This book, which primarily targets policy makers, draws on a strong body of empirical work conducted in a dozen technical background papers contributed by a team of internationally-renowned researchers and field practitioners of the Malaysian economy. These background papers will be published in a separate volume.

The premise of this book is that a regional strategy to develop the “Northern Corridor” of Malaysia is critical in encouraging the emergence of globally-competitive clusters. For the Northern Corridor to succeed, Penang, its largest conurbation, must succeed and vice versa. However, it seems to be caught in the “middle-income trap” and needs to reinvent itself. Penang cannot rely for much longer on cheap labour, subsidised infrastructure and its ability to provide suitable land for low-tech manufacturing. It must focus on developing industries which provide economies of scale, where on-the-job learning provides the base for continuous improvement in productivity. This requires a new growth strategy that positions Penang to take advantage of the new global trends. If the Northern Corridor can escape the middle-income country (MIC) trap, then, so can Malaysia.

The book proposes a multidimensional growth strategy which embraces three elements: cities, people and the economy. At present, these elements are out of phase with

each other in Penang. The urban cycle is just starting to enter a recovery phase, following the World Heritage designation of George Town. The people cycle is still in a recession, with new graduates choosing to leave the area. The economy is caught in a slump, with the boom years a thing of the past. Implementing a coherent strategy across these areas — cities, people and the economy — could lead to a sustainable, inclusive and rapid development that benefits not just Penang and its environs in the Northern Corridor, but the nation as a whole. The book suggests some levers of change and contributes inputs to the preparation of the 10th Malaysia five-year plan.

This book was prepared by Dr Homi Kharas (Brookings Institution, The World Bank Consultant), Dr Albert Zeufack (Director of Research and Investment Strategy, Khazanah Nasional) and Mr Hamdan Abdul Majeed (Senior Vice President and Head of the Khazanah Koridor Utara Office), under the overall guidance of Dr Nungsari Ahmad Radhi, Executive Director, Khazanah Research and Investment Strategy. Background reports were authored by Tan Sri Andrew Sheng, Dato’ Dr Kim Tan, Dato’ Dr Leong Yueh Kwong, Dr Rajah Rasiah, Dr Shahid Yusuf, Dr Kaoru Nabeshima, Dr Julian Velez, Dr Shahridan Faiez, Dr Hiau Kee, Mr K Gopalan, Mr Charles Landry, Mr Laurence Loh, Mr John Lamb, Mr Yoon Chon Leong and Dr Ooi Giok Ling (in memoriam). Additional input and support were received from Azlina Jaffar, Intan Nadia Jalil, Devendran Nadaraja, Yusminov Ahmad, Aziz Kevin Lee, Lim Su San, Dr Neil Khor, Christopher Choong and Nur Amalina. >>>



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Views expressed in this book do not necessarily represent The World Bank's or Khazanah's and should solely be attributed to the authors.

**Homi Kharas, Albert Zeufack
and Hamdan Majeed**



RISING IN RHYTHM: PENANG'S CITIES, PEOPLE & ECONOMY

- CYCLES OF DEVELOPMENT
- RESTORING LUSTRE TO THE "PEARL OF THE ORIENT"
- RETAINING AND ATTRACTING TALENT
- REINVENTING ECONOMIC OPPORTUNITY
- LOOKING FORWARD

The three key foundations of growth in Penang — its cities, people and economy — are not developing in tandem. Their cycles of development must be synchronised to turn Penang into a globally-networked economy and a secondary city leveraging on its unique endowments and niche capabilities. As a middle-income region with a strong track record of economic success, Penang must now set a new multidimensional agenda to be the most vibrant economic hub for the Northern Corridor of Peninsular Malaysia. It must accentuate the links, within and without, and coordinate the development of its cities, people and economy, so as to develop abreast of an Asia that is expected to drive global economic growth in the 21st century.

