MALAYSIA ECONOMIC MONITOR

DECEMBER 2018

Realizing Human Potential

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Photography: Samuel Goh

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Abbreviations

1MDB	1 Malaysia Development Berhad
11MP	11th Malaysia Plan
AERA	American Educational Research Association
ALMP	Active Labor Market Programs
APA	American Psychological Association
ASEAN	Association of Southeast Asian Nations
ASR	Adult Survival Rate
B40	Bottom 40 percent (of the population)
BNM	Bank Negara Malaysia
BR1M	1 Malaysia Peoples Aid (*Bantuan Rakyat 1Malaysia*)
BSH	Cost of Living Aid (*Bantuan Sara Hidup Rakyat*)
CPI	Consumer Price Index
CP-TPP	Comprehensive and Progressive Agreement for Trans-Pacific Partnership
DFI	Development Financial Institution
DOSM	Department of Statistics Malaysia
E&E	Electrical and Electronics
EAP	East Asia and Pacific
EBA	External Balance Assessment
ECCE	Early Childhood Care and Education
EIS	Employment Insurance System
EMDE	Emerging Market and Developing Economies
EPF	Employees Provident Fund
FDI	Foreign Direct Investment
FBM KLCI	FTSE Bursa Malaysia Index
GDP	Gross Domestic Product
GFCF	Gross Fixed Capital Formation
GLC	Government-linked Company
GLIC	Government-linked Investment Company
GNI	Gross National Income
GST	Goods and Services Tax
HCI	Human Capital Index
HCP	Human Capital Project
HOTS	Higher Order Thinking Skills
IHSR	Institute of Health Systems Research Malaysia
IPH	Institute of Public Health Malaysia
IHME	Institute of Health Metrics and Evaluation
KWAP	Retirement Fund Incorporated (*Kumpulan Wang Persaraan*)
LCR	Liquidity Coverage Ratio
M40	Middle 40 percent (of the population)
M&E	Machinery and Equipment
MACC	Malaysian Anti-Corruption Commission
MCH	Maternal and Child Health
MDG	Millennium Development Goal
MEM	Malaysia Economic Monitor
MENAP	Middle East, North Africa and Pakistan
MMR	Maternal Mortality Ratio
MOF	Ministry of Finance
MOH	Ministry of Health
NCD	Noncommunicable Disease
NCME	National Council on Measurement in Education
NPCS	National Preschool Curriculum Standards
NFA	Net Foreign Assets
NFPC	Non-Financial Public Corporation
NGO	Non-governmental Organization
NHMS	National Health and Morbidity Survey
NIIP	Net International Investment Position
NPLs	Non-Performing Loans
OECD	Organization for Economic Cooperation and Development
OPR	Overnight Policy Rate
PISA	Programme for International Student Assessment
PITA	Petroleum Income Tax
PPP	Public Private Partnership
Q/Q	Quarter-on-Quarter
RCEP	Regional Comprehensive Economic Partnership
SAAR	Seasonally Adjusted Annual Rate
SABER	Systems Approach for Better Education Results
SME	Small and Medium-sized Enterprise
SST	Sales and Services Tax
STEM	Science, Technology, Engineering and Mathematics
T20	Top 20 percent (of the population)
TIMSS	Trends in International Mathematics and Science Study
TPP	Trans-Pacific Partnership
UHC	Universal Health Coverage
UNICEF	United Nations International Children's Emergency Fund
WHO	World Health Organization
Y/Y	Year-on-Year

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Summary

While Malaysia's economic growth remains resilient, it began to moderate during the course of 2018

Growing risks weigh on the economic outlook. On the external front, a slowing global economy, rising concerns regarding the impact of US-China trade tensions and increased volatility in financial and commodity markets all weigh on the prospects for Malaysia's economy. On the domestic side, increased reliance on oil-related revenue amid heightened uncertainty around the commodity price forecasts and relatively high levels of private and public debt pose risks to growth.

Efforts to sustain growth in the near term have to be carefully balanced with the need to restore fiscal buffers. In the short term, fiscal consolidation efforts are expected to be driven primarily by measures to reduce expenditure. However, efforts to broaden the tax base, to diversify revenues away from unstable oil and gas revenues, and to introduce greater progressivity, will require a multi-year reform agenda. Restoring fiscal buffers will be necessary to ensure that Malaysia is better prepared to respond to future macroeconomic shocks.

The Mid-term Review of the 11th Malaysia Plan and the 2019 budget outline the *Pakatan Harapan* government's new priorities, with an emphasis on strengthening governance and improving accountability. The government has also expressed a commitment to reform the role of the state in business to level the playing field and to unlock future productivity growth. Reforms to increase the effectiveness of pro-inclusion expenditure programs have the potential to achieve greater impact with lesser public resources.

The Malaysia Economic Monitor consists of two parts. Part 1 presents a review of recent economic developments and a macroeconomic outlook. Part 2 focuses on a selected special topic that is key to Malaysia's medium-term development prospects. In this edition, the focus of the special topic is on realizing human potential.

Accelerating human capital development will be critical for enabling Malaysia's successful transition to a high-income and developed nation. With the advent of digital and other disruptive technologies, there has been a significant change in the nature of jobs, with an increasing premium on higher-order cognitive skills, such as complex problem-solving, socio-behavioral skills, reasoning and self-efficacy. Building these skills requires a transformation in the way that Malaysia nurtures, invests and protects its human capital.

According to the World Bank's new Human Capital Index, Malaysia ranks 55th out of 157 countries. While Malaysia performs well in some components of the index, it does less well in others. To fully realize its human potential, Malaysia will need to make further advances in education, health and nutrition, and social protection outcomes. Key priority areas include enhancing the quality of schooling to improve learning outcomes, rethinking nutritional interventions to reduce childhood stunting, and providing adequate social welfare systems to enable households to invest in human capital formation.

Recent economic developments

Malaysia's rate of economic growth has begun to slow somewhat, with a more moderate expansion at a rate of 4.4 percent in Q3 2018. Strong domestic demand has continued to provide support to the economy, but growth has been weighed down by a weaker export performance and continued inventory drawdowns.

Throughout the year, private consumption continued to be the main driver of economic growth, with the growth rate increasing to 9.0 percent in Q3 2018. Most of the increased spending during the quarter was recorded in July and August 2018, following the zeroization of the Goods and Services Tax (GST). There was a significant increase in the purchase of durable items, as well as food and beverages, with households taking advantage of the zero-rated GST period. In addition, stable labor market conditions and steady income growth continued to support private consumption.

Growth in private investment edged up to 6.9 percent in Q3 2018 on account of increased capital spending in the manufacturing and services sectors. Capital expenditure growth in these sectors was mainly driven by increased spending in machinery and equipment, which grew at 5.9 percent in Q3 2018. Higher private investment also contributed to a higher gross fixed capital formation growth, standing at 3.2 percent in Q3 2018.

Following a contraction in the previous quarter, public sector expenditure growth rebounded to 1.1 percent in Q3 2018, driven mainly by public consumption. Higher spending on supplies and services contributed to an increase in public consumption, which grew at 5.2 percent. Meanwhile, public investment continued to contract in Q3 2018, albeit at a lower rate of -5.5 percent, due to decreased capital outlays following the near completion of several large infrastructure projects and the deferment and cancellation of several major public infrastructure projects.

On the supply side, growth continued to be affected by shocks in the commodity-related sectors. In the mining sector, growth continued to contract in Q3 2018, at the rate of -4.6 percent, with the production of natural gas continuing to be affected by unplanned supply outages and pipeline repairs. Similarly, agriculture output declined by 1.4 percent during the quarter, due to interruptions to the production of crude palm oil caused by adverse weather and production constraints. The impact of the contraction on these two sectors was offset by the expansion in the services sector, in line with the increased consumer spending during the zero-rated GST period.

Export growth eased to 5.1 percent in Q3 2018 due to slower manufactured export growth and sustained declines in agricultural exports. Much of the growth momentum in Q3 2018 was driven by the relatively sustained growth of semiconductor exports, amid signs in Q3 2018 that Malaysia has gained market share in the US following the latter's imposition of tariffs on China. The current account surplus has narrowed appreciably since Q1 2018 due to a lower goods surplus and a larger deficit on primary income.

A slower growth rate was recorded for gross imports, at 6.3 percent in Q3 2018. This partly reflected a significant deceleration in capital import growth from the previous quarter, with the rate sinking to 1.1 percent in the quarter. Imports of intermediate goods, which accounted for 53 percent of total imports, continued to contract amid easing foreign demand for manufactured exports, with the rate standing at -1.6 percent.

In recent months, domestic inflationary pressures have continued to ease. The headline inflation rate continued to decline in Q3 2018, standing at an average of 0.5 percent. This low average rate mainly reflected the impact of changes in the consumption tax policy and lower growth in transport prices.

Labor markets have remained stable, with modest improvements to labor force participation seen throughout 2018. In Q3 2018, the labor force participation rate increased to 68.5 percent, up by 0.1 percentage points compared to Q2 2018 and by 0.6 percentage points compared to September 2017. However, there is a persistent disparity between wage growth in the manufacturing and services sectors.

Over the year, conditions in the financial system have remained broadly stable. Monetary policy has remained unchanged since January 2018, with the overnight policy rate held at 3.25 percent. Financial soundness indicators continue to show that the banking system remains resilient. In Q3 2018, net financing increased, largely driven by increased growth in the outstanding loans of the banking system and development financial institutions, with the growth rate increasing to 5.1 percent.

Domestic financial markets continue to be affected by heightened risk aversion arising from global developments. In November, the decline in the net non-resident portfolio flows amounted to RM5.9 billion. Against the US dollar, the ringgit has tended to depreciate over the year, reflecting the outflows in the bond and equity markets.

The government announced its budget on November 2, 2018, setting out several new fiscal policy measures. Through the budget, the government revised several key projections to better reflect the current economic environment and its fiscal plans for the future. The fiscal deficit target was raised to 3.7 percent of GDP in 2018 amid several fiscal policy changes, before narrowing to 3.4 percent in 2019 and 3.0 percent in 2020.

In proportion to GDP, Federal Government revenue is expected to increase marginally to 16.5 percent in 2018. Following the replacement of the GST with the Sales and Services Tax (SST) and the implementation of the 3-month consumption tax holiday from June to August, the collection of consumption-based tax is projected to contract by half, to 1.6 percent of GDP. The revenue shortfall will be partially offset by an increase in petroleum-related proceeds, to 3.6 percent of GDP, amid higher prevailing global oil prices in 2018.

The government's operating expenditure is also projected to trend slightly higher to 16.4 percent of GDP in 2018. The increase is primarily due to larger subsidy outlays expected over the year to facilitate the stabilization of diesel and RON95 petrol prices. Expenditure on debt service charges is also projected to increase, in line with a higher fiscal deficit.

In 2018, the government's development expenditure is estimated to increase to reach 3.8 percent of GDP, reflecting the inclusion of several outlays previously classified as operating expenditure. Over the year, social expenditure, which accounts for about a quarter of the total value of development spending, is projected to increase slightly to 1 percent of GDP, with marginal growth expected across the education, health and housing sectors.

As part of its efforts to increase transparency, the government has adopted a new approach to the disclosure of its overall liabilities and commitments. With this new approach, liabilities reporting takes into account Federal Government debt, committed government guarantees, and other obligations, including from PPPs. As of Q2 2018, the level of Federal Government debt in proportion to GDP remained unchanged at 50.7 percent, with risks appearing manageable. However, as of end-June 2018, debt guaranteed by the Federal Government had increased to 18.1 percent of GDP. Almost half of these outstanding loan guarantees were extended to facilitate the implementation of infrastructure investments by non-financial public corporations. By contrast, the value of the Federal Government's outstanding PPP commitments was revised down to 12.9 percent in Q2 2018 as a result of the cancellation and postponement of several large-scale transportation projects during the period.

Near-term fiscal consolidation efforts will be achieved primarily through measures to rationalize expenditure, with the adjusted government expenditure[1] set to decline markedly to 18.1 percent of GDP in 2019. Downward expenditure adjustments are expected to be broad-based across most major components of operating and economic development outlays.

[1] Excludes the one-off payment of outstanding income tax and GST refunds in 2019.

Economic outlook

Malaysia's economy is expected to grow at a moderate pace in the near term, expanding by 4.7 percent in 2019. Private sector consumption will continue to be the main driver of economic growth, although growth is projected to moderate to 6.4 percent in 2019. The deceleration will be due to consumers having frontloaded their spending for durable items during the zero-rated GST period and factoring in the effect of the SST in their spending. Nevertheless, household spending will be supported by stable labor market conditions; the implementation of the *Bantuan Sara Hidup Rakyat* (BSH) cash transfer program; and the one-time repayment of tax refunds.

The external sector faces risks associated with heightened global uncertainty and the possible escalation of trade tensions between the US and China. In addition, export growth is likely to be affected by a weaker global demand and deceleration in the global electrical and electronics (E&E) cycle. This is expected to be partially offset by a recovery in commodities production and sustained demand from regional trading partners.

The headline inflation rate is expected to increase in 2019, driven by higher domestic fuel prices following the implementation of the float pricing mechanism for fuel beginning in Q2 2019. In addition, the reintroduction of the SST will also result in higher headline inflation, although its effect is expected to taper towards the end of the year.

With Malaysia's economy tightly integrated with the global economy through financial and trade linkages, increased uncertainty in the external environment poses downside risks in the near-term future. A key source of risk relates to escalating protectionist tendencies and increasing trade tensions between the US and China. While there may be short-term opportunities for Malaysia to gain US market share as a result of trade and investment diversion away from China, escalating tensions may result in a decline in global investment confidence. This could have disproportionate negative consequences for highly open economies such as Malaysia. News-based measures of economic sentiment suggest a relatively pessimistic forecast regarding Malaysia's growth compared to professional forecasts.

Increased reliance on oil-related revenue poses risks to the government's fiscal space in the event of a major oil price or supply shock. The government has introduced several new revenue measures in the budget such as taxing foreign service providers and on the expenditure side, a more targeted fuel subsidy scheme which could alleviate some fiscal strains. However, the narrowing of the government's revenue base, and its increased reliance on less stable oil-related revenue could limit its flexibility to make fiscal adjustments against future macroeconomic shocks.

Other near-term risks relate to the relatively high levels of private and public-sector debt. In the public sector, the government recently disclosed the size of committed government guarantees, amounting to 8.2 percent of GDP (more than half of all government guarantees), which have the possibility of being assumed by the government. With this accumulation of both government debt and committed guarantees, the government's total liabilities will remain elevated into the near-term future.

Malaysia has the opportunity to undertake bold structural reforms that would strengthen the foundations for more sustainable and inclusive growth. The Mid-term Review of the 11th Malaysia Plan sets out a series of new goals that would serve to strengthen governance and increase transparency, improve public sector efficiency and foster equitable growth. Over time, the implementation of these reforms would serve to improve not only the quantity of economic growth, but also the quality of this growth.

Near-term economic growth will be more dependent on government measures to boost private investment, with the increasingly challenging external environment reducing opportunities for export-led growth, and with reduced fiscal space limiting the scope for public investment-led expansion. Malaysia already has one of the world's lowest cost business environments, as indicated by the World Bank's Doing Business report, the most recent of which ranked Malaysia in 15th place out of 190 economies. However, Malaysia continues to experience gaps in broader measures of competitiveness, including major weaknesses in the areas of skills, productivity and human capital. High-level policy statements on leveling the playing field between state enterprises and the private sector are welcome, signaling the government's commitment to boosting investor confidence, promoting healthy competition and increasing private sector participation.

While immediate fiscal consolidation efforts will be conducted through expenditure rationalization, over the medium-term Malaysia will also need to boost efforts to mobilize and diversify fiscal revenues. As Malaysia's average income and societal expectations continue to grow, raising adequate resources to finance the needs of an expanding middle class will become an increasingly important priority. Meeting these needs will involve the improved provision of basic public services, growth-enhancing investments and scaling up of social protection systems, among other measures. To improve revenue collections, the government's reform efforts should aim to broaden the tax base through new measures; to reduce unproductive tax expenditures, particularly deductions and incentives; and to strengthen overall tax administration and compliance.

On the expenditure side, reform efforts should aim to contain the relatively sizeable cost of civil service salaries and pension outlays, to further rationalize discretionary spending and untargeted subsidies, as well as to improve the efficiency of development spending. The administration's commitment to strengthening public financial management, including through measures to improve governance and transparency, is a welcome development. Going forward, as the potential for incremental fiscal savings from efficiency-enhancing rationalization diminishes, it will become increasingly necessary to focus on containing the relatively sizable expenditure on civil service salaries and pensions, which constitutes a growing share of overall public spending.

Fostering greater economic inclusiveness begins with expanding access to more productive and remunerative employment. This requires interventions and investments in health and education throughout the life cycle, complemented by policies to increase participation in the labor force. A strengthened social protection system is also a necessary complement for those who cannot benefit fully from expanded productive employment. For some people – such as the elderly, persons with disabilities, and those encountering transient shocks such as unemployment – employment-based solutions are insufficient. A well-functioning social protection system is needed to keep them out of poverty and support living with dignity.

Realizing human potential

Human capital – the knowledge, skills, and health that people accumulate over their lives – has been a key factor behind the sustained economic growth and poverty reduction rates of many countries in the 20th century, especially in East Asia. With rapid technological change, the wealth of nations has become even more closely tied to the human capital of its people. Automation threatens to eliminate many jobs that previously required only low-level cognitive skills. The global economy now increasingly places a premium on higher-order cognitive skills – including complex problem-solving, socio-behavioral skills, reasoning, and self-efficacy. Production processes in industry, agriculture and services have all become highly human capital and technology intensive. Greater policy focus on human capital is needed to build the knowledge, competencies, and skills to enable an economy to achieve high rates of inclusive economic growth in this rapidly evolving context.

Education, health, and social protection play complementary roles in the development of human capital. Among high-income countries, levels of educational attainment are closely linked to economic performance. Similarly, health is critically important to the achievement of high levels of economic growth, with a healthy population capable of being more productive. Social protection also plays a crucial role in nurturing human capital.

The World Bank's new Human Capital Index (HCI) is a cross-country metric designed to forecast a country's human capital. The index tracks the future trajectory, from birth to adulthood, of a child born today. It quantifies the level of human capital that a child can expect to attain by the end of secondary school, given the risks of poor health and education at the time of the child's birth.

The HCI captures the impact of investments in children today on productivity and economic growth over the long term. According to the HCI, Malaysia scores 0.62. This indicates that children in Malaysia will be only 62 percent as productive as they could be in adulthood compared to optimal outcomes, given the prevailing education and health outcomes in the country.

Overall, Malaysia ranks 55th out of the 157 countries included in the HCI. While Malaysia performs well in some components of the HCI, it performs less well in others. Relative to other countries, Malaysia does well in child survival, expected years of schooling, and overall health conditions for adults. However, Malaysia has room for improvement in the areas of child malnutrition and learning outcomes. With improvements in these areas, Malaysia could record increased levels of productivity.

Looking to the future, how can Malaysia continue to improve its human capital and thus to boost productivity? This report identifies three key priorities: (i) enhance learning outcomes; (ii) improve child nutrition; and (iii) provide adequate protection through social welfare programs to enable households to invest in human capital.

According to the World Bank's Human Capital Index, children in Malaysia will be only 62 percent as productive as they could be in adulthood

To enhance learning outcomes, a key measure is to provide universal access to high-quality early childhood care and education to ensure that children are "ready for school." International evidence has shown that the quality of early childhood and preschool education programs is directly linked with the better development of children's cognitive and social skills. Efforts to ensure universal access to early childhood care and education have contributed to the remarkable educational performance of countries like Korea and Japan.

Improvements to learning assessment systems can also improve learning outcomes. The quality of an education system can only be accurately determined by an effective system of educational assessment, which can include classroom-based assessments, national assessments and international assessments. When implemented correctly, specific types of assessment activities may have a positive impact on student learning. The results of the 2018 Programme for International Assessment – which will be released in December 2019 – will provide an opportunity to assess Malaysia's learning outcomes relative to international comparators.

Child malnutrition is an important constraint on learning and human capital development. One in five Malaysian children under five suffer from stunting, a key marker of malnutrition.[2] This rate in Malaysia is higher than that of other countries at similar levels of income. There is overwhelming international evidence that malnutrition in early years of life (from conception to two years of age) is associated with measurable negative consequences for health, cognition, productivity, and income throughout the course of life. Further analytical work is needed to understand the drivers of stunting in Malaysia and to identify the most effective policy channels to reduce undernutrition.

Social welfare programs can help households invest in human capital. Programs can be designed with a mix of mandates and incentives. Many countries impose some form of condition on beneficiaries of cash transfers if these beneficiaries are not in employment, education or training but are capable of working. Most frequently, these conditions include job search requirements, a requirement that could be considered in Malaysia.

BSH has the potential to more actively facilitate human capital development. BSH recipients could benefit from information provided through accompanying measures, to raise parents' awareness of best practices for providing nurturing care, to support family members to make better choices, and to increase the use of services provided by other agencies and of new services directly provided by or linked to the program, including training to further enhance human capital formation.

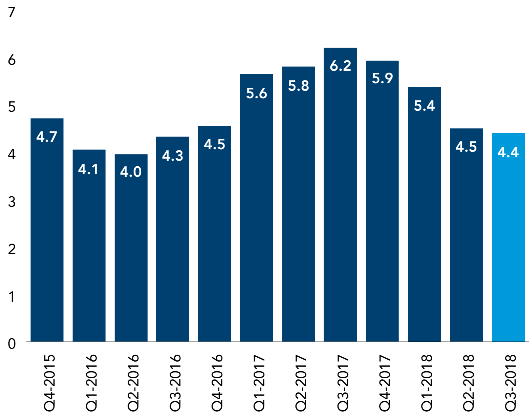
Malaysia's social insurance programs could also be more effectively leveraged to support human capital formation. The recent introduction of the Employment Insurance System creates a window of opportunity to allow Malaysian workers to mitigate the impacts of jobs loss.

[2] Child stunting (low height-for-age) is the type of undernutrition of most concern for policy makers. Stunting results from chronic undernutrition and indicates a failure of a child to attain the height expected among healthy children.

Recent economic developments and outlook

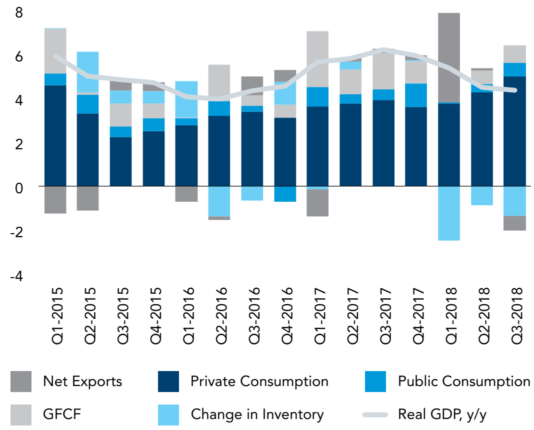
Malaysia's economy continued to grow at a moderate pace in Q3 2018...

GDP, y/y, Percentage



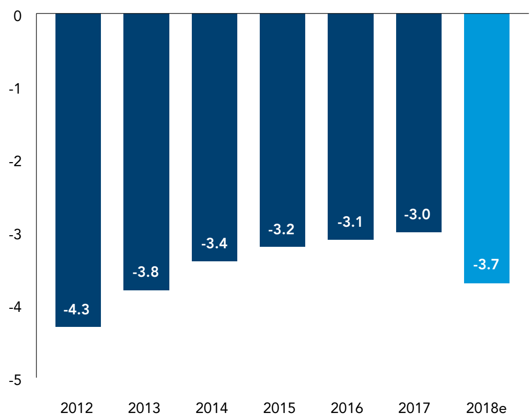
...with private consumption contributing an increased share of growth

Contribution to GDP, y/y, Percentage



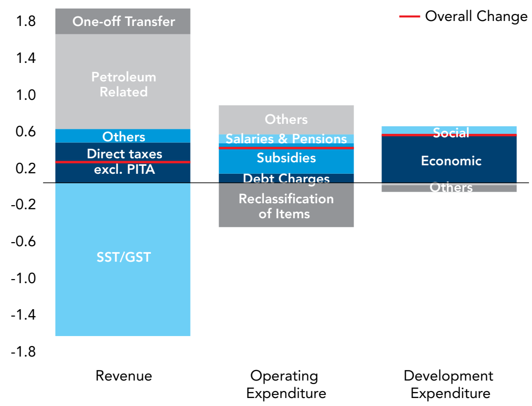
The fiscal deficit is expected to increase to 3.7 percent in 2018...

Federal Government Overall Balance, Percentage of GDP



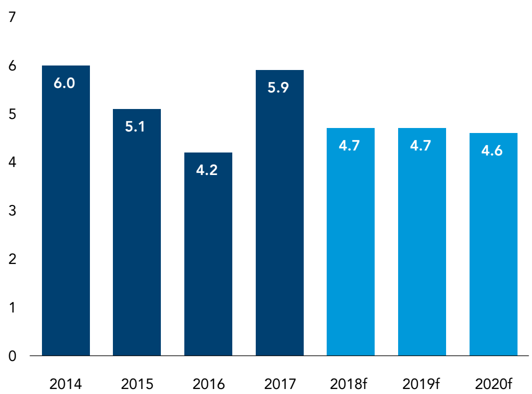
...amid lower consumption-based tax revenues and a larger fuel subsidy allocation

Change in Federal Government Revenue and Expenditure Between 2017-2018, Percentage of GDP



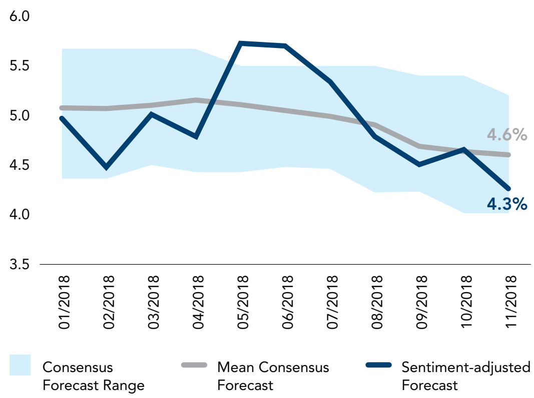
Malaysia's economy is forecast to grow at 4.7 percent in 2019...

GDP, y/y, Percentage



...while sentiment-based forecasts are trending below the market consensus

GDP, 2019f, y/y, Percentage

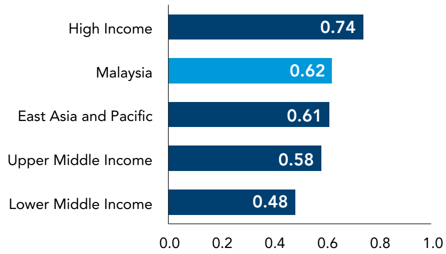


Realizing human potential

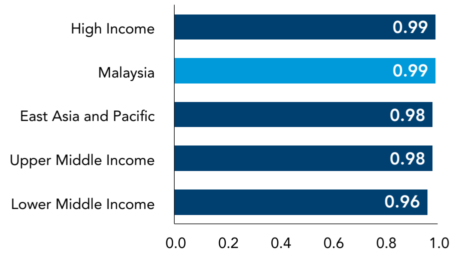
Malaysia's performance on the human capital index is about as expected compared to other upper middle-income economies…

World Bank Human Capital Index and its Components, 2017

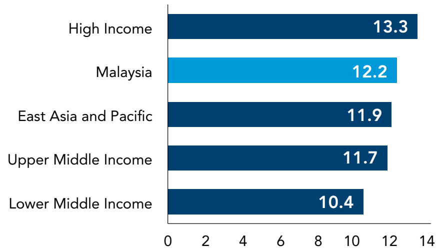
Human Capital Index



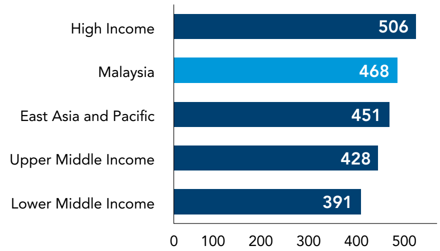
Probability of Survival to Age 5



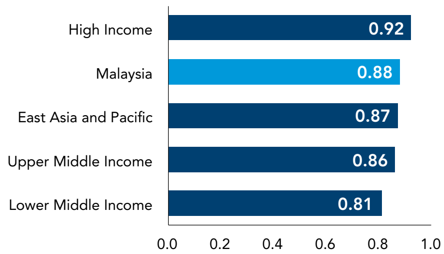
Expected Years of School



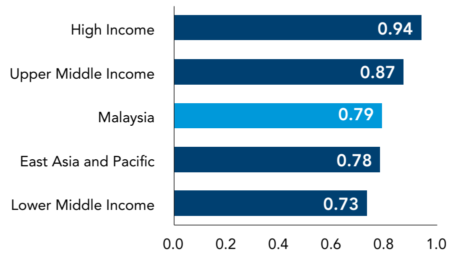
Harmonized Test Scores



Adult Survival Rate

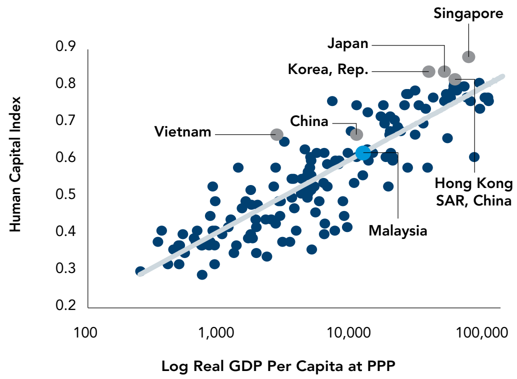


Fraction of Children Under 5 Not Stunted



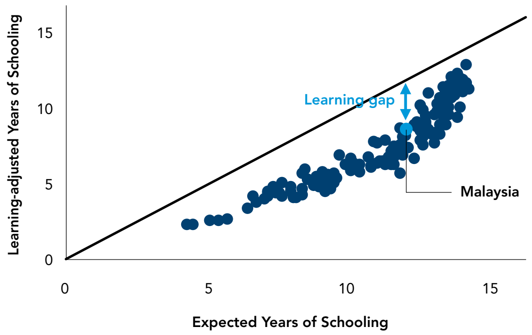
…but performance falls well below Malaysia's aspirational peers…

Human Capital Index Versus GDP per Capita, Selected EAP Countries, 2017



…and the shortfall is especially pronounced with regard to educational attainment, with an average learning gap of 3.1 years

Expected Years of Schooling Versus Learning Adjusted Years of Schooling, 2017




PENGEDAR TEKSTIL
SK-2
Textile
AL AIN IMPEX
BORONG & RUNCIT
PENGEDAR TEKSTIL
SK-2 Textile

PART ONE

Recent Economic Developments and Outlook

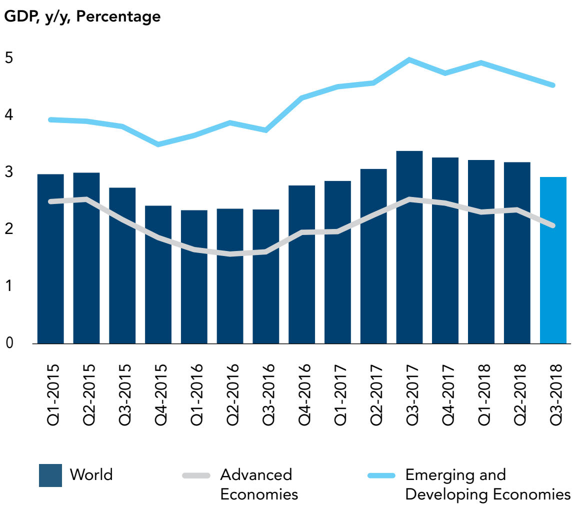
Recent economic developments

East Asia's economies are facing increased headwinds

In 2018, global growth has shown signs of moderation amid softening trade and investment activity. In aggregate, global economic growth eased to 2.9 percent[3] in the third quarter (Q2 2018: 3.2 percent) (see Figure 1). The expansion has also become less synchronized across countries. While the United States has maintained solid growth, largely driven by fiscal stimulus, a softening pace of growth has been observed in other major advanced economies. The deceleration of global industrial production and trade activity has been more pronounced than had been expected in an environment of heightened trade policy uncertainty. The interaction of global trade tensions, monetary policy tightening in advanced economies and the strengthening of the U.S. dollar have contributed to tighter financing conditions as well as increased uncertainty regarding trade and investment flows in emerging markets and developing economies (EMDEs).

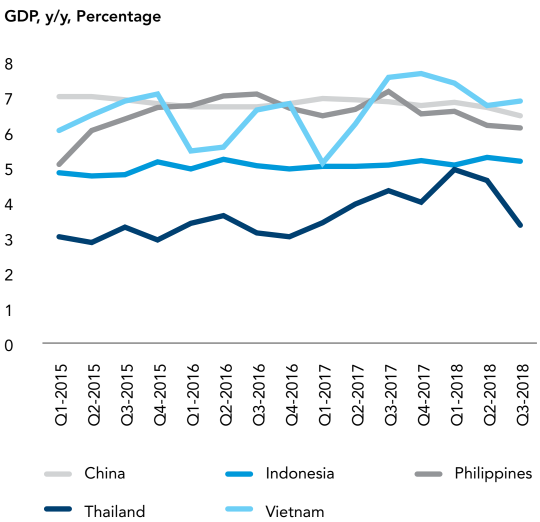
Growth in the developing countries of East Asia and Pacific (EAP) has slowed recently in the context of a less favorable global environment (see Figure 2). Growth in the region has eased to a still-robust 6.4 percent in Q2 2018 and to 6.2 percent in Q3 2018 (Q1 2018: 6.6 percent), with the decline reflecting diminishing support from external demand. Economic activity in China continued to be driven by domestic demand throughout the year amid resilient consumption spending, offsetting the effects of easing global demand on export growth. While growth in the other large regional economies has also slowed in Q3 2018, it has remained generally solid, underpinned by strong household consumption. Despite the slowdown, the EAP remains one of the world's fastest-growing regions and has been relatively resilient against recent bouts of financial market volatility.

FIGURE 1
Global growth has moderated amid softening trade and investment activity



Source: World Bank Global Economic Prospects

FIGURE 2
Growth among regional economies has also slowed in a context of a less favorable global environment



Source: World Bank Global Economic Prospects

[3] The default measure of growth is on a year-on-year basis, unless otherwise stated.

Malaysia's rate of economic growth has begun to slow

In Q3 2018, Malaysia's economy continued to grow at a moderate pace, at 4.4 percent (Q2 2018: 4.5 percent) (see Figure 3). Domestic demand continued to provide support to the economy, with private sector expenditure growing at a higher rate than in the previous quarter at 8.5 percent (Q2 2018: 7.5 percent). This was primarily due to an acceleration in private consumption (see Figure 4). Nonetheless, overall growth was weighed down by a weaker external sector performance and continued inventory drawdowns.

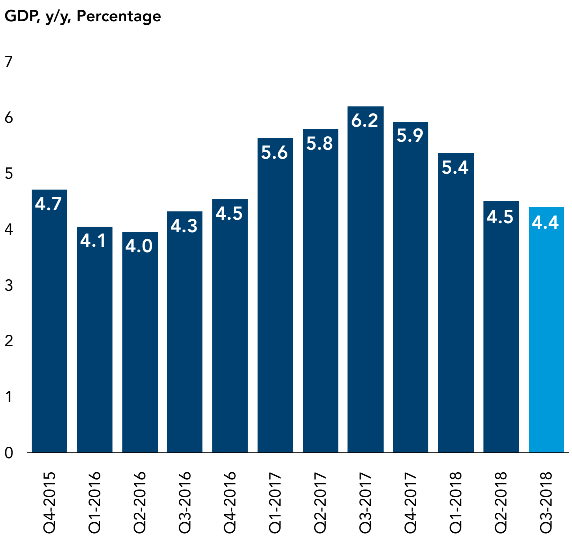
Private consumption continued to be the main anchor for the economy, accelerating at a rate of 9.0 percent in Q3 2018 (Q2 2018: 8.0 percent). The higher spending pattern during the quarter was largely observed in July and August 2018, following the zeroization of the GST. In particular, there were marked increases in the purchase of durable items, especially motor vehicles, and food and beverages with households taking advantage of the GST zeroization. In addition, stable labor market conditions and steady income growth continued to provide support to private consumption.