Cycles of development

Shih Chung Branch School, along Northam Road (Jalan Sultan Ahmad Shah) in George Town, Penang, was a magnificent colonial-era building in the heart of town. It is now abandoned. Its roof and some internal walls have collapsed. Vegetation is growing wildly among the ruins. Shih Chung is a grim reminder of the state's changing fortunes.

Once the "Pearl of the Orient", present-day Penang is home to many dilapidated buildings. But efforts are under way to reverse this cycle. In July 2008, the historic port cities in the Straits of Malacca — George Town and Melaka — were listed by the United Nations Educational, Scientific and Cultural Organisation (UNESCO) as World Heritage Sites for their living culture, history, architecture and multiculturalism. With this, projects to restore the cities are being actively developed.

The Penang Free School, founded in 1816, was the first English school in Southeast Asia. Convent Light Street (founded 1852), the oldest girls' school in Malaysia, and Chung Ling High School (1917), one of the first formal Chinese schools in the region, were also founded in Penang. The state's long history of formal learning has continued to this day. It is now home

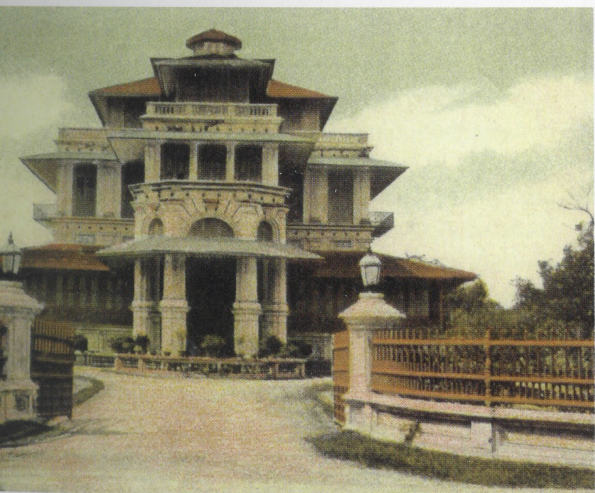
to Universiti Sains Malaysia (USM), one of the largest universities in Malaysia and a multitude of research institutes.

Ironically, it has also experienced marked shortages of skilled labour. Brain drain remains a significant problem for local business. There are limited opportunities for graduates to work with cutting-edge technologies in many areas of industry, including the hard sciences (for example, with nanotechnology and grid computing), services and management. Often, multinational corporations (MNCs) rotate staff to other countries as part of their global talent-management programmes, further encouraging the drain of skilled human resources.

The Bayan Lepas industrial park, the first free trade zone (FTZ) in Malaysia, became a significant pillar of Penang's economy after the island lost its "free port" status in 1969. It also became a model for the rest of the country. Manufacturing assembly work for MNCs, especially in the electrical and electronics industries, along with tourism, provided a dynamism that allowed Penang to grow at rates exceeding the national average, and upwards of 7 per cent for the period 1970-2005.

Manufacturing's share of state gross domestic product (GDP), grew from 13 per cent in 1970 to 54 per cent by 2008. But both tra-

The grand building that later housed the Shih Chung Branch School (left) and the state it is in today (below)



Courtesy of Malcolm Wade



The cycles of development in Penang's physical infrastructure, its human resource base and its economy are not in tandem with each other today. Despite some impressive advances, Penang's economy is falling behind some of its rapidly-growing neighbours and even other regions within Malaysia.

ditional manufacturing and tourism are facing competitive threats. Lower wages and the lower cost of doing business in neighbouring countries are eroding Penang's advantages in manufacturing assembly, while tourism arrivals have fallen as alternative destinations gain popularity. Foreign tourist arrivals have declined from a peak of 2.3 million visitors in 2000 to perhaps 1.8 million in 2008. From 2001 to 2005, Penang's GDP growth averaged just 5.9 per cent, much less than its historical average. It needs to develop new sources of comparative advantage if it is to grow rapidly again.

Penang's fortunes are intimately linked to developments in these three areas: its cities, its people, and its economy. The three can complement each other.