Growth in private investment edged up in Q3 2018 on account of increased capital spending in the manufacturing and services sectors. After growing at a subdued rate in Q1 2018 (0.5 percent), capital spending in the manufacturing and services sectors provided support to private investment in Q3 2018, which expanded at 6.9 percent (Q2 2018: 6.1 percent). Investment in these sectors were mainly driven by higher spending in machinery and equipment (M&E), expanding at 5.9 percent during the quarter (Q2 2018: 3.6 percent). Increased private investment also contributed to a higher gross fixed capital formation (GFCF) growth of 3.2 percent observed over the period (Q2 2018: 2.2 percent).

There was a small rebound in public sector expenditure in Q3 2018 at 1.1 percent (Q2 2018: -1.4 percent), driven mainly by public consumption. Higher spending on supplies and services contributed to the increased public consumption, which grew at 5.2 percent (Q2 2018: 3.1 percent). Meanwhile, public investment continued to contract in Q3 2018, albeit at a slower pace at 5.5 percent (Q2 2018: 9.8 percent), due to lower capital outlays by public corporations following

FIGURE 3

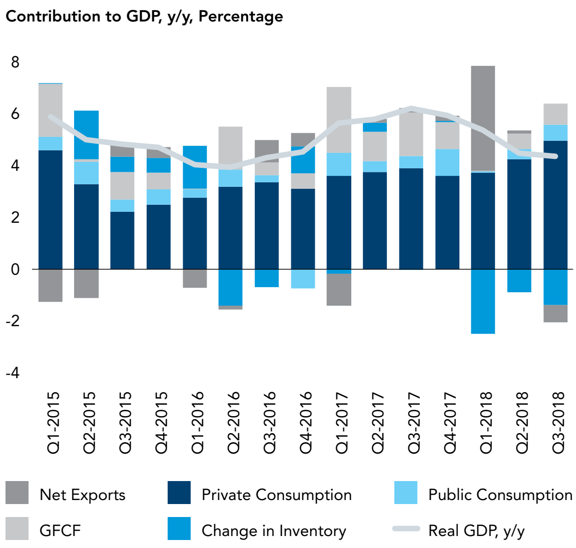
Malaysia's economy continued to grow at a moderate pace in Q3 2018...



Source: DOSM

FIGURE 4

...with private consumption contributing an increased share of growth



Source: World Bank staff calculations based on DOSM data

the near completion of several large infrastructure projects, and the deferment and cancellation of several major public infrastructure projects.

On the supply side, growth continued to be affected by supply shocks in the commodity-related sectors (see Table 1). In the mining sector, the contraction in growth deepened in Q3 2018, with the rate standing at -4.6 percent (Q2 2018: -2.2 percent). This was primarily due to the impact on the natural gas production of unplanned supply outages and pipeline repairs. Similarly, in the agriculture sector, adverse weather and production constraints had a negative impact on the production of crude palm oil. As a result, the output of the agricultural sector contracted by -1.4 percent in Q3 2018 (Q2 2018: -2.5 percent). Nevertheless, the impact of the contraction in these two sectors was offset by growth in other sectors, particularly in the services sector, which grew by 7.2 percent (Q2 2018: 6.5 percent). This high rate of growth was in line with the increased consumer spending during the zero-rated GST period.

Recent economic indicators suggest that Malaysia's growth momentum will continue to moderate in the near term. The Malaysia Composite Leading Index, a measure of the overall economic performance in the months ahead, indicates that growth will continue to ease between January and March 2019. Similarly, the Malaysian Institute of Economic Research's Business Conditions and Consumer Sentiment Index in Q3 2018 point towards a more moderate pace of economic expansion in the near term.

TABLE 1
GDP growth decomposition

GDP, y/y, Percentage

	Q3 2016	Q4 2016	2016	Q1 2017	Q2 2017	Q3 2017	Q4 2017	2017	Q1 2018	Q2 2018	Q3 2018
GDP	**4.3**	**4.5**	**4.2**	**5.6**	**5.8**	**6.2**	**5.9**	**5.9**	**5.4**	**4.5**	**4.4**
Consumption											
Private Sector	6.3	6.1	6.0	6.7	7.1	7.2	7.0	7.0	6.9	8.0	9.0
Public Sector	2.1	-4.3	0.9	7.5	3.3	3.9	6.8	5.4	0.4	3.1	5.2
Gross Fixed Capital Formation	2.0	2.4	2.7	10.0	4.1	6.7	4.3	6.2	0.1	2.2	3.2
Exports of Goods & Services	-0.2	2.4	1.3	9.8	9.4	11.8	6.7	9.4	3.7	2.0	-0.8
Imports of Goods & Services	-1.6	1.9	1.3	13.0	10.4	13.3	7.3	10.9	-2.0	2.1	0.1
Sectoral											
Agriculture	-6.2	-2.5	-5.2	8.4	5.9	4.1	10.7	7.2	2.8	-2.5	-1.4
Mining	2.8	4.9	2.1	1.4	0.1	3.0	-0.3	1.0	0.1	-2.2	-4.6
Manufacturing	4.3	4.7	4.4	5.6	6.0	7.0	5.4	6.0	5.3	4.9	5.0
Construction	7.9	5.1	7.4	6.6	8.3	6.1	5.9	6.7	4.9	4.7	4.6
Services	6.2	5.6	5.7	5.8	6.3	6.5	6.2	6.2	6.5	6.5	7.2

Source: World Bank staff calculations based on DOSM data


Sunkist
Strawberry

The current account surplus has narrowed due to a smaller goods surplus

Export growth of goods eased to 5.1 percent in Q3 2018 (Q2 2018: 8.3 percent) due to slower manufactured export growth and continued declines in agricultural exports (see Figure 5). Much of the growth momentum in Q3 2018 was driven by the relatively sustained growth of semiconductor exports, at 24.2 percent (Q2 2018: 21.0 percent), accounting for 91 percent of the total gross export growth during the quarter. Other electrical and electronics (E&E) as well as most major non-E&E manufactured exports recorded noticeable declines in growth over the period, to -3.9 percent and 4.6 percent respectively (Q2 2017: -2.3 and 11.4 percent), amid a less supportive global environment. The contraction in commodity exports persisted into Q3 2018, with the rate standing at -3.0 percent (Q2 2018: -3.8 percent), weighed down mainly by temporary production constraints in the crude palm oil sector.

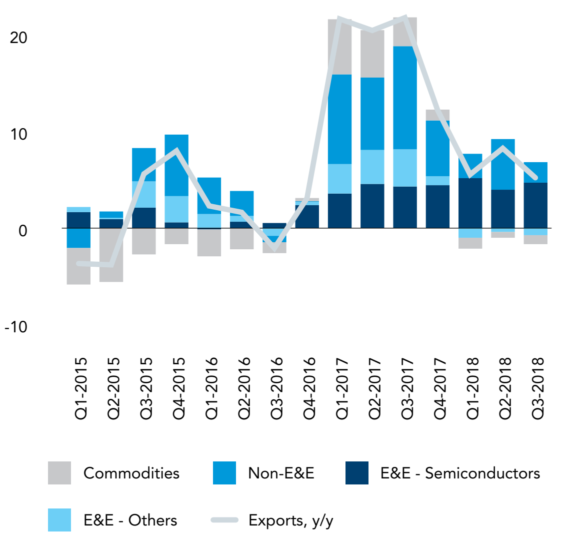
Growth in gross imports also decelerated over the quarter, going down to 6.3 percent (Q2 2018: 8.5 percent). This deceleration was partly due to the significant slowdown in capital import growth in Q3 2018, which declined to 1.1 percent (Q2 2018: 11.7 percent). During the quarter, imports of intermediate goods, which constitutes 53 percent of total imports, continued to contract amid easing foreign demand for manufactured exports, with the rate standing at -1.6 percent (Q2 2018: -4.7 percent). Meanwhile, imports of consumption goods rebounded in Q3 2018, with a positive growth rate of 5.5 percent (Q2 2018: -2.8 percent). This rebound occurred in the context of a surge in household spending during the period.

The current account surplus has narrowed appreciably since Q1 2018, owing to a lower goods surplus and a larger deficit on primary income (see Figure 6). In Q3 2018, current account surplus remained at 1.0 percent of GDP (Q2 2018: 1.1 percent). During the quarter, the goods surplus remained relatively flat at RM26.6 billion (Q2 2018: RM26.1 billion) amid easing export growth, while the deficit in the services account narrowed to RM3.3 billion (Q2 2018: -RM6.2 billion) on account of increased net tourism receipts and lower payments for construction services. The slight overall improvement in the trade account during the period, however, was more than offset by the increased deficit on primary income in Q3 2018. At the end of

FIGURE 5

Export growth has eased due to slower manufactured export growth and a continued output decline in agriculture exports...

Contribution to Export Growth, y/y, Percentage

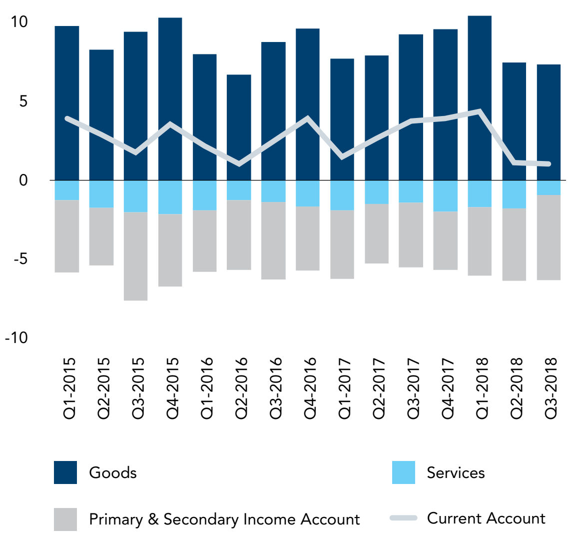


Source: World Bank staff calculations based on BNM and DOSM data

FIGURE 6

...contributing to an appreciable narrowing in the current account surplus

Current Account Balance, Percentage of GDP



Source: World Bank staff calculations based on DOSM data

this quarter, the deficit stood at RM15.0 billion (Q2 2018: RM11.2 billion), with the increase mainly due to increased net payments related to investment income. Meanwhile, the secondary income account deficit was sustained at RM4.5 billion (Q2 2018: -RM4.7 billion), reflecting continued sizeable outward remittances by foreign workers (see Box 1 for a wider discussion on Malaysia's current account balance).

TABLE 2
Selected external sector indicators

	Q3 2016	Q4 2016	Q1 2017	Q2 2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018
Balance of Goods & Services (% of GDP)	7.4	8.0	5.8	6.4	7.8	7.6	8.7	5.7	6.4
Current Account Balance (% of GDP)	2.5	3.9	1.5	2.7	3.7	3.9	4.4	1.1	1.0
Total Exports (% of GDP)	67.1	69.4	71.2	71.2	72.3	70.9	70.1	69.2	69.6
Total Imports (% of GDP)	59.8	61.4	65.4	64.8	64.5	63.3	61.4	63.5	63.2
Net Portfolio Investment (RM billion)	-9.8	-20.1	-32.4	17.5	-9.1	11.6	-2.6	-38.3	0.6
Gross Official Reserves (RM billion)	405.0	424.0	422.2	424.9	427.8	414.7	416.4	423.4	427.0
(US$ billion)	97.7	94.5	95.4	98.9	101.2	102.4	107.8	104.7	103.0

Source: World Bank staff calculations based on BNM and DOSM data

BOX 1

Good or bad? Making sense of the current account balance

On the surface, a current account surplus seems to have many more positive implications than a current account deficit, with the latter raising greater fears of illiquidity and insolvency than the former. However, depending on what drives the balance, a deficit may not necessarily be a bad thing. Similarly, a surplus does not necessarily imply that all is well in an economy, despite its suggestion of a stronger net foreign assets (NFA) position. In addition, whether in deficit or surplus, the current account balance may not in itself be sufficient to indicate near-term financial vulnerabilities. What matters for macroeconomic stability is that the external position (including the current account and gross foreign flows and stocks) is sustainable, without the risk of drastic disruptions or the need for sharp policy adjustments in response to domestic or external shocks.

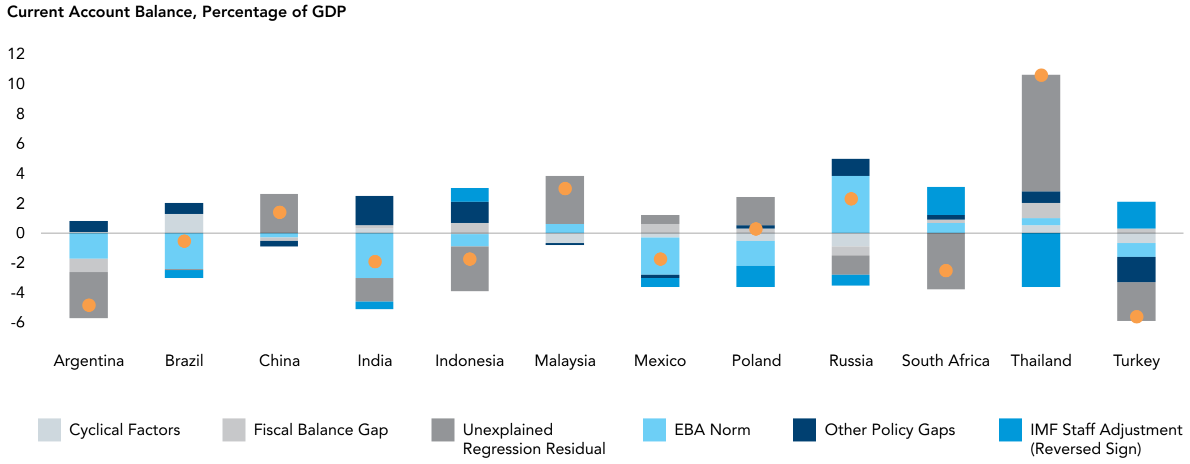
The underlying drivers of current account balances include economic and demographic characteristics that imply a benchmark for normal balances. Other drivers include the institutional environment and government policies that may mitigate or exacerbate a departure from the benchmark (see Devadas and Loayza 2018 for an overview and references). A current account deficit may be an optimal response, given a country's fundamentals that cut across its level of income and stage of development, demographics, trade and financial characteristics. Some of these may signal strength, indicating the potential for future increases in output. For example, at an early stage of an economy's development, higher average output growth or productivity, faster population growth (resulting in a higher youth dependency ratio), low terms-of-trade volatility, and financial deepening are associated with higher deficits. A deficit may also be an optimal response to cyclical conditions, particularly conditions characterized by a positive output gap and a negative terms-of-trade shock. On the other hand, in terms of policy settings, a deficit that coincides with relatively large budget deficits, exchange rate overvaluation (which may be due to interventions that prevent the exchange rate from serving as an effective shock absorber), and excessive credit growth imply the risk of over-consumption and over-investment.

The results of the IMF's External Balance Assessment (EBA) provide a basis to determine the level of excesses in current account balances and their source.[4] However, the explanatory power of the regression model works better for some countries than others. For some deficit countries (e.g. Brazil, India and Mexico), estimated norms established a deficit that was in excess of their actual deficit, given their lower income, higher growth potential, and faster population growth, thus resulting in no overall excesses. Though Malaysia's current account surplus has narrowed since 2010 to 3 percent of GDP in 2017, much of the surplus cannot be adequately explained by the EBA model, potentially reflecting country-specific factors that contribute to relatively high savings and low levels of investment. In terms of identified policy gaps, the low level of public healthcare spending explained a small portion of the excess saving and current account surplus. Product market regulations, which could hinder investment, also accounted for some of the unexplained gap. The model also did not explain much of Thailand's current account surplus, which stood at 10.6 percent of GDP. An excessively tight fiscal stance and high level of foreign exchange intervention contributed to identified policy gaps, with the IMF assessment finding that the unexplained gap was partially related to political uncertainty and a temporary tourism boom. Both factors would have led to higher savings. Consistent with assessed current account excess surpluses, both Malaysia and Thailand showed some signs that their real effective exchange rates were undervalued, despite the fact that these exchange rates had appreciated in 2017.

[4] The model-based estimation of excessive current account balances is provided by the sum of policy gaps, which is a normative assessment of actual policies against desirable policies, and an unexplained gap (regression residuals) after accounting for current account 'norms' (reflecting fundamentals, the institutional environment, and policies set at desirable levels) and cyclical factors.

FIGURE 7

Decomposing the sources of current account balances



Source: Authors' illustration based on data from IMF (2018). See IMF (2018) for further details on the External Balance Assessment (EBA).

EBA model-based gap = Policy gaps + Unexplained regression residual
= Actual current account deficit - Cyclical factors - EBA norm

EBA norm comprises fundamentals and desirable policies. Fundamentals include productivity and expected growth, demographics, initial NFA, oil and natural gas net exports, and institutional/political environment.

Cyclical factors = output gap and commodity terms of trade gap.

Policy gaps = the differences between actual and desirable policies. Fiscal balance gap = the difference between current cyclically adjusted fiscal balance and one desirable in the future at full employment.

Other policy gaps are for public expenditure on health (versus benchmark), foreign exchange intervention (against 0, or non-zero if deemed necessary to reach reserves adequacy), the private credit-to-GDP ratio (deviation from detrended value), and capital controls (against cross-country average or own level, whichever is lower).

IMF staff adjustment = outside-the-model adjustments for special factors such as high mortality risk (South Africa) and high political uncertainty (Thailand). A negative (positive) value implies a negative (positive) EBA model-based gap.

Even if drivers of current account balances can be identified, they remain insufficiently informative about the immediate risks to financial stability. Financial liabilities that are more stable (such as foreign direct investment (FDI)), that foster greater automatic risk sharing (such as equity), or that correspond to investors with a longer time horizon limits the fallout from a negative domestic shock and reduces the probability of contagion from an external shock (Forbes 2013). For instance, while Argentina and Turkey were identified as having large excess current account deficits with some policy gaps, both have been especially vulnerable in recent times given the high share of short-term foreign liabilities in their net international investment positions (NIIPs) (IMF 2018). The balance sheets of different sectors also matter. Aggregate NFA may hide imbalances across different sectors. For example, despite previously having current account surpluses, the Republic of Korea was badly affected during the global financial crisis. Banks and corporates with high levels of external debt and negative net positions were hit by large financial outflows and sharp exchange rate depreciation (Avdjiev, McCauley, and Shin 2016). More than half of Malaysia's external debt is of medium-to-long-term maturities, limiting rollover risk. Foreign-currency denominated debt, which accounts for two-thirds of external debt, is mainly held by banks and corporations and is subject to BNM's prudential requirements and external debt approval framework respectively. Banks also have substantial external assets that can be drawn upon to meet their short-term external debt obligations (Rozimi 2018).

Perceived vulnerabilities are undoubtedly greater for deficit countries. Deficits are used to proxy reliance on foreign borrowing and exposure to shifts in sentiment, especially when foreign exchange reserves are relatively low. Sound policies and institutional features can go a long way to attracting and sustaining a healthy demand for domestic assets.

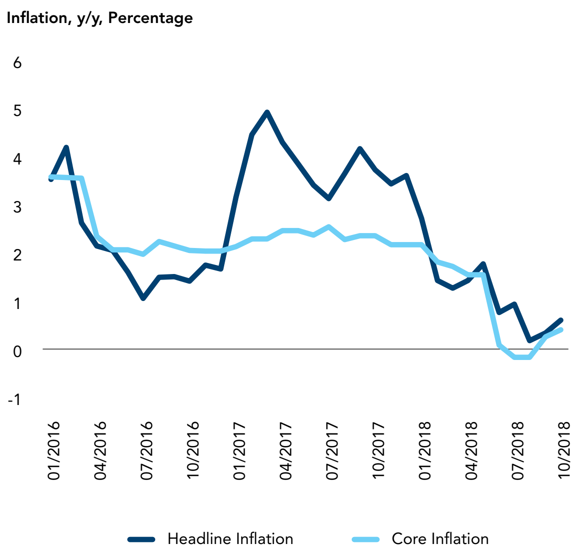
Domestic inflationary pressures have eased further in recent months

The headline inflation rate eased further in Q3 2018, mainly due to the impact of changes in the consumption tax policy (see Figure 8). Consumer Price Index (CPI) inflation has moderated further since June 2018, following the zeroization of the GST on June 1, 2018, with the average rate for the quarter standing at 0.5 percent in Q3 2018 (Q2 2018: 1.3 percent). Over the period, there were declines in seven out of twelve main consumption groups, while the overall inflation rate for food and non-alcoholic beverages was relatively modest, at 0.5 percent (Q2 2018: 1.8 percent) (see Figure 9). This was partially offset by continued price increases in the transportation category, at 3.0 percent (Q2 2018: 3.2 percent), due to the base effect from lower domestic petrol prices in July 2017. Among households with monthly incomes of less than RM 3,000, average prices increased by 0.3 percent in the period from September 2017 to September 2018, primarily due to increases in housing and utilities (2.0 percent, Q2 2018: 1.9 percent). Consumer prices remained subdued at 0.6 percent in October 2018, despite the reintroduction of the SST on September 1, 2018.

Measures of underlying inflation have remained generally stable. In Q3 2018, the inflation rate for items other than food and energy, excluding the direct impact of the GST zeroization, remained roughly unchanged compared to the previous quarter, at 1.4 percent (Q2 2018: 1.5 percent). While the overall inflation rate has temporarily eased over recent months, there remain ongoing concerns regarding the cumulative increase in the cost of living pressures over the past years. In particular, lower-income households (who tend to spend a greater proportion of their incomes on essential items such as food and housing) have been disproportionately impacted by the higher relative increases in food prices and the declining affordability of housing in recent years.

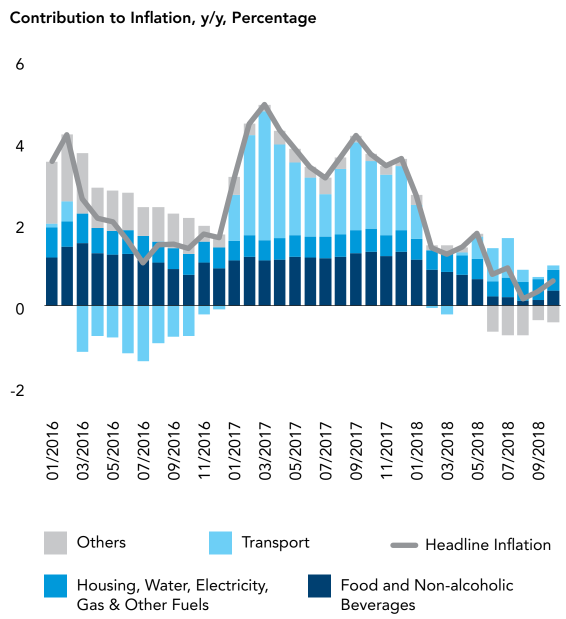
Labor markets have remained stable, with modest improvements in labor force participation throughout 2018 (see Figure 10). In Q3 2018, the labor force participation rate increased to 68.5 percent, up by 0.1 percentage points from Q2 2018 and 0.6 percentage points from Q3 2017. The women's

FIGURE 8
CPI inflation has moderated further in recent months...



Source: DOSM

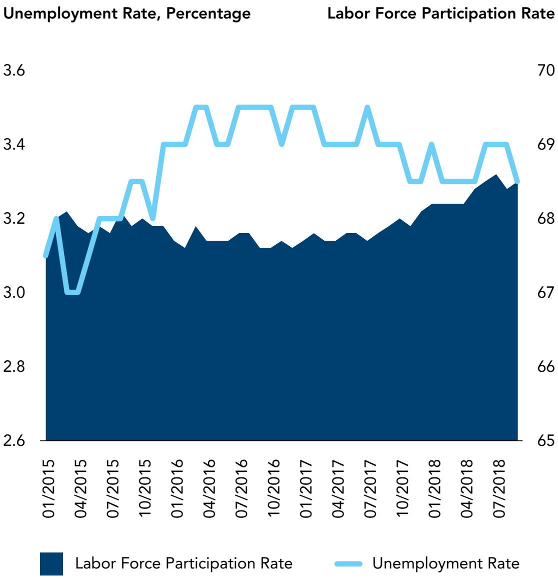
FIGURE 9
...due largely to the zeroization of the GST and lower growth in transport prices



Source: World Bank staff calculations based on DOSM data

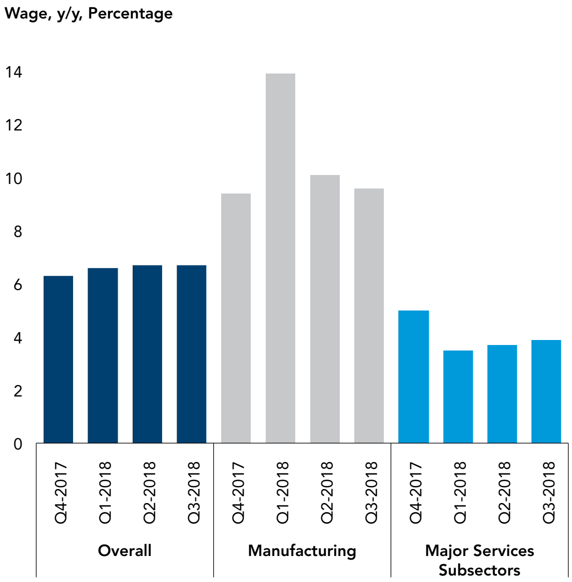
labor force participation rate rose from 55.3 percent in Q2 2018 to 55.5 percent in Q3 2018. In Q3 2018, the unemployment rate stood at 3.4 percent, a slight increase from the 3.3 percent recorded in Q1 2018 and Q2 2018. Unemployment among those aged between 15 to 24 years continues to be an area of concern, increasing from 10.4 percent in Q2 2018 to 11.4 percent in Q3 2018. By contrast, for every other age group, it was less than 3 percent. Private sector wage growth[5] was broadly sustained at 5.7 percent in Q3 2018 (Q2 2018: 5.7 percent), mainly due to the continued strong wage increases in the manufacturing sector, which grew at 9.6 percent (Q2 2018: 10.1 percent). This was considerably higher than the average for the service sectors (3.9 percent; Q2 2018: 3.7 percent) (see Figure 11).

FIGURE 10
Labor market conditions have remained broadly stable...



Source: DOSM

FIGURE 11
...but there is continued disparity in wage growth between the manufacturing and services sectors



Source: BNM and DOSM

[5] Average wage growth for manufacturing sector and major services subsectors, covering 62 percent of total employment.

BOX 2

Has Malaysia's economic growth become less inclusive?

The Mid-term Review of the 11th Malaysia Plan and the 2019 National Budget have reaffirmed Malaysia's commitment to becoming a developed and more inclusive nation. These key policy documents emphasize the government's commitment to improving the wellbeing of the poorest 40 percent of the population (the B40) to ensure that all Malaysians share in the country's prosperity. Official statistics point to significant reductions in income inequality and poverty in recent years, yet there is widespread sentiment that the B40 have not been receiving their share of the benefits. How can these apparently contradictory perspectives be reconciled?

In the period from 2008 to 2013, the growth rate in household income per capita was highest among the lowest income households. The growth incidence curves in Figure 12 depict the inflation-adjusted average annual growth in income per capita for each percentile of the income distribution[6]. From 2008 to 2011, per capita incomes grew at an average of 8–11 percent per year among the B40, 6–8 percent among the middle 40 (M40, percentiles 41–80), and 4-6 percent among those in the top 20 percent (T20, percentiles 81–100). The steeper growth incidence curve for 2011–13 indicates an even more favorable income growth for lower income households, with income growth rates in the B40 more than double those experienced by the T20. From 2008 to 2013, average incomes of the B40 grew by a total of 67 percent, and their share of national income increased from 12.9 to 15.4 percent. The latter is consistent with a reduction in the Gini coefficient from 0.471 to 0.425. In short, Malaysia's economic pie was expanding rapidly, and the B40 were gaining an increasing share of that pie.

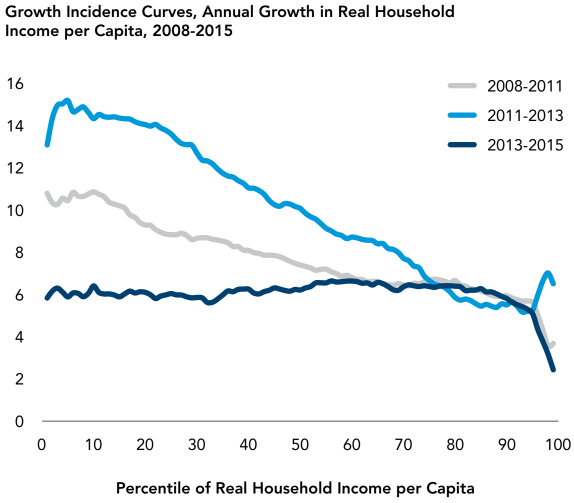
However, from 2013 to 2015, the income growth rate among the B40 fell sharply to 6 percent, less than half the rate during the period from 2011 to 2013, and lower than for the M40. Even though 6 percent annual income growth is very respectable, the change in the pace and especially the pattern of Malaysia's income growth marked a distinct break from past trends. Although B40 incomes were still increasing, they were doing so much more slowly. More notably, B40 incomes were no longer converging with those of the M40. From 2013 to 2015 there was no significant change in either the Gini coefficient or the B40's share of total income. Malaysia's economic pie was growing more slowly, and the B40's share of the pie had stopped increasing. From this perspective, Malaysia's income growth was very inclusive from 2008 through 2013, but much less so from 2013 through 2015.

Malaysia's income growth was very inclusive from 2008 through 2013, but much less so from 2013 through 2015

Throughout the period from 2008 to 2015, the absolute gaps in average B40, M40, and T20 incomes were increasing. For many – especially non-economists – the absolute gap in incomes is more salient, and more important, than proportional measures such as higher B40 income growth rates or declining inequality measures. Figure 13 presents the average income increase for each income group, showing larger absolute gains for higher income groups in each of the three periods. For example, from 2011 to 2013 the B40 average incomes per person per month increased by RM 113, 179, and 313 for the B40, M40, and T20, respectively. That the differences in gains across income groups are proportionally smaller than the income differences that existed in 2011 (as illustrated

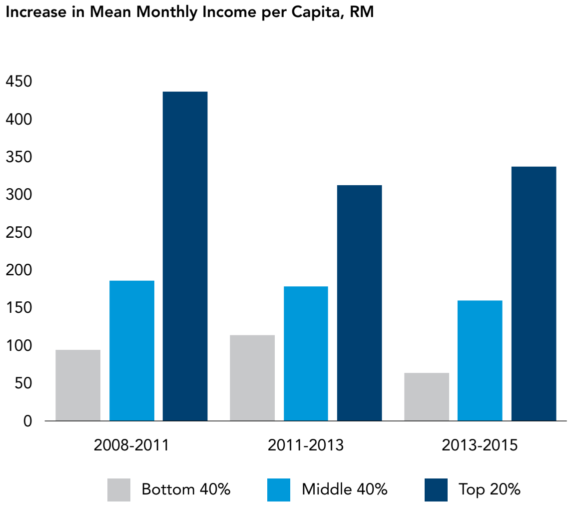
[6] All statistics reported here are based on household income per capita, weighted by the population size and adjusted for inflation using the CPI. Thus, there are differences from the statistics reported by DOSM, which generally use income per household, weighted by the number of households, and with no adjustment for inflation. Another difference is that whereas DOSM reports statistics based on the year that households are interviewed for the Household Income Survey, these figures use the "income reference year", which is the year prior to the HIS interview. For example, the HIS 2014 reports incomes earned in 2013.

FIGURE 12
Until 2013, incomes were growing faster for those at the lower end of the distribution...



Source: World Bank staff calculations using Household Income Survey data from DOSM

FIGURE 13
...but the absolute gap between those at the bottom and those at the top continues to widen



Source: World Bank staff calculations using Household Income Survey data from DOSM

in Figure 12) may be of secondary or lesser importance to people who see that larger income increments are going to those who were already better off. From the perspective of absolute income differences, one may argue that income growth was not inclusive in any of the three periods examined.

To improve the socio-economic circumstances of the B40 and to foster inclusiveness, the constructs of 'shared prosperity' and the 'shared prosperity premium' are useful. One of the World Bank Group's twin goals is to promote shared prosperity around the world through measures to raise the incomes of the B40 in every country in a sustainable manner and to facilitate the achievement of concomitant improvements in nonmonetary dimensions of wellbeing. The 'shared prosperity premium' refers to the difference, in percentage points, between the income per capita growth rates of the B40 and the nationwide average. Both increases to national income and a positive shared prosperity premium are the pillars on which the achievement of inclusive growth is based. In Malaysia, there are many pathways to ensure that the B40 participate in and benefit from the countries ongoing growth and development. These include measures to enhance opportunities to accumulate human capital; to ensure that human capital can be effectively utilized to provide gainful employment to all members of society; and to establish a more effective social protection system to increase resilience to negative shocks.

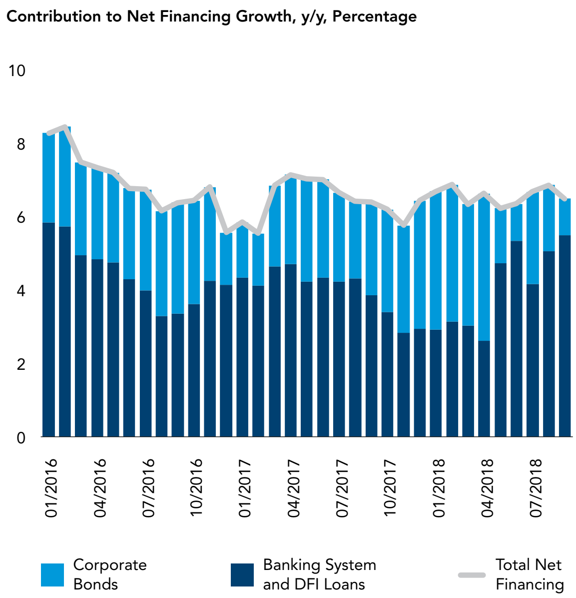
Conditions in the financial system have remained broadly stable

Monetary policy has remained unchanged since January 2018, with the Overnight Policy Rate (OPR) held at 3.25 percent. In its most recent monetary policy statement in November 2018, BNM indicated that Malaysia's economy is expected to remain on a steady growth path in 2019, with private consumption forecast to continue to be the main driver of growth and investment activity to be sustained. However, economic growth is expected to be constrained by a decrease in public sector expenditure. On the external front, while BNM expects that growth in exports will continue to provide additional support to the economy, although at a more moderate pace, it warns that any further escalation in global trade tensions poses downside risks to growth. At the same time, BNM expects the headline inflation to increase in 2019 due to higher global oil prices and the floating of domestic fuel prices. At the present point, BNM views its monetary policy stance as accommodative and supportive of economic activity.

Financial soundness indicators show that the banking system remains resilient. As at end-June 2018, financial institutions recorded sound levels of profitability, with a return on equity rate of 13.3 percent (2017: 13 percent) for the banking sector and 15.5 percent (2017: 16 percent) for the insurance sector. The banking system's liquidity levels remain sufficient to support financial intermediation, with all banking institutions having Basel III Liquidity Coverage Ratio (LCR) levels in excess of the minimum statutory requirement of 90 percent. In addition, the impairment and delinquencies level remained low and stable, reflecting the banking system's sound asset quality. The overall debt servicing capacity of households and businesses remained steady, supported by healthy financial positions.