Vibrant cities can lower the transaction costs for the flow of goods and transfer of ideas, producing what economists call "agglomeration economies" — higher productivity based on bringing people and firms closer together in dense environments. They also serve as a magnet for talented people.

People, in turn, provide the life and soul of cities. The wide presence of skilled professionals can elevate a production assembly economy to a higher value-added plain. A talented resident population is a critical requirement for a successful knowledge economy — knowledge flows best through face-to-face contact and interaction, even in an electronically-linked world.

A vibrant economy serves as a magnet for talent and provides the rhythm of city life. Economic opportunity is the means by which wages and living standards rise.

Penang can regain its dynamism only if it restores and maintains an upswing in the cycle of development in all the three areas: its cities (especially the George Town Conurbation, see

Box 1), its people and its economy. But recent history shows that they can move with their separate rhythms unless they are coordinated. In reality, the cycles of development in Penang's physical infrastructure, its human capital and its economy are not in tandem with each other today. The old city centre has become run-down. Many of the best graduates are leaving the area. That is why, despite some impressive advances, Penang's economy is falling behind some of its rapidly-growing neighbours and even other regions within Malaysia.

The prospects for Penang depend importantly on policies undertaken at the national level, and on decisions taken by the federal government in terms of projects to be undertaken in the state. The responsibility for Penang's future also rests with the state government. It is the state government that implements many federal programmes and it has the closest links with local businesses and the people. The state government, and Penang-based federal government agencies, can provide crucial inputs into articulating a vision for Penang's development. But, as former Chief Minister Tun Lim Chong Eu has said, "It is indeed the people of Penang who have made us what we are today",¹ and it will be the people of Penang who will determine the prospects for their state.

Today, in 2010, the world is still recovering from a major recession. Penang's principal economic model of export-led manufacturing based on cheap labour is under threat from lower-wage competitors in China and Vietnam. Some MNCs are relocating their production base elsewhere in the region, unemployment is on the rise, and the state government is in opposition to the federal government, making coordinated policies harder to achieve.

But this does not mean that prospects are dim. At another time, in 1969, Penang also faced a global recession, the loss of its free port status on which much of its economy depended, the exit of a major multinational (the Royal Australian Air Force from its airbase in Butterworth), rising unemployment and a state