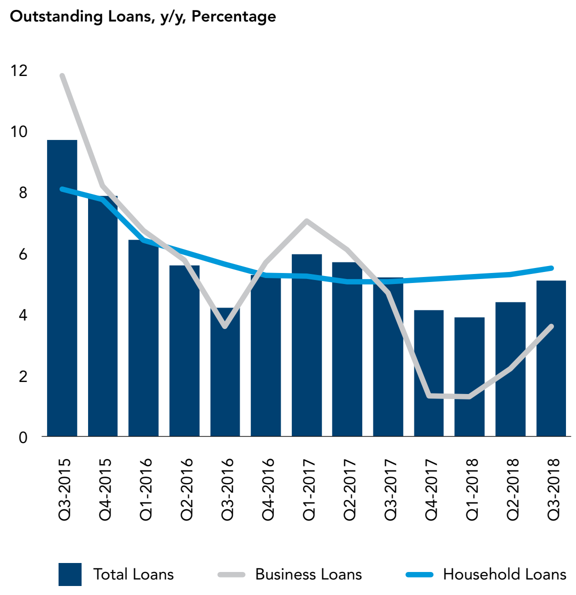
Net financing increased in Q3 2018, largely driven by accelerated growth in outstanding loans by the banking system and development financial institutions (DFIs), with growth increasing to 5.1 percent (Q2 2018: 4.4 percent). Meanwhile, in the third quarter, growth in outstanding issuances of corporate bonds continued at double-digit rates, standing at 10.8 percent (Q2 2018: 12.4 percent) (see Figure 14). Issuances of corporate bonds were mainly

FIGURE 14
Net financing rose amid higher loan growth



Source: BNM

FIGURE 15
Household loan growth was higher, partly driven by an increase in purchases of vehicles



Source: BNM

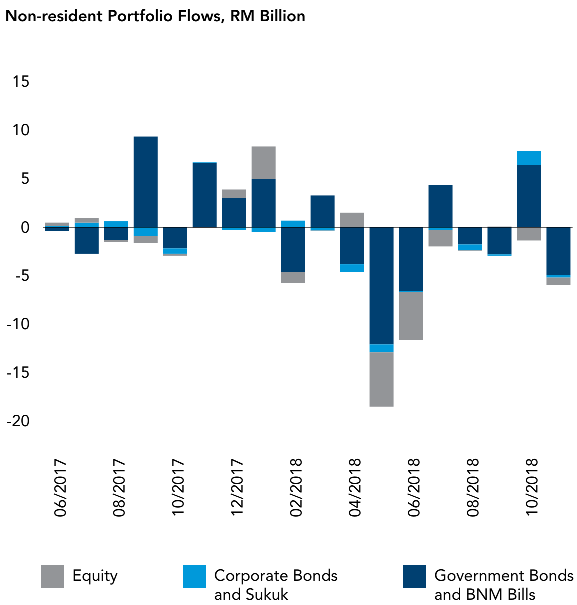
channeled towards financing capital expenditure and operating expenses. In the banking system, growth in outstanding loans for businesses accelerated from the previous quarter, reaching 3.6 percent (Q2 2018: 2.2 percent). Loan growth for both businesses and DFIs was driven mainly by the manufacturing, construction, wholesale and retail trade, as well as restaurants and hotels sectors. Meanwhile, the outstanding loan growth rate for the household sector increased slightly over the quarter, to 5.5 percent (Q2 2018: 5.3 percent) (see Figure 15). This reflected an increase in the purchase of passenger cars.

Domestic financial markets have been affected by heightened risk aversion arising from external developments. Non-resident investors have reduced their exposure in the equity market, with the value of outflows standing at RM0.7 billion in November (see Figure 16). During the same period, the FBM KLCI declined by 1.8 percent amid a confluence of global factors, including concerns regarding an escalation of the trade tensions between the US and China, declining global oil prices, and the developments in the US monetary policy. In the domestic bond market, yields on Malaysian Government Securities remained broadly stable during the period, despite initial concerns regarding the increase in government disclosed debt and liabilities and widening fiscal deficit for the year. In November, the value of non-resident outflows from the domestic bond market stood at RM5.2 billion. Interbank rates remained broadly unchanged, with minimal signs of tightening in liquidity.

The ringgit continued its depreciating trend relative to the US dollar in November, reflecting outflows from domestic bond and equity markets (see Figure 17). The ringgit depreciated slightly by 0.1 percent relative to the US dollar in November, standing at RM4.19 on November 30. Over this period, the ringgit also depreciated against the euro (-0.6 percent), UK pound sterling (-0.7 percent) and most regional currencies. At end-November, the international reserves stood at US$ 102 billion. The reserve position is sufficient for 7.5 months of retained imports cover and is at the ratio of 1.0 to short-term external debt.

FIGURE 16

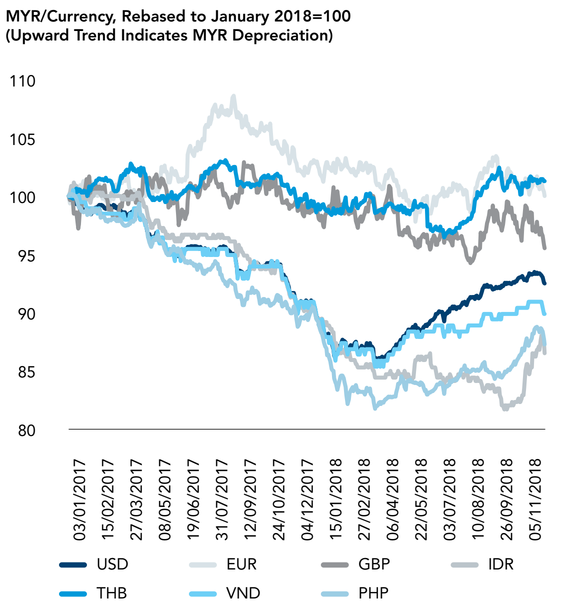
Cautious sentiment arising from a confluence of global factors has contributed to portfolio outflows...



Source: BNM and Bursa Malaysia

FIGURE 17

...contributing to a depreciation of the ringgit against the US dollar



Source: World Bank staff calculations based on BNM data

The 2019 budget sets out new directions for Malaysia's fiscal policy

The *Pakatan Harapan* government announced its first budget on November 2, 2018, with this budget outlining a number of new fiscal policy measures (see Box 3). The government revised several key projections to better reflect the current economic environment and to outline its fiscal plans going forward. The government's GDP forecast for 2018 was revised downward from 5.0-5.5 percent to 4.8 percent. According to government projections, the momentum is expected to continue into 2019, with the economy projected to grow at 4.9 percent. The government also raised its fiscal deficit target for 2018 from 2.8 percent of GDP to 3.7 percent amid several fiscal policy changes (see Figure 18), before narrowing to 3.4 percent of GDP in 2019 and 3.0 percent of GDP in 2020. The pace of fiscal consolidation is expected to deviate from past expectations due to a mixture of both increased expenditures (including those linked to the clearance of tax refund arrears) and reduced revenues (temporarily offset by enlarged oil and gas dividend receipts).

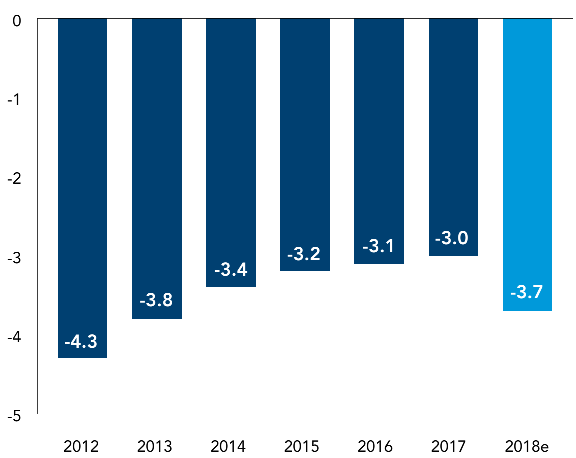
In 2018, Federal Government revenue in proportion of GDP is expected to increase marginally compared to the previous year, to 16.5 percent (2017: 16.3 percent). Following the replacement of the GST with the SST and the 3-month consumption tax holiday in the period from June and August, the collection of consumption-based taxes is projected to contract by half, to 1.6 percent of GDP (2017: 3.3 percent) (see Figure 19). The revenue shortfall will be partially offset by larger petroleum-related proceeds, the value of which will reach 3.6 percent of GDP (2017: 2.5 percent), amid higher prevailing global oil prices in 2018, relative to the government's initial projection of oil prices at US$52 per barrel. The bulk of the increase in petroleum-related proceeds will be derived from dividend payments by Petronas amounting to RM26 billion. Tax revenue from non-oil related sources is also expected to increase. This is premised on expectations of a larger corporate tax collection, which is projected to increase by 9.4 percent (2017: 1.3 percent), and personal income tax, which is expected to grow by 20.2 percent (2017: 5.0 percent). In addition, the government will receive a one-off contribution of RM4 billion (0.3 percent of GDP) from the state-owned Retirement Fund Incorporated (KWAP) to finance the civil servant retirement charges during the year.

The government's operating expenditure is also projected to trend marginally higher in 2018 to reach 16.4 percent of GDP (2017: 16.1 percent). This is largely due to the increased subsidy outlays expected over the year, at 2 percent of GDP (2017: 1.7 percent), to facilitate the stabilization of diesel and RON95 petrol prices. Expenditure on pension outlays is also expected to grow to 1.8 percent of GDP (2017:

FIGURE 18

The fiscal deficit is expected to increase to 3.7 percent in 2018...

Federal Government Overall Balance, Percentage of GDP

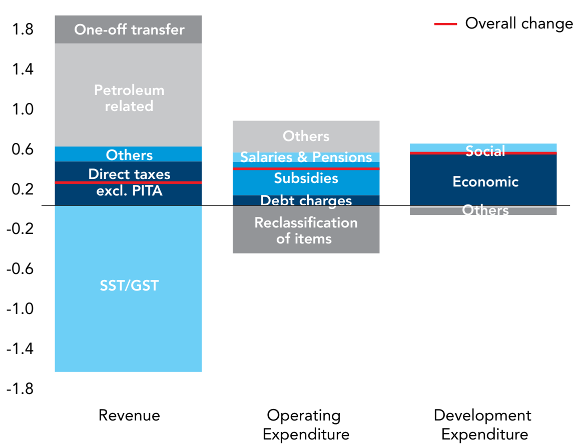


Source: MOF

FIGURE 19

...amid lower consumption-based tax revenues and a higher fuel subsidy allocation

Change in Federal Government Revenue and Expenditure between 2017 and 2018e, Percentage of GDP



Source: World Bank staff calculations based on MOF data

BOX 3

What are the key takeaways from the *Pakatan Harapan* government's inaugural budget?

Budget 2019 is the government's first budget since it was elected in May 2018. The inaugural budget highlighted the government's realignment of priorities, with an increased emphasis on improving governance and ensuring a more equitable growth that benefits all Malaysians. This reaffirms similar messages delivered through the Mid-term Review of the 11th Malaysia Plan. In the context of decelerating global growth and an increasingly challenging global environment, the tabling of the budget also followed a number of announcements related to key policies in the preceding months. In particular, the government signaled its intention to reintroduce the SST following the removal of the GST and to increase the level of disclosure regarding the stock of government liabilities and unpaid tax refunds. In this budget, the challenge for the government was to achieve a careful balance between maintaining fiscal prudence and ensuring adequate fiscal buffers, while safeguarding growth and improving the welfare of lower income groups.

In the formulation of the budget, the government focused on three main pillars: (i) implementing institutional reforms; (ii) preserving socio-economic well-being; and (iii) fostering an entrepreneurial economy. The budget outlines 12 key strategies to achieve these goals. To facilitate institutional reforms, the government plans to table the new Government Procurement Act in 2019 and the Fiscal Responsibility Act by 2021, and to establish a debt management office. The government has also introduced several new revenue measures, such as taxation on imported services by foreign service providers. Underscoring its commitment to improving the socio-economic status of all Malaysians, particularly the B40 group, the government announced the introduction of a more targeted BSH cash transfer program, and a targeted fuel subsidy mechanism. The government is also engaging with relevant stakeholders to develop peer-to-peer home financing exchange platforms, serving as an alternative source of financing for first-time homebuyers. To facilitate the emergence of a more entrepreneurial ecosystem, the government announced the introduction of several financing incentives and measures to support the digital economy, including the allocation of funds totaling RM1 billion to implement the National Fiberization and Connectivity Plan in 2019.

The Ministry of Education and the Ministry of Health received the largest funding allocations under the budget, accounting for 34.5 percent and 12.8 percent of the total respectively. Some of the funds allocated to the education sector will be used to improve school infrastructure and to upgrade facilities in universities and training institutions. Similarly, some of the funding allocations for the health sector are to be used to build, maintain, and upgrade healthcare facilities and to procure medical equipment.

In the budget, the government reiterated its commitment to welcome productive investments and to promote greater competition in the economy. While acknowledging that GLICs and GLCs play an important role in the economy, the government also recognized that in a number of areas, the sheer scale of state-owned enterprise activities has caused distortions to economic activity and a stifling of competition, resulting in increased costs for consumers. In a recent high-level statement, the government stated that: "It is not the business of government to be in business." Going forward, the government will review the role and functions of publicly-owned entities to focus its expenditure and investments on specific areas in which the private sector is unable to meet the needs of the public.

1.7 percent), while expenditure on debt service charges is forecast to reach 2.2 percent (2017: 2.1 percent). These increases are in line with an expanded pensioner base and a higher fiscal deficit. The larger expenses in these areas are expected to be partially offset by a reclassification of several development expenditure items, amounting to 0.5 percent of GDP, from operating outlays to development expenses.

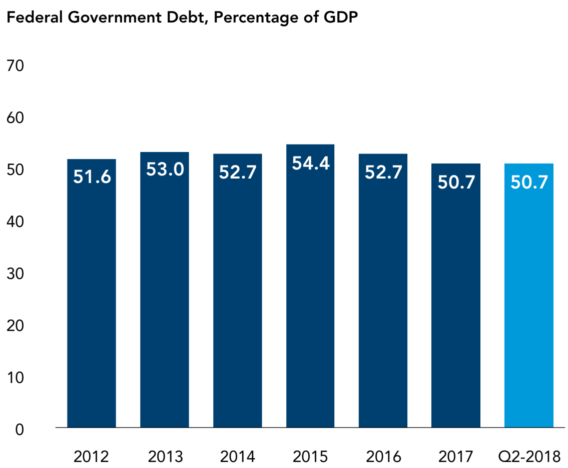
In 2018, the government's development expenditure is estimated to increase to 3.8 percent of GDP (2017: 3.3 percent), reflecting the inclusion of several expenses previously classified as operating expenditure. These reclassified expenses mostly relate to public transportation infrastructure developments, contributing to a noticeable upward revision of the economic development expenditure to 2.3 percent of GDP during the year (2017: 1.8 percent). Social expenditure, which accounts for about a quarter of the total development spending, is projected to expand slightly in 2018 to 1.0 percent of GDP (2017: 0.9 percent), with marginal growth expected across education, health and housing sectors. Despite the overall increase, the level of development expenditure in proportion to GDP has remained relatively low compared to the average level of 4.6 percent recorded in the period from 2008 to 2017.

As part of its efforts to improve transparency, the government has adopted a new approach to the disclosure of its overall liabilities and commitments. With the new approach, the reporting of government liabilities now takes into account Federal Government debt, committed government guarantees and other obligations, including obligations associated with public-private partnerships (PPP). The inclusion of committed contingent liabilities will provide a more comprehensive picture of the longer-term implications of the government's obligations, consistent with the methodology for the IMF's Public Sector Debt Statistics.

Federal Government debt in proportion to GDP remained unchanged as of Q2 2018, at 50.7 percent (4Q 2017: 50.7 percent), with risks appearing manageable (see Figure 20). Ringgit-denominated papers constituted 97.1 percent of the Federal Government borrowing as of Q2 2018 (Q4 2017: 96.9 percent), limiting the risks arising from exchange rate fluctuations. The debt structure also continues to skew towards longer-tenured issuances, with the average time to maturity projected to increase to 7.6 years in 2018 (2017: 7.2 years), thus reducing rollover risks. As of Q2 2018, large domestic institutional holders continued to account for more than two-thirds of the total outstanding debt, providing underlying support for the government's borrowing requirements in the context of lower demand from foreign investors. The share of ringgit-denominated debt securities held by non-residents declined significantly throughout 2018, standing at 23.8 percent in Q2 2018 (Q4 2017: 28.0 percent).

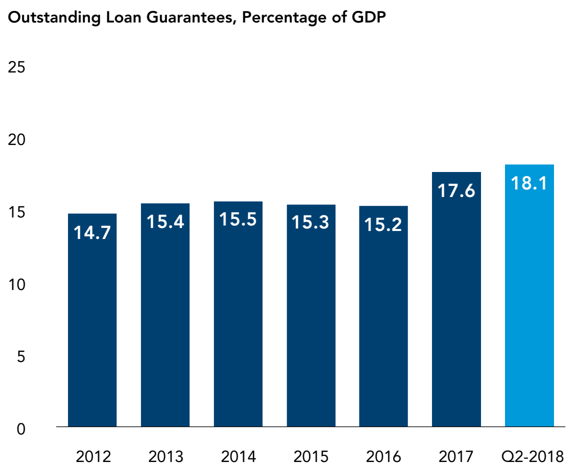
By end-June 2018, the value of debt guaranteed by the Federal Government had increased to 18.1

FIGURE 20
Federal Government debt as a share of GDP has remained stable...



Source: MOF

FIGURE 21
...but guaranteed debt has increased further



Source: MOF

percent of GDP (Q4 2017: 17.6 percent) (see Figure 21). Almost half of these outstanding loan guarantees were extended to facilitate the implementation of infrastructure investments by non-financial public corporations (NFPCs), while another one-fifth were provided to support the government's tertiary education and public servant home financing schemes. Meanwhile, by end-June 2018, the value of committed government guarantees stood at 8.2 percent of GDP. These committed guarantees include those for the provision of financial support in the form of coupons or profit payment at the early stage of project operations due to insufficient income, especially for rail operators such as the Mass Rapid Transit.

Meanwhile, the Federal Government's outstanding PPP commitments were revised down to 12.9 percent in Q2 2018 (Q4 2017: 19.2 percent), due to the cancellation and postponement of several large-scale transportation PPP projects during the period. Investments in the social sector, relating mainly to the construction of higher education and healthcare facilities, constitute 41 percent of the total government PPP commitments, followed by the general administration (including the construction of government buildings) and economic (building of transport terminals and maintenance of federal roads) sectors at 29 percent and 28 percent respectively.

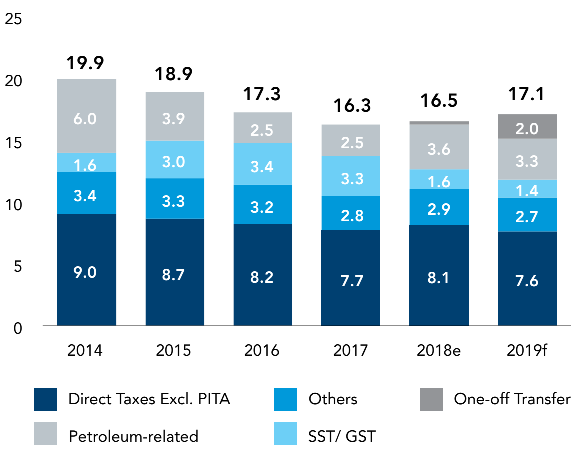
Near-term fiscal consolidation efforts will be primarily driven by expenditure rationalization

In 2019, Federal Government revenues are expected to increase to 17.1 percent of GDP (2018e: 16.5 percent) (see Figure 22). This increase is mainly attributed to the receipt of a special dividend transfer of RM30 billion (2.0 percent of GDP) from Petronas. The one-off dividend will be allocated towards the clearance of outstanding income tax and GST refunds accumulated over the recent years, totaling RM37 billion (2.4 percent of GDP). Total government expenditure is also projected to grow slightly, to 20.5 percent of GDP (2018e: 20.3 percent), due to the need to clear accumulated arrears of GST and income tax refunds (see Figure 23). Over the same period, government debt is expected to trend higher to 51.8 percent of

FIGURE 22

Federal Government revenue as a share of GDP is expected to increase in 2019 due to a special transfer from Petronas

Federal Government Revenue, Percentage of GDP

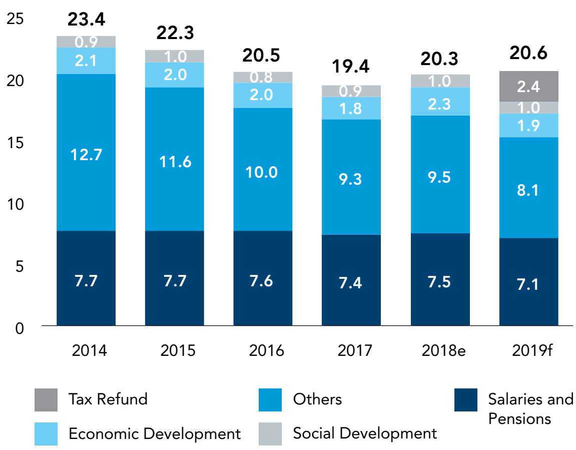


Source: World Bank staff calculations based on MOF data

FIGURE 23

Similarly, Government expenditure as a share GDP is projected to grow on account of a one-off tax refund payment

Federal Government Gross Expenditure, Percentage of GDP



Source: World Bank staff calculations based on MOF data

GDP, reflecting the increased costs of deficit financing and refinancing of matured government issuances. These projections assume a marginally higher real GDP growth rate of 4.9 percent and average crude oil prices in the range of US$ 60 to 70 per barrel in 2019.

Adjusting for the one-off dividend transfer from Petronas, government revenue in proportion to GDP is expected to decline in 2019. Subtracting the one-off dividend transfer from Petronas, the value of Federal Government revenue in proportion to GDP is projected to decline to 15.1 percent in 2019 (2018e: 16.2 percent after adjusting for the special contribution from KWAP) (see Figure 24). The decline mainly reflects projected decreases in revenue contributions from corporate and personal income taxes, consumption-based taxes and dividend payments from the state-owned entities, which are expected to stand at 6.9, 1.4 and 1.9 percent of GDP respectively (2018e: 7.4, 1.6 and 2.3 percent). Following the replacement of the GST with the SST, the share of consumption-based taxes is expected to decline to 9.4 percent of the adjusted Government revenue (2017: 20.1 percent), while petroleum-related income is forecast to increase to 22.0 percent, up from 15.7 percent in 2017. Meanwhile, in 2019, government revenue at the state and local levels is projected to be lower, at 2.8 percent of GDP (2018e: 2.8 percent), compared to its level in 2017 (3.1 percent).

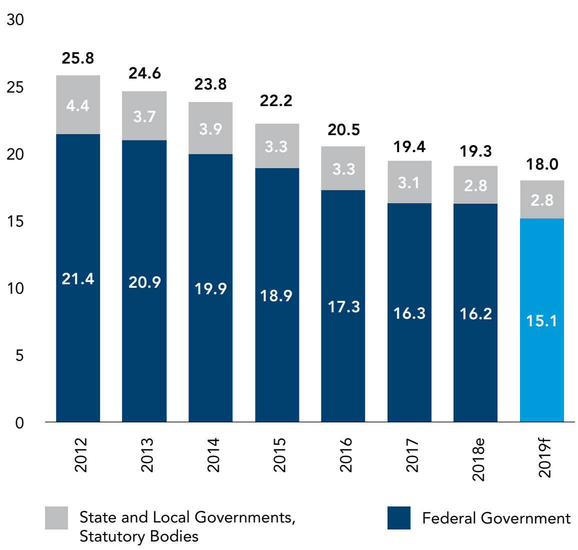
Malaysia is projected to record one of the lowest levels of fiscal revenue in proportion to GDP in 2019, well below the average for middle-income and advanced economies

Over the longer term, general government revenue in proportion to GDP has declined steadily since reaching a peak of 25.8 percent of GDP in 2012 (see Figure 24). In 2019, the adjusted general government revenue[7] is expected to stand at 18.0 percent of GDP, almost one-third lower than its level in 2012, with marked reductions observed across oil-based incomes, non-oil direct and indirect taxes over a span of seven years. Relative to international comparators, Malaysia is projected to record one of the lowest levels of fiscal

FIGURE 24

Government revenue[7] has been on a steady downward trend since 2012...

General Government Revenue[7], Percentage of GDP

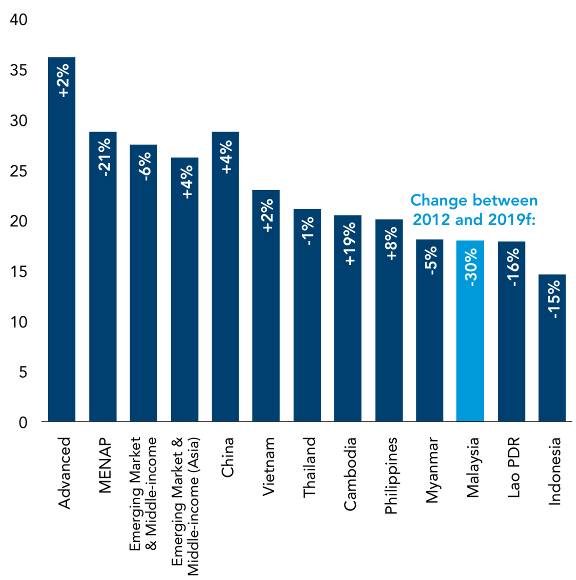


Source: World Bank staff calculations based on MOF data

FIGURE 25

...reaching a relatively low level by international comparison

General Government Revenue[7], 2019f, Percentage of GDP



Source: World Bank staff calculations based on IMF and MOF data

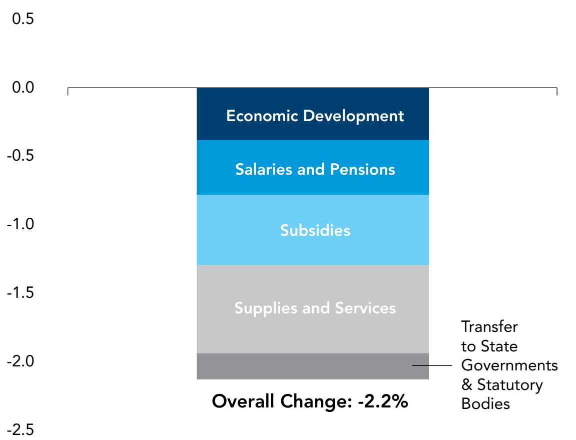
[7] Excludes the one-off contributions expected from KWAP in 2018 and Petronas in 2019.

revenue in proportion to GDP in 2019, well below the average figures for EMDEs (27.5 percent of GDP) and advanced economies (36.2 percent of GDP) (see Figure 25). Malaysia has also recorded one of the steepest revenue declines over recent years. This limits the government's scope to respond to future shocks and to provide the public services that Malaysia's expanding middle class will increasingly expect from the state.

In the near term, the government will strive to achieve fiscal consolidation through rigorous rationalization of expenditure, with the adjusted government expenditure[8] set to decline considerably to 18.1 percent of GDP in 2019 (2018e: 20.3 percent). Downward adjustments to expenditure are expected to be broad-based across most major components of operating and economic development outlays (see Figure 26). In particular, current government spending on subsidies and on supplies and services are expected to be cut to 1.5 and 1.9 percent of GDP respectively (2018e: 2 and 2.6 percent). These reductions will account for about half of the total gross expenditure cuts, with the cuts reflecting the government's intention to move towards more targeted programs for petrol subsidies and social assistance, and to reclassify some development-related supplies and services spending as development expenditure rather than operating expenses. Noticeable spending reductions are also expected across economic development outlays (from 2.3 percent in 2018 to 1.9 percent in 2019), civil servant salaries (5.7 percent to 5.4 percent) and transfers to state governments and statutory bodies (1.5 percent to 1.3 percent). These cuts notwithstanding, expenditure on civil service salaries and pensions has continued to dominate public spending, with the share projected to increase to 39.1 percent (2018e: 36.9 percent) of the total by 2019 (see Figure 27).

FIGURE 26
Broad-based declines in Federal Government operating and economic development outlays are expected in 2019

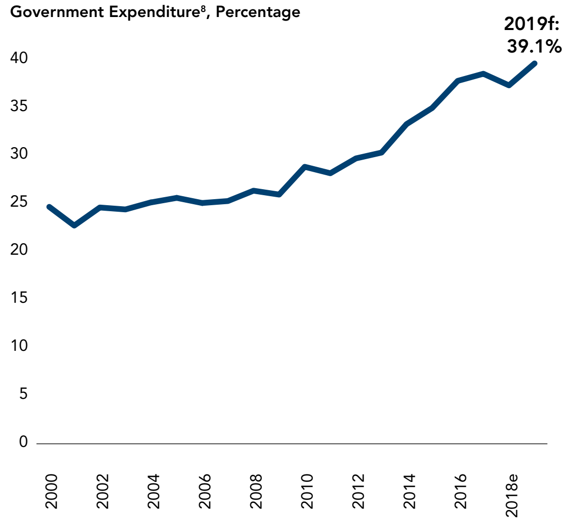
Change in Federal Government Expenditure[8] between 2018e and 2019f, Percentage of GDP



Source: World Bank staff calculations based on MOF data

FIGURE 27
The civil service wage bill continues to dominate Malaysia's public spending, with its share projected to increase further next year

Share of Civil Service Salaries and Pensions to Federal Government Expenditure[8], Percentage



Source: World Bank staff calculations based on MOF data

[8] Excludes the one-off payment of outstanding income tax and GST refunds in 2019.

TABLE 3
Federal Government financial position

	RM billion				Percentage of GDP (current prices)			
	2016	2017	2018e	2019f	2016	2017	2018e	2019f
Revenue	**212.4**	**220.4**	**236.5**	**261.8**	**17.3**	**16.3**	**16.5**	**17.1**
Direct Taxes	109.6	116.0	113.5	135.1	8.9	8.6	9.3	8.8
Companies Income Tax	63.6	64.5	70.5	70.2	5.2	4.8	4.9	4.6
Petroleum Income Tax	8.4	11.8	16.8	18.1	0.7	0.9	1.2	1.2
Individual income tax	27.6	28.9	34.8	35.0	2.2	2.1	2.4	2.3
Others	10.0	10.9	11.3	11.8	0.8	0.8	0.8	0.8
Indirect Taxes	59.7	61.6	41.2	41.1	4.9	4.6	2.9	2.7
Goods and Services Tax	41.4	44.4	23.1	22.0	3.4	3.3	1.6	1.4
Excise Duties	11.7	10.1	10.7	11.4	1.0	0.7	0.7	0.7
Others	6.6	7.2	7.4	7.7	0.5	0.5	0.5	0.5
Non-Tax Revenue	40.0	39.5	57.9	81.6	3.3	2.9	4.0	5.3
Non-Revenue Receipts	3.1	3.2	3.8	4.0	0.3	0.2	0.3	0.3
Operating Expenditure	**210.2**	**217.7**	**235.5**	**259.9**	**17.1**	**16.1**	**16.4**	**17.0**
Emoluments	73.1	77.0	81.3	82.0	5.9	5.7	5.7	5.4
Retirement Charges	21.0	22.8	25.8	26.6	1.7	1.7	1.8	1.7
Debt Service Charges	26.5	27.9	30.9	33.0	2.2	2.1	2.2	2.2
Supplies and Services	30.1	34.7	36.5	29.1	2.4	2.6	2.6	1.9
Subsidies	24.7	22.4	28.1	22.3	2.0	1.7	2.0	1.5
Others	34.8	32.9	32.9	66.9	2.8	2.4	2.3	4.4
Gross Development Expenditure	**42.0**	**44.9**	**54.9**	**54.7**	**3.4**	**3.3**	**3.8**	**3.6**
Economic Services	25.1	24.2	33.0	29.2	2.0	1.8	2.3	1.9
Defense and Security	4.8	5.3	5.3	7.1	0.4	0.4	0.4	0.5
Social Services	10.4	12.4	14.5	15.2	0.9	0.9	1.0	1.0
General Administration	1.6	2.9	2.0	3.2	0.1	0.2	0.1	0.2
Less: Loan Recoveries	1.3	1.9	0.6	0.7	0.1	0.1	0.0	0.0
Net Development Expenditure	40.6	43.0	54.3	54.0	3.3	3.2	3.8	3.5
Overall Surplus / Deficits (-)	-38.4	-40.3	-53.3	-52.1	-3.1	-3.0	-3.7	-3.4

Source: World Bank staff calculations based on MOF data

Economic outlook

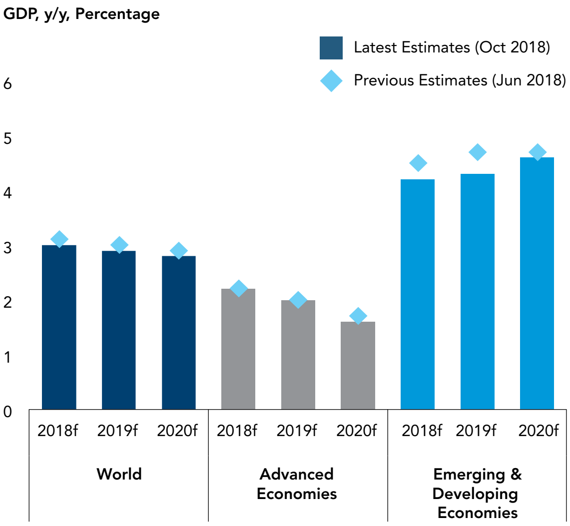
Growth in East Asia is expected to moderate slightly over the near term

Global growth is expected to slow over the next two years, reflecting mainly a gradual slowdown in advanced economies. In 2018, the growth rate for advanced economies is projected to moderate slightly to 2.2 percent (see Figure 28). In 2019-20, it is expected to slow further to an average of 1.8 percent, as economic slack diminishes, monetary-policy accommodation is gradually unwound and the effect of US fiscal expansion wanes. Over the longer-term forecast horizon, advanced economies are expected to move closer to their relatively modest long-run potential growth rates, which remain constrained by aging populations and subdued productivity growth. Similarly, EMDE growth is expected to increase only slightly over 2019-2020, reflecting a projected slowdown in advanced-economy growth, easing global trade and investment activity, tightening financing conditions and maturing cyclical recovery in commodity exporters. Their longer-term growth drivers are also expected to weaken, weighed down by maturing demographic and productivity trends.

In 2019-2020, the growth rate for developing EAP is expected to moderate slightly but to remain generally solid across the region (see Figure 29). In 2018, China's rate is projected to slow from 6.5 percent to an average of 6.2 percent over the next two years as it continues to rebalance its economy, with this forecast assuming that the negative impact of higher US tariffs on Chinese exports will be offset by accommodative domestic policy responses. Meanwhile, economic activity in the developing ASEAN countries is expected to remain generally robust, with these countries recording an estimated growth of 5.4 percent in 2018 and 5.3 percent in 2019-2020. Robust private consumption will remain the main driver of growth among the ASEAN-5 economies, partially offsetting the effects from a weaker outlook for external demand.

FIGURE 28

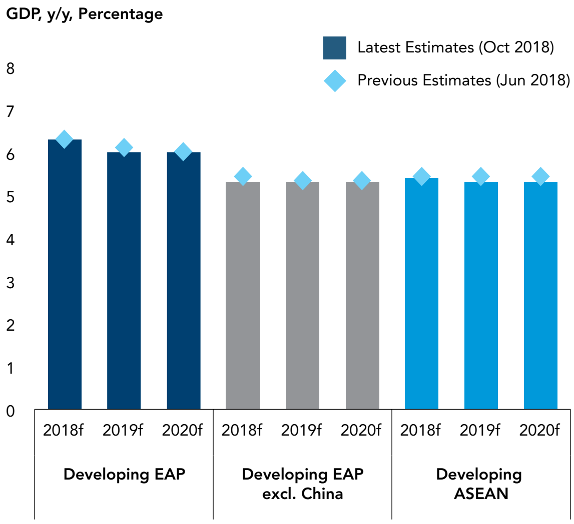
Global economic growth is expected to moderate over the next two years



Source: World Bank staff projections

FIGURE 29

Economic activity in developing EAP is expected to ease but remain solid across the region



Source: World Bank staff projections

Malaysia's economy is expected to grow at a more moderate pace

Malaysia's economy is expected to grow at a more moderate pace in the near term, with the rate projected to reach 4.7 percent in 2019. Private sector consumption will continue to be the main driver of the economy, although growth is projected to moderate to 6.4 percent in 2019 (2018f: 7.2 percent), as consumers have frontloaded their spending during the zero-rated GST period and will factor in the effect of the SST in their spending. Nevertheless, household spending will be buoyed by stable labor market conditions, income-supporting measures including the BSH, and the one-time repayment of tax refunds. In addition, targeted fuel and electricity fuel subsidies for the B40 households could help sustain disposable incomes among this group. In the public sector, the government's expenditure rationalization measures are expected to weigh down on public consumption, which is projected to grow at 0.7 percent (2018f: 1.2 percent).

In 2019, gross fixed capital formation growth is expected to increase slightly to reach 2.3 percent (2018f: 2.1 percent). The private investment growth rate is expected to be sustained at 3.2 percent (2018f: 3.3 percent), due to ongoing expansion in key sectors such as manufacturing and a gradual recovery in the commodity-related sectors. However, growing uncertainty regarding the external environment could affect investment decisions, particularly among export-oriented firms. Meanwhile, public corporations' capital expenditure is expected to remain subdued due to the government's ongoing expenditure rationalization program, resulting in the scaling down of several infrastructure-related projects.