1 SERI Penang Lecture 2005, "Building on Penang's strengths: Going forward".

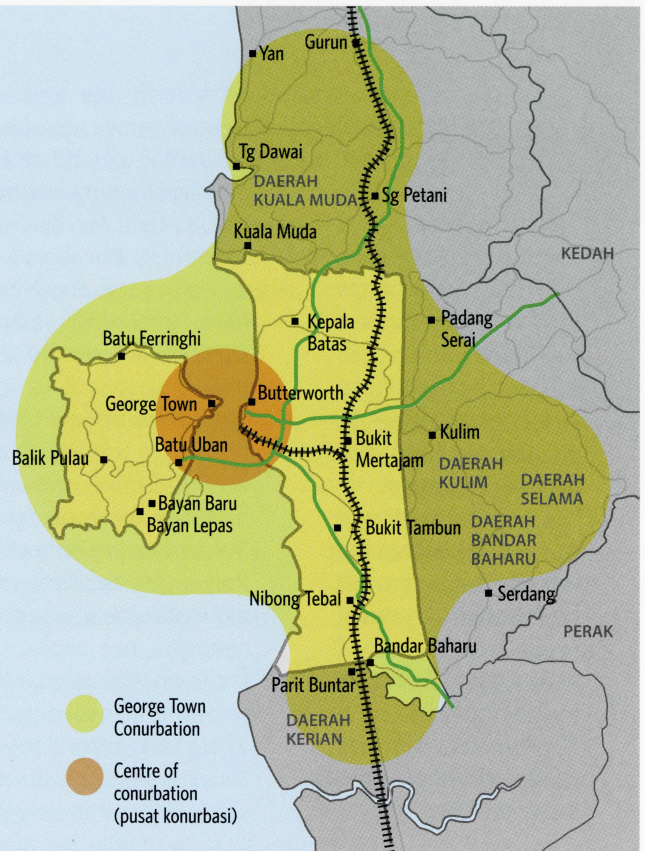
BOX 1: George Town Conurbation

Envisaged in the National Physical Plan (NPP) of Malaysia, the George Town Conurbation (GTC) consists of the highly-urbanised Penang Island, Seberang Prai, Sungai Petani, Kulim and the surrounding areas (see map). With a population of 1.6 million according to the National Census in 2000, it was the second-largest metropolitan area in Malaysia after the Kuala Lumpur conurbation (Klang Valley), which had a population of 4.9 million. Johor Bahru had 1.5 million. The population of the GTC is now estimated at 2 million.

Like Johor Bahru and its surrounds, the GTC has been designated a regional growth conurbation while the areas linked to Kuala Lumpur is the national growth conurbation.

A conurbation is defined as “an urban area that encompasses several cities or towns physically agglomerated and forming a built-up area through population growth”. Under the NPP, for consistency, a conurbation is named after the most prominent town within it — and not because it is the state capital or the state in which it is situated. Its name is also not based on locality such as “northern” or “eastern”. That township will be the reference centre within its conurbation. In this case, George Town represents the most-developed area and main growth centre in the GTC.

The federal government is currently upgrading the infrastructure in the GTC. However, these developments lack a central strategy and if there is one, it is poorly articulated. Furthermore, there are risks that, due to lack of coordination, the infrastructure developed would not synergise to enable seamlessness of operations.



government in the Opposition vis-à-vis the national government. From that forbidding starting point, it enjoyed a period of prosperity and growth for over 30 years based on a strategy of export-led, labour-intensive manufacturing.

Once more, it is time to articulate a new development strategy that can guide Penang to provide better wages, jobs and prospects for the next generation. This strategy is to turn Penang into a globally-networked economy.

Restoring lustre to the “Pearl of the Orient”

Penang has been called the “Pearl of the Orient”. The image of idyllic beaches, temples and mosques, coupled with world-class schools and infrastructure, made the island an attractive destination for major MNCs from the 1970s. In those days, many skilled people lived in or around George Town, but the city today is no longer a magnet for the highly-skilled and creative. Many of its buildings are empty, with their owners awaiting redevelopment oppor-

tunities. Despite the hollowing out, traffic congestion is greater than one would expect from a city of its size. Penang has the highest per-capita car ownership in Malaysia.

The World Heritage designation for George Town provides an opportunity for a fundamental renewal. The issues, however, do not have a simple “engineering” fix — remove the congestion, improve the environment, and reduce the crime. That approach would focus efforts on the continual search for property development opportunities to optimise the use of space, and to maximise density and short-term profits. The most successful cities in the world do more than this. They develop as liveable, multicultural and sustainable environments, where quality of life, beauty and aesthetics spur innovation and creativity. In short, cities which possess the right physical, cultural, economic and social conditions would become a magnet for talent, a “sticky place” for skills.

It is time to articulate a new development strategy that can guide Penang to provide better wages, jobs and prospects for the next generation. This strategy is to turn Penang into a globally-networked economy, but it is not a simple “engineering” fix.

Penang is small and lacks the dominant position but the global experience is that “pocket-sized” places can develop niches that permit them to grow rapidly. But they must avoid the path that makes them oversized and suffer the diseconomies of poor living conditions in many major metropolises.

Successfully balancing the ambition to become a global leader, move up the value chain and be a destination of choice for the young would not be easy. Penang is small and lacks the dominant position, for example, of Kuala Lumpur. But across the world, while major global cities like London and New York

have thrived by becoming centres of creativity, there have also been highly successful secondary cities.

In Spain, Bilbao, Barcelona, Seville and Valencia have become important hubs. Bologna is the richest city in Italy in per-capita terms, and generates the greatest export revenues per capita, with a focus on education, research and advanced manufacturing. The global experience is that “pocket-sized” places can develop niches that permit them to grow rapidly. But they must avoid the path that makes them oversized and suffer the

diseconomies of poor living conditions in many major metropolises (Landry, 2009).