The external sector may be negatively affected by heightened uncertainty surrounding the global environment, particularly the possible escalation of trade tensions between the US and China. In addition, export growth would likely be affected by a slowdown in the global E&E cycle. This is expected to be partially offset by a recovery in commodity exports and relatively sustained demand from regional trading partners. In 2019, Malaysia's export growth is projected to remain subdued at 3.0 percent (2018f: 2.8 percent). Growth in imports is likely to decelerate, as a less supportive global environment would impact the imports of intermediate and re-export goods, with a decline in GFCF growth potentially resulting in a slower growth of capital imports. In the context of a more challenging external environment, the current account

TABLE 4
GDP growth and contribution to growth

	Annual Growth, y/y, Percentage				Contribution to Annual GDP Growth (Percentage Point)			
	2017	2018f	2019f	2020f	2017	2018f	2019f	2020f
GDP	5.9	4.7	4.7	4.6				
Domestic Demand (including stocks)	6.5	6.0	5.3	5.1	6.0	4.4	4.1	4.0
Final Consumption	6.7	6.0	5.5	5.2	4.4	4.0	3.6	3.5
Private Sector	7.0	7.2	6.4	6.2	3.7	3.8	3.5	3.4
Public Sector	5.4	1.2	0.7	0.4	0.7	0.2	0.1	0.04
Gross Fixed Capital Formation	6.2	2.1	2.3	2.2	1.6	0.5	0.5	0.5
Change in Stocks					0.1	0.0	0.0	0.0
External Demand								
Exports of Goods & Services	9.4	2.8	3.0	2.9	6.6	2.0	2.6	2.5
Imports of Goods & Services	10.9	2.7	2.6	2.5	-6.8	-1.8	-2.0	-1.9

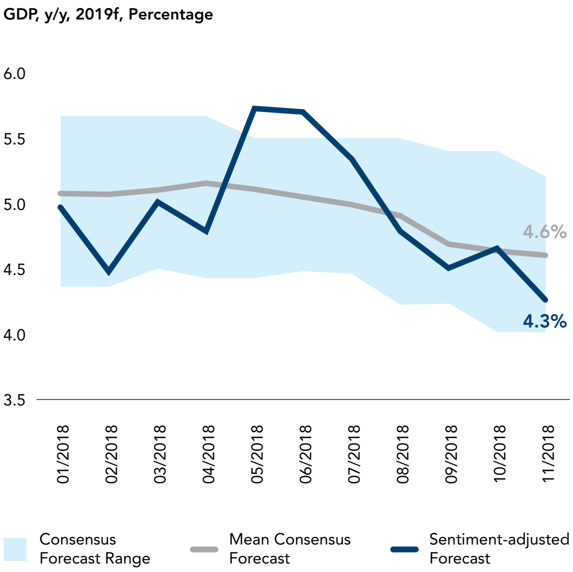
Source: World Bank staff calculations and projections surplus is projected to narrow to around 2.5 percent of GDP in 2019, with a trade surplus helping to offset the persistent deficit in services and income accounts.

News-based measures of economic sentiment point towards a lower forecast of GDP growth compared to those of professional forecasters. The complementary news-based measures of economic sentiment[9] indicate a less optimistic sentiment regarding Malaysia's near-term macroeconomic prospects during 2H 2018, with the sentiment-adjusted forecast of Malaysia's GDP growth in 2019 tracking below the consensus forecast of 4.6 percent in November (see Figure 30). Below-trend optimism was notable across the economic, corporate and industrial categories, while the public sentiment associated with the financial markets and political clusters has not deviated significantly from its historical averages (see Figure 31).

In 2019, Malaysia's headline inflation rate is expected to increase, due to higher domestic fuel prices following the implementation of the float pricing mechanism for fuel beginning Q2 2019. In addition, the impact of the reintroduction of the SST would also be reflected in higher headline inflation, although its effect is expected to taper towards year-end. The underlying inflation rate, which removes the impact of the consumption tax, is expected to remain stable, given minimal demand pressures in the economy.

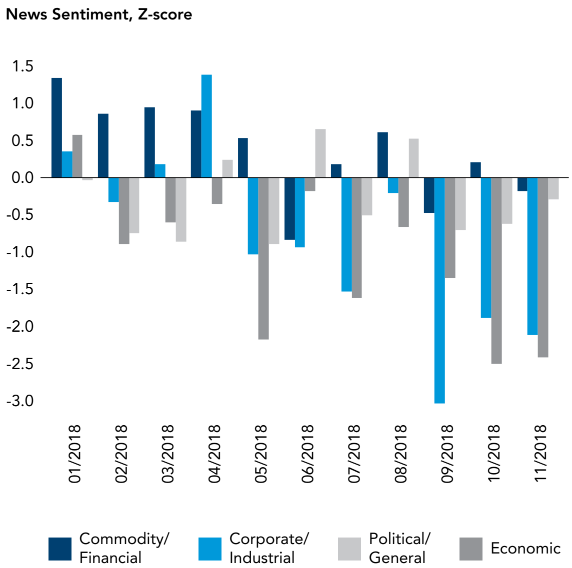
At a more granular level, the most recent World Bank estimates indicate that the poverty rate in Malaysia is expected to continue to decline. Using the World Bank's upper-middle income poverty line of US$5.50/day (2011 PPP), the poverty headcount ratio is projected to decline to 1.2 percent by 2020. The government continues to emphasize a commitment to improving the socio-economic status of lower income groups. When the Budget 2019 was announced, it contained a number of measures intended to benefit the B40 and M40 groups. These include the recently reviewed and revised cash transfer program, BSH, an additional increase of the minimum wage to RM1,100, and the introduction of a nationwide health screening program and health insurance scheme for the B40.

FIGURE 30
Sentiment-based forecast of GDP growth in 2019 trended below the consensus forecast in November...



Source: World Bank staff projections

FIGURE 31
...reflecting mainly below-trend optimism in the economic and corporate clusters



Source: World Bank staff calculations

[9] The news-based sentiment index is derived by the staff of the World Bank through an analysis of the proportion of positive words ("gain", "improve", "agreement", etc.) relative to the proportion of negative words ("concern", "fear", "decline", etc.) present in a vast collection of news articles on Malaysia's economy. Information derived from media reports has two main advantages compared to official statistics. First, measurements of economic conditions can be calculated in real-time, at a daily frequency. Second, this information enables the measurement of economic forces that might not be easily captured by traditional data sources, providing complementary insight into factors such as the collective sentiment regarding economic prospects. A recent study based on historical data in 25 countries between 1991 and 2017 suggests that including news-based measures of sentiment reduces the forecast errors of GDP growth by 12 percent on average relative to the consensus forecast.

BOX 4

What does the CP-TPP mean for Malaysia?

The Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CP-TPP) is a free trade agreement negotiated by eleven countries, including Malaysia, that will come into force for six countries in December 2018. The CP-TPP was established following the withdrawal of the United States from the original Trans-Pacific Partnership, after which the remaining countries continued negotiations and renamed the pact, which became the CP-TPP. The CP-TPP covers about 14 per cent of global GDP and 16 percent of global trade, with the total population of the participating nations coming to about 500 million people. The text of the CP-TPP is broadly the same as the TPP, with some changes to provisions covering intellectual property, labor and environment rules, and investor-state dispute settlement.

The CP-TPP is expected to have positive effects on trade and income for participating countries, although the magnitude of the impact is expected to be smaller than it would have been under the TPP. World Bank studies have estimated the economic and distributional impacts of the CP-TPP for member and non-member countries using a global dynamic computable general equilibrium model combined with a microsimulation tool based on household surveys (Maliszewska et al. 2018). The impact of the CP-TPP is compared to a baseline scenario that assumes no implementation of the CP-TPP. By 2030, or 12 years after the implementation of the agreement commences, under conservative assumptions, CP-TPP members' income is estimated to be on average 0.87 percent higher than in the baseline, with small average losses for non-members of 0.03 percent.

Malaysia, which has yet to ratify the CP-TPP, is expected to reap significant net gains from the agreement, with an estimated net income gain of 1.0 percent by 2030. For developing countries, the estimated income gains range between 0.13 percent for Mexico to 2.8 percent for Vietnam. Non-members are slightly worse off under the CP-TPP due to preference erosion and trade diversion away from CP-TPP markets. In an alternative scenario that allows for productivity gains resulting from openness, the average gains for CP-TPP members range from 0.6 percent for Mexico to 4.4 percent for Vietnam by 2030, with Malaysia's gains estimated to reach 1.3 percent. The gains are determined mainly by two factors: (i) a combination of assumed reduction in tariffs and non-tariff measures resulting from the CP-TPP; and (ii) the importance of CP-TPP members as trading partners.

Reduced trade barriers would stimulate Malaysia's trade with CP-TPP partners. Exports by CP-TPP members are projected to be on average 2.7 percent higher in 2030, with Malaysia's exports projected to expand by about 5 percent and imports to expand by about 6 percent. Trade flows of non-members are projected to decline on average by 0.1 percent due to trade diversion resulting from the preference erosion. Even the largest expected decline of exports relative to the baseline would not exceed 0.4 percent.

Malaysia, which has yet to ratify the CP-TPP, is expected to reap significant net gains from the agreement, with an estimated net income gain of 1.0 percent by 2030

It is expected that output would expand in most manufacturing and services subsectors. In the case of Malaysia, the subsectors likely to experience the most significant expansion of output include food, beverages, and tobacco; chemicals, rubber and plastics; and machinery and equipment. Most services subsectors would also expand faster than in the baseline. Increases in output are mostly driven by higher exports. By 2030, Malaysia's export flows would be US$ 24 billion higher than the baseline. By contrast, without improvements in competitiveness of subsectors such as agriculture, natural resources and selected services subsectors, their exports to East Asian trading partners, including China, would likely decline.

Risks to Malaysia's outlook are increasingly weighed to the downside

Given Malaysia's high degree of integration with the global economy through financial and trade linkages, rising uncertainty in the external environment poses downside risks to the economy in the near term. A key source of risk relates to the escalation in protectionist tendencies and trade tensions between the US and China. While there may be short-term opportunities for Malaysia as a result of trade and investment diversion away from China, escalating tensions may translate into a more general decline in global investment confidence. In turn, this would have disproportionate negative consequences for highly open economies such as Malaysia, which have a high level of global value-chain integration (see Box 5). Similarly, on the financial side, a faster-than-expected pace of monetary normalization in advanced economies could result in changes to investor appetite for EMDE assets and heighten financial market volatility, portfolio outflows and additional pressures on exchange rates in EMDEs.

The government's increasing dependence on oil-related revenue could potentially exert constraints on fiscal policy space in the event of a major oil price or supply shock. In its inaugural budget, the government has introduced a number of new revenue measures, including taxes on foreign service providers and, on the expenditure side, a more targeted fuel subsidy scheme that could alleviate some fiscal strains. However, the narrowing of the government's revenue base and its greater reliance on less stable direct taxation and oil-related revenue could constrain the flexibility of fiscal adjustment against future macroeconomic shocks. Slower growth, particularly in the context of a deceleration in demand for Malaysia's exports as global growth slows, would make fiscal adjustment more challenging.

Other near-term risks relate to the relatively high levels of private and public-sector debt. In the public sector, as part of its transparency measures, the government has disclosed the value of committed government guarantees (which have the possibility of being assumed by the government), which amounts to 8.2 percent of GDP as of Q2 2018. The accumulation of the government debt and these committed guarantees implies that the government's total liabilities will remain elevated into the near-term future. While the stock of public debt appears manageable, an elevated debt level means that there is limited space for a counter-cyclical fiscal response if Malaysia's economy experiences a major shock. In the private sector, the relatively high level of household debt in the context of persistent property market excesses remains a source of risk to macro-financial stability, as well as acting as a constraint on household spending, a situation which warrants close monitoring.

BOX 5

How will the growing US-China trade tensions affect Malaysia?

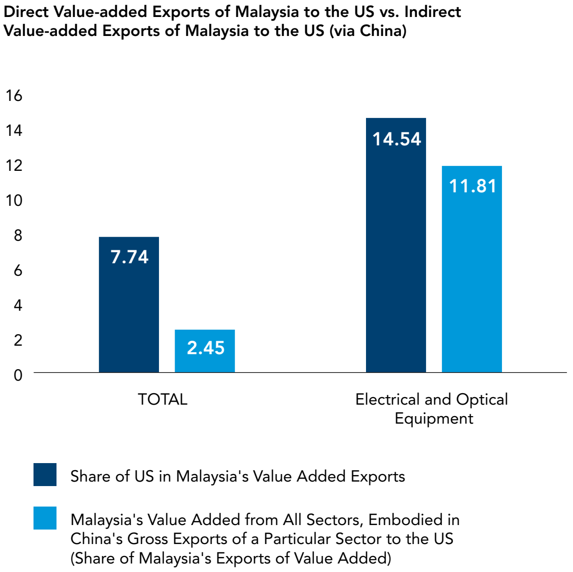
In recent months, there has been an escalation in trade tensions between the US and China following the imposition of a series of tariffs by both parties on bilateral trade. Tariffs of 25 percent were imposed on US$34 billion of two-way trade in July 2018, followed by tariffs of 25 percent on a further US$16 billion of trade in August 2018. Then, the US imposed a further 10 percent tariff on US$200 billion of Chinese imports in September, with China imposing tariffs ranging from 5 to 10 percent on a further US$60 billion of US imports at the same time. Further increases have been threatened, including a 25 percent tariff on all products traded between the US and China to be implemented in January 2019, although a 90-day pause was later announced at the G20 Summit in November 2018.

Malaysia has one of the world's most open economies and is deeply integrated into global value chains involving both China and the US, so naturally it is affected by these measures. However, it is important to distinguish between Malaysia's direct exports to the US, which are not directly affected by the tariffs, and indirect exports to the US via value chains that are routed through China and therefore are affected by the tariffs. A clear majority of Malaysia's total export value added is routed directly to the US with 7.74 percent of Malaysia's value-added exports direct to the US, compared to just 2.45 percent of value-added exports to the US embodied in China's gross exports (see Figure 32). However, Malaysia's indirect exports of electrical and optical equipment are more vulnerable, where the ratio between direct and indirect exports is more balanced.

Early indications suggest that Malaysia is gaining market share in the US at the expense of China, particularly in electrical equipment. Chinese exports affected by the additional tariffs have already lost sizeable US market share, with Malaysia gaining an additional 1.5 percentage points of market share for US imports of electrical equipment during July-September 2018 compared to the same period in 2017 (see Figure 33). Smaller gains have also been seen in plastic and rubber products, and in optical and photographic equipment.

FIGURE 32

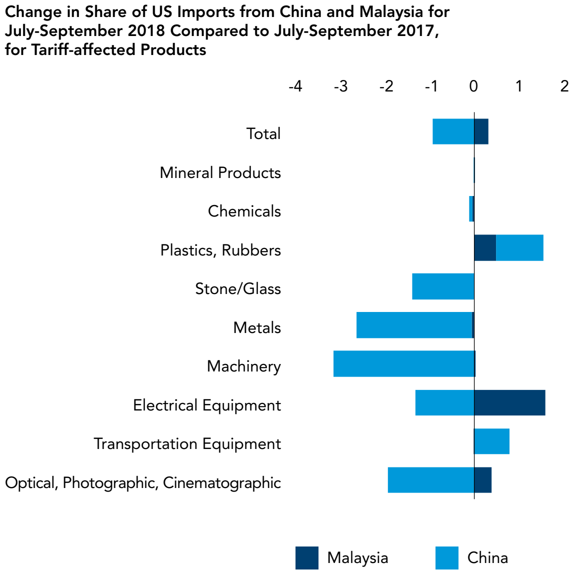
For Malaysia, most exports to the US are direct, but a significant share of E&E exports to the US are routed via China-centric value chains



Source: World Bank staff calculations based on OECD TiVA data

FIGURE 33

Early indications show that Malaysia is gaining market share in the US at China's expense...



Source: World Bank staff calculations based on US Census data

World Bank modelling scenarios point to significant risks, if the trade tensions escalate further and trigger a reduction in investor confidence. Using a global trade computable general equilibrium model, World Bank staff estimated the impact of trade tensions on Malaysia exports and income according to three different scenarios:

- **Scenario 1:** China-US tariff increases on bilateral trade as of September 2018 covering US$253 billion of US imports from China and US$113 billion of Chinese imports from the US;
- **Scenario 2:** a 25 percent surcharge on all products traded between the US and China; and
- **Scenario 3:** a 25 percent tariff on all products traded between the US and China, plus a decline in investor confidence, resulting in a 0.5 percentage points drop in the investment to GDP ratio at a global level.

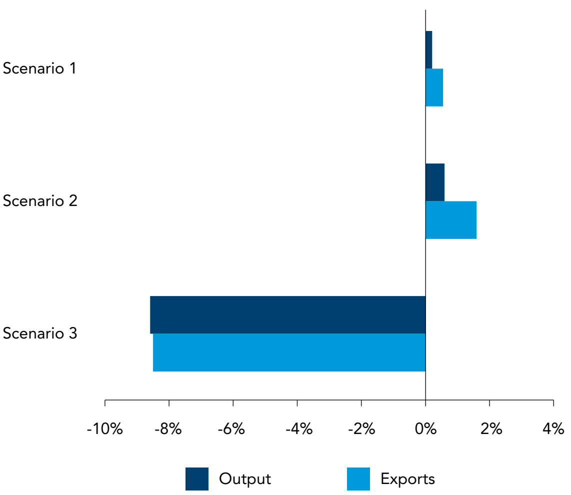
Under the first and second scenarios, Malaysia would be expected to achieve some net gains in terms of exports and income. In fact, the evidence so far in terms of the direction of changes in trade and sectoral impact appears to be consistent with the first scenario. The benefits hinge on the extent to which Malaysian products are close substitutes to Chinese exports to the US and on how quickly Malaysian exporters can scale up output for exports.

However, should tensions escalate and result in a slowdown in investment and economic activity, the consequences would be severely negative for Malaysia (see Figure 34 and Figure 35). The model results suggest that in the third scenario of full tariffs and a decline in the investment to GDP ratio, the negative impact on Malaysia's export and imports would heavily outweigh any short-term gains from trade diversion as a result of tariffs alone.

In order to mitigate the risks associated with rising trade tensions, other countries – including Malaysia – should redouble their commitment to an open, rules-based international trade and investment system. This system is critical to the efficient allocation of production and the diffusion of technology, having served ASEAN countries well for many years. Deepening of regional integration, through mechanisms such as the CP-TPP and the Regional Comprehensive Economic Partnership (RCEP), would also help to bolster opportunities. Deeper reform in areas that have tended to see limited coverage under preferential trade agreements, such as public procurement, subsidies, state trading companies, non-tariff measures and treatment of services trade would play a role in enhancing competition and promoting the deepening of global value chains.

FIGURE 34
...but if the trade tensions spill over to affect investor confidence, Malaysia would be severely affected...