Successfully capturing the opportunities afforded by place requires Penang to build on its diversity. It is the differences that make a difference. With these in mind, there are four aims for the future:

- Make diversity a strength, with opportunities for people from different income levels and ethnicity;
- Be creative and innovative in ways that benefit the local economy, Malaysia and the world;
- Develop as a transactional hub for products and services — a spatially-connected economy; and
- Encourage ideas, knowledge and creativity — an Internet- and people-connected economy.

Together, these changes will position Penang as a networked economy: globally, regionally and domestically.

Growing, retaining and attracting talent

The pattern of migration in Malaysia over the last two decades has favoured the Klang Valley and the south relative to Penang. For example, between 1991 and now, the population of the town of Klang has almost trebled. It has grown to 2.5 times in Ampang Jaya and more than doubled in Johor Bahru.

In the similar period as above, the population in Penang has only grown by 0.5 times (Intan Nadia, 2009). This is partly reflective of the lack of job opportunities, especially as investment has started to fall relative to other locations, and is partly the result of a perceived decline in the quality of life.

In a globalised world, where people have many options as to where to live and work, the links between quality of life and economic performance of a location have strengthened. Whereas in the past most skilled people chose a company and job, and located to where their work took them, in the modern economy, skilled people choose the place they wish to live and look for jobs there. Even if a locality is efficient and competitive, it may not attract people to live there. As an example, for many years, firms in Penang have complained about a lack of qualified skilled personnel, especially engineers. The jobs are there, but there are few qualified takers.

Instead of productive efficiency, the main source of competitiveness of a region has become the ability to attract people, especially the young. Places that attract talented youths end up being the winners in the national and global battle for development. The cohort of 25- to 35-year-olds has energy and ambition and is flexible and adventurous.

The young people in Penang surveyed for this study say that they seek a culture of openness, good career opportunities and good governance. They may migrate overseas for a time to gain experience, but they will return if family, lifestyle and cultural factors become effective pulls. The current global circulation of young people allows them to build up overseas networks, ideas and linkages. They would

add to the social capital of Penang if they can be attracted back.

It is not only engineers that Penang needs, but a broad group of creative professionals. For a city to function well, it needs a diversity of talent. So far, there has been a tendency to focus on attracting those with specific skills, like engineers or business service professionals. But arts and media practitioners, educationists, entertainers, activists and others give a city the creative edge that supports innovation.

While it is important to attract and retain talent, it is also important to develop it. Penang has a rich array of higher educational institutions, research organisations and think tanks, but these have fallen short of global standards of excellence. Restrictions on the import of skilled talent from abroad are remnants of an outmoded idea that skilled jobs must be subjected to control to provide opportunities for locally-trained professionals to flourish.

These policies have pushed the best local talent abroad to find collaborators at the cutting edge of their fields. Penangites are flourishing in Singapore, Britain and the United States because those are places where they can interact with the best in their chosen fields. Similar opportunities for them to interact with global peers and mentors are needed at home.

Reinventing economic opportunity

Economic growth in Penang has been driven by the dynamism of the manufacturing sector, especially in electronics. Manufacturing jobs account for 37 per cent of all jobs in the area and all groups are well represented in manufacturing. But the financial crisis of 2009 has shown the limits of such a strategy.

While Penang is well-integrated into the global supply chains, domestic value-added is limited and the supply chain does not extend enough to local firms or into the hinterland. Penang has grown as a sweatshop factory for the rest of the world. It must do better and become a smartshop for sustainable products.

Penang cannot rely for much longer on cheap labour, subsidised infrastructure and the ability to provide suitable land for manufacturers. It must focus on developing industries that provide economies of scale, where on-the-job learning provides the base for continuous improvement in productivity. It cannot do all things but must be selective in what it tries to develop.

Penang must position itself to take advantage of:

- The emergence of Asia as the economic driver in the world, and of Asian consumers as a dynamic new force for growth;
- Its strategic location facing the Indian Ocean and the Bay of Bengal;
- The need for new technologies to power a low-carbon global economy; and
- The continued progress of globalisation and outsourcing that is developing new markets, especially in the modern service sectors, and innovations in new products and processes.

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Looking forward

Penang today is a middle-income region. As such, it has various advantages like firms with enhanced capabilities and a well-developed track record of economic success. But it also faces the disadvantages of rising labour costs and greater competition from lower-cost neighbours such as China, Vietnam and Thailand. This study explores strategies suitable for middle-income regions.

Moving to a new growth strategy is not easy. A multidimensional approach is needed, and it must embrace the three elements of developing cities, people and the economy. At present, these elements are out of sync with each other. The urban cycle is just entering a



recovery phase, following the World Heritage designation. The people cycle is still in recession, with new graduates choosing to leave. The economy is caught in a slump, with the boom years a thing of the past. A coherent strategy is needed across these areas.

Moving to a new growth strategy is not easy. A multidimensional approach is needed, and it must embrace the three elements of developing cities, talent and the economy.

For the Northern Corridor to succeed, Penang must succeed and vice versa. If the Northern Corridor can escape from the middle-income trap, then so can Malaysia. Conversely, if the Northern Corridor stagnates, the likelihood of Malaysia escaping the middle-income trap declines considerably.

All over the world, cities are trying to embrace the knowledge economy and become more creative. Such pronouncements are easily made, but much harder to achieve. If a premature move takes place, with everything oriented towards a new knowledge economy, there is a high risk of failure. Along with this, the current core strengths of the economy (basic manufacturing) may be eroded at an accelerated pace — with nothing substantial to replace them. But if no move in this direction is taken, it is inevitable that Penang will decline, at least in relative terms.

Penang has excelled over the past 40 years in orienting itself externally and linking with the global economy. Its exports go to all corners of the world. It has attracted foreign direct investments (FDI) from major MNCs, especially in the electronics sector.

Penang has also started to develop closer links with its neighbours and to integrate within the region. Already, Indonesians are the major-

ity of patients in the medical tourism sector in Penang. India, China, the Middle East and Indonesia are expected to continue to have dynamic economies, and closer integration with them can bring about positive development for all. Upgrading logistics and international agreements with these neighbours can deepen regional integration ties.

Where Penang has fared poorly is in integrating domestically, in connecting the natural resources and human capital of its hinterland with the global economy. This is an area with untapped potential. Investments here can build the critical mass and density needed for the economy to benefit from scale. The premise of this book is that a regional strategy to develop the Northern Corridor of Malaysia is critical in encouraging the emergence of globally-competitive clusters.

For the Northern Corridor to succeed, Penang must succeed and vice versa. Penang is the heart of the Northern Corridor and the Northern Corridor can provide the scale required for Penang to grow. Successful development in this locality can reduce the economic distance of many Malaysian citizens to global markets, and can reduce divisions by offering opportunities for all groups to participate in economic growth.

The way forward can feature sustainable, inclusive and rapid development that benefits not just Penang and its environs in the Northern Corridor of Peninsular Malaysia, but also the nation as a whole. If the Northern Corridor can escape from the middle-income trap, then so can Malaysia. Conversely, if the Northern Corridor stagnates, the likelihood of Malaysia escaping the middle-income trap declines considerably.



NEW OPPORTUNITIES AND PITFALLS IN THE GLOBAL ECONOMY

- GLOBAL RECESSION OF 2009
- EMERGENCE OF EAST ASIA, CHINA AND REGIONAL ECONOMICS
- AVOIDING THE MIDDLE-INCOME TRAP
- DOING DIFFERENT THINGS AND DOING THINGS DIFFERENTLY:
STRATEGIC PLANNING IN PENANG
- THE NORTHERN CORRIDOR ECONOMIC REGION

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