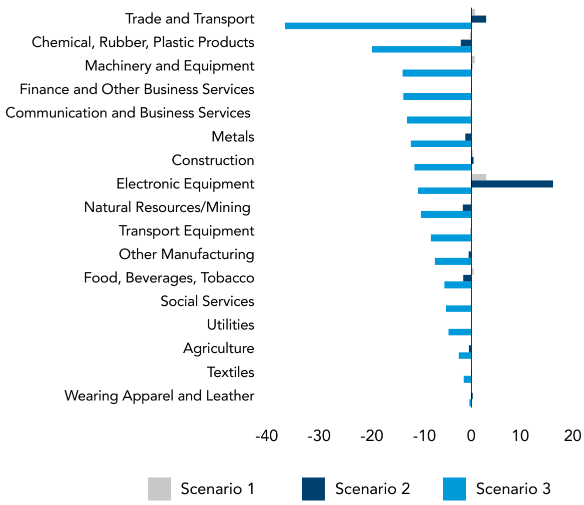
Change in Share of US Imports from China and Malaysia for July-September 2018 Compared to July-September 2017, for Products Affected by Increased Tariffs



Source: World Bank staff calculations using LINKAGE model and GTAP dataset

FIGURE 35
...with exports expected to fall across all major product categories under the scenario of an investment slowdown

Export Deviations from the Baseline for Malaysia in US$ Billions, Three Scenarios



Source: World Bank staff calculations using LINKAGE model and GTAP dataset

A more uncertain external environment places a higher premium on reforms to boost resilience

Malaysia has the opportunity to undertake bold structural reforms that would strengthen the foundations for more sustainable and inclusive growth. Medium-term plans, as outlined in the Mid-term Review of the 11th Malaysia Plan (see Box 6), establish a set of new goals, the achievement of which would serve to strengthen governance and transparency; to improve public sector efficiency; and to foster equitable growth. Such reforms will pay dividends over time, with the potential to improve not just the quantity of economic growth, but, just as importantly, the quality of this growth. In the short term, Malaysia will need to strike a careful balance between safeguarding growth, sustaining private sector confidence, promoting fiscal responsibility, managing debt sustainability and protecting the vulnerable.

Near-term economic growth will be more dependent on boosting private investment, with a more challenging external environment reducing the opportunities for export-led growth, and with reduced fiscal space resulting in a more limited scope for public investment-led expansion. Malaysia already has one of the world's lowest cost business environments, as indicated in the World Bank's Doing Business report, with the latest rankings placing Malaysia 15th out of 190 economies. However, Malaysia continues to experience gaps in broader measures of competitiveness, with major weaknesses in terms of skills, productivity and human capital (see part two of this edition of the Malaysia Economic Monitor). High-level policy statements on leveling the playing field between state enterprises at the private sector are

welcome, indicating a commitment to boosting investor confidence and to promoting healthy competition. While Malaysia's GLICs and GLCs form an important part of the economy, given their market dominance, some of their activities have distorted economic activity and stifled competition, resulting in increased costs for consumers. With economic growth and job creation in the coming years expected to be more dependent on the private sector, high-level support for the idea that the public sector should cede space to the private sector is an important first step. Similarly, a sustained commitment to multilateral trading though agreements such as the CP-TPP and the RCEP (see Box 4) would both send strong positive signals to investors and buttress market access at a time when trade is under pressure.

Medium-term plans to strengthen governance and increase transparency will pay dividends over time

While immediate fiscal consolidation efforts will be implemented mainly through expenditure restraint, over the medium-term it will also be necessary to boost efforts to mobilize revenues in order to expand fiscal space and to sustainably finance the needs of Malaysia's increasingly middle-class society. As Malaysia's average income and societal expectations continue to grow, raising adequate resources to finance the needs of its expanding middle-class (including through the improved provision of basic public services, growth-enhancing investments and social protection systems) will become an increasingly important priority. These needs notwithstanding, government revenues have declined steadily over the past several years, and is expected to narrow further in the near future, with the value of these revenues remaining relatively low in proportion to GDP compared to countries at similar levels of economic development. Along with the Malaysian government's increased dependence on oil-related incomes, the trend towards declining revenues will increasingly constrain its underlying capacity to implement flexible fiscal policy to address economic fluctuations, to sustain the provision of vital public services, and to facilitate redistribution through taxes and transfers. Addressing this structural challenge will require a recalibration of the fiscal consolidation mix, with greater focus on implementing revenue-enhancing reforms over a multi-year period. At the same time, the pace and magnitude of these adjustments should be carefully calibrated to manage associated risks to economic activity in the short term.

Reforms efforts on the revenue front should focus on broadening the tax base, reducing unproductive tax expenditures via deductions and incentives, and strengthening overall tax administration and compliance. In this regard, the government has taken important steps by establishing the Committee of Tax Reform to review the overall tax system and collection, and to streamline existing investment incentives. It has also taken the decision to include imported services within the scope of the SST, particularly those related to the digital economy, and to raise taxes on property gains. These are timely initiatives that are well-aligned with emerging international practice. However, in the coming years, more can be done to diversify fiscal revenues. This may include expanding the collections of direct taxes (such as personal income and wealth taxes) to raise additional fiscal resources and to increase overall tax progressivity, as has been practiced in many high-income economies. In particular, there appears to be considerable potential to increase the collection of revenues from personal income taxation, which currently accounts for a relatively low value in proportion to GDP compared to high-income economies.[10] This could be achieved by enhancing tax compliance, rationalizing deductions, and increasing progressivity at the top of the income distribution. Another efficient means to increase revenues would be to broaden the coverage of consumption-based taxation, while the associated distribution concerns could be effectively addressed through targeted transfers. Malaysia could also strengthen the effectiveness of its tax administration through the increased adoption of digital technology and through measures to more effectively enforce compliance.

On the expenditure side, reform efforts should aim at containing the relatively sizeable cost of civil service salaries and pension outlays, further rationalizing discretionary spending and untargeted subsidies, as well as improving the efficiency of development spending. The new administration's efforts to strengthen public financial management, including through measures to improve governance and to promote transparency, are a welcome development. Going forward, as the potential for incremental fiscal savings from efficiency-enhancing rationalization diminishes, it will be necessary to focus on containing the relatively high cost of expenditure

[10] In 2018, Malaysia's personal income tax revenue is estimated at 2.4 percent of GDP, significantly lower than the average of eight percent among advanced economies. By contrast, corporate income tax income is projected to be at 4.9 percent on GDP in 2018, compared to the OECD average of three percent.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on civil service salaries and pensions, which constitutes an increasingly large share of overall public spending. This would require fundamental reforms to the terms of civil service employment and the compensation system (for instance by reviewing the various functions of the government to promote more efficient employment levels, and by strengthening the link between salary adjustments and employee performance) to ensure expenditure on the public wage bill is commensurate with the provision of services. The government's commitment to implementing better-targeted fuel subsidies is also a step in the right direction, although for effective implementation, it requires appropriate mechanisms to minimize administrative costs and to prevent leakages of benefits to unintended groups. To contain development expenditure, measures to promote spending efficiency will be required, particularly in the transportation and education sectors. However, any such measures would have to be carefully balanced against the need to sustain growth-enhancing investments and to provide adequate social safety nets.

As Malaysia's average income and societal expectations continue to grow, raising adequate resources to finance the needs of the expanding middle-class will become an increasingly important priority

Fostering greater economic inclusiveness begins with expanding access to more productive and remunerative employment. This requires interventions and investments in health and education throughout the life cycle, complemented by policies to increase participation in the labor force. Stunting affects one in five Malaysian children less than five years-old, with long-term negative consequences for physical and mental development. The crucial period for preventing stunting is the first 1,000 days, from conception until the second birthday. Universal access to high-quality education and training is needed to ensure that all young Malaysians are equipped the cognitive and noncognitive skills to be productive workers, with adequate adult retraining opportunities for those made unemployed by changes in technology or market forces. Adult health also matters. Nearly half of Malaysian adults are overweight or obese (NHMS 2015), which is strongly linked to noncommunicable chronic diseases, with adverse impacts on wellbeing, productivity, and health budgets. The 2019 budget's tax on sweetened beverages is an initial step to address this issue and should be augmented by other measures to discourage unhealthy diets and sedentary lifestyles. Inclusivity is also enhanced by increased labor force participation, particularly policies to encourage women to return to work after starting a family. The 2019 budget's provision for increasing the availability of on-site child care facilities in government offices will help in this regard, and could be strengthened by similar measures in the private sector, as well as additional measures such as greater access to flexible working arrangements.

A strengthened social protection system is a necessary complement for those who cannot benefit fully from expanded productive employment. For some people – such as the elderly, persons with disabilities, and those encountering transient shocks such as unemployment, illness, or a death in the family – employment-based solutions are insufficient. A well-functioning social protection system is needed to keep them out of poverty and support living with dignity. The BSH cash transfer program is one component of that system, and its effectiveness may be enhanced by the decision to adjust program benefits according to the number of children in recipient households. It could be made even more effective by adjusting the program eligibility criteria by the number of children (or household size more generally). With its rapidly aging population, it is increasingly important for Malaysia to expand the number of individuals covered by the formal pension system, and encourage adequate pension savings to ensure that the elderly can live without fear of falling into poverty.

BOX 6

Malaysia's new policy priorities - highlights from the Mid-term Review of the 11th Malaysia Plan

On October 18, 2018, the government tabled the Mid-term Review of the 11th Malaysia Plan (11MP) with this review outlining updated policy directions for the remaining two years of the plan. The report consists of two distinct parts: Part I, which reviews the performance of the Plan's six strategic thrusts in 2016 and 2017 under the previous government; and Part II, which outlines the government's new policy directions in six pillars. These newly defined pillars and the order in which they are prioritized reflects the priorities of the government: (i) reforming governance towards greater transparency and enhancing efficiency of public service; (ii) enhancing inclusive development and wellbeing; (iii) pursuing balanced regional development; (iv) empowering human capital; (v) enhancing environmental sustainability through green growth; and (vi) strengthening economic growth.

Overall, the updated policy framework outlined in Part II covers most of the key policy areas and highlights the institutional reforms that will be required to facilitate the fulfilment of Malaysia's aspirations to achieve sustainable and equitable growth. The updated policy framework continues to emphasize some of the themes of the earlier 11MP, including the emphasis on inclusive wellbeing, human capital development and green growth. The key difference in the updated framework is the inclusion of pillars on governance reforms and on balancing regional development.

The inclusion of the new pillar on "Reforming governance towards greater transparency and enhancing efficiency of public service" signals the government's commitment and political will to reform the public sector. In the context of concerns regarding Malaysia's public finance management and widespread public dissatisfaction with public service delivery and political systems, the prominent inclusion of this pillar communicates the government's strong commitment to addressing these concerns and its awareness of the challenges that currently impede reform. Under this pillar, reforms are categorized into four priority areas that aim to improve governance at all levels; to elevate integrity and accountability; to enforce prudent public finance management; and to enhance public service delivery.

Another newly included pillar is "Pursuing balanced regional development", which signals the government's commitment to reducing developmental imbalances across states and between urban and rural areas. Although the earlier 11MP outlined measures to further develop the regional economic corridors, this new pillar contains more comprehensive measures to better spread socioeconomic benefits across states and to promote equitable growth, particularly in less-developed states such as Sarawak, Sabah, Kedah, Kelantan, Terengganu and Perlis. The inclusion of this pillar is encouraging, signaling the government's commitment to establishing stronger linkages between urban and rural areas and between leading and lagging regions, which will help to boost inclusive economic growth and development across Malaysia.

In addition, the review has an updated framework on "Empowering human capital." This pillar on human capital remains a high priority for the government, as it is crucial for Malaysia's transition to an inclusive, high-income economy. This updated pillar places emphasis in fostering stronger linkages with industry and academia, enhancing access to quality education and skills training, reforming the labor market and improving labor efficiency and productivity. Skilled individuals contribute significantly to economic growth through direct channels, such as technology and design innovations, but also indirectly, through coordination and guidance of the actions of others. The transition to a developed economy requires systematic investment in human capital. Recent research shows that human capital is a necessary pre-condition to make other investments work and that the marginal returns from investment in human capital are 40 percent higher than investment in R&D.

On the whole, the review is comprehensive in scope, providing useful insights into the government's

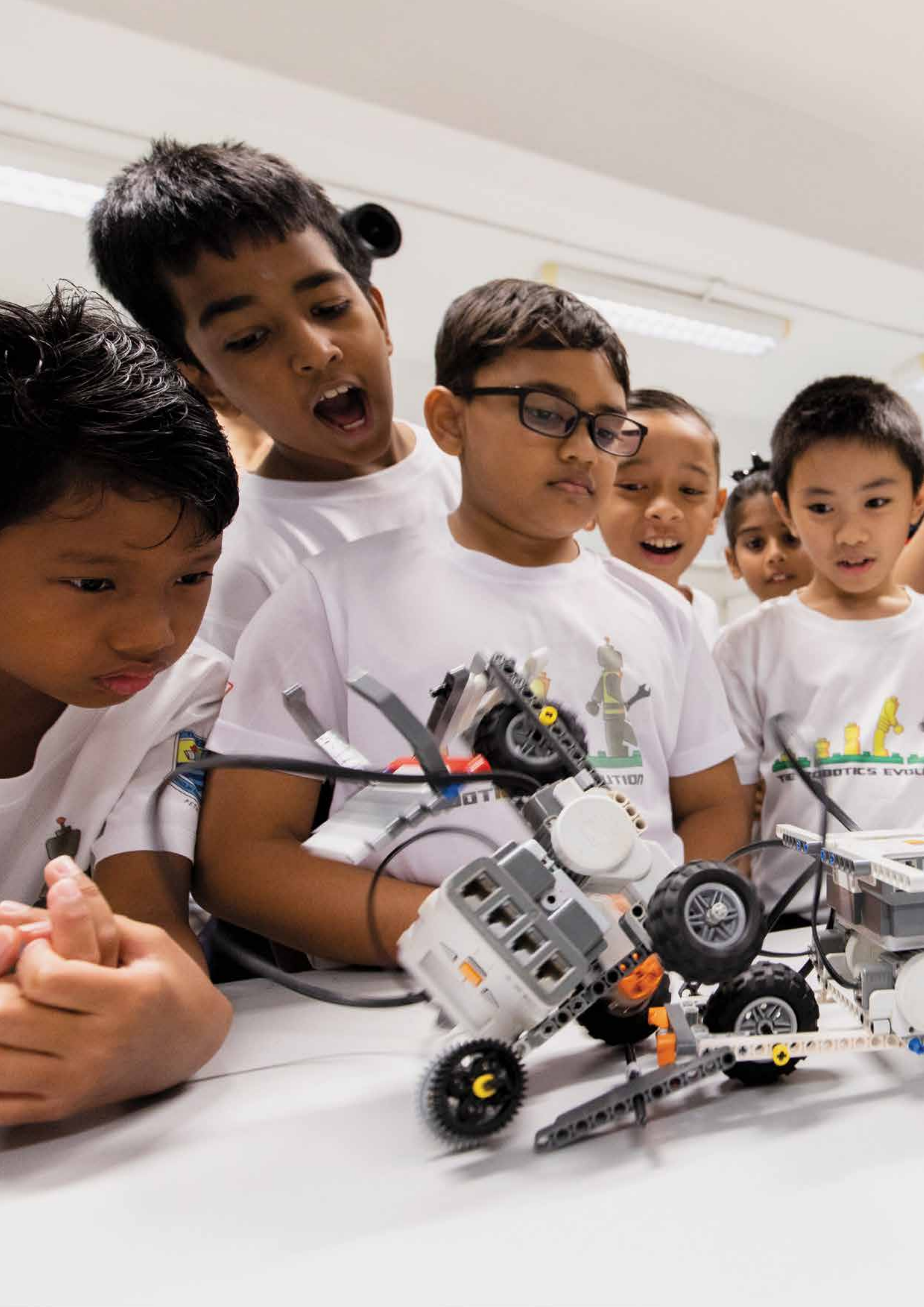
future social and economic policy directions. It also contains a candid assessment of the limitations of past policy design and implementation. However, by its nature, the document focuses on higher level, broad strategic measures, rather than defining specific implementation details. This is understandable, given the short time frame that the new government had to develop the review. The prioritization of policies and programs under each of the pillars and more detailed information to guide ministries and agencies are likely to be formulated in the coming months, as the government determines more specifically the implementation of the Plan's reform measures.

In addition, some of the more ambitious reforms and strategies outlined in the review may require more time for completion, beyond the remaining period of the 2018-2020 plan. Given this possible outcome, it would be useful to formulate an assessment of the implementation capacity and risks, and to commit to the conduct of an interim review to signal the government's commitment towards the achievement of the reforms outlined under the new pillars. The use of intermediate outcome indicators or milestones could also enable the public to better understand and anticipate how the Plan's targets will be achieved at various stages of implementation and to hold institutions to account.

TABLE 5
New priorities and emphases for 2018-2020, selected highlights

PILLAR 1 **Reforming Governance Towards Greater Transparency and Enhancing Efficiency of Public Services**	• Enforcement of a two-term limit for the positions of Prime Minister, Chief Minister and Menteri Besar to prevent the abuse of power. • Review and streamlining of the role of state-owned enterprises and monopoly entities to promote market efficiency and healthy competition. • Decentralization of some functions, including public transport, social services and environmental protection to empower state governments. • Lowering of the voting age limit to 18 years and the introduction of a legislation on political financing. • Transformation of the MACC into a full independent body, accompanied by a review of the MACC Act 2009, the Witness Protection Act 2009 and the Whistleblower Protection Act 2010 to strengthen anti-corruption legislation.
PILLAR 2 **Enhancing Inclusive Development and Wellbeing**	• A target of 200,000 units of affordable houses set to be built through promotion of greater private sector participation, and the establishment of a National Affordable Housing Council to coordinate the management of public affordable housing. • Formulation of a national health policy aimed at increasing human capital capacity and healthcare facilities. • Construction of a new cancer center in the northern region, and a national center for disease control and prevention in Negeri Sembilan to detect, prevent and overcome disease threats. • Formulation of an action plan to increase public awareness on mental health.
PILLAR 3 **Pursuing Balanced Regional Development**	• Building and upgrading of 1,500 kilometers of rural roads. • Expansion of access to clean and treated water supply for 60,000 additional homes, and extension of electricity supply to 41,160 additional homes. • Construction of 300 new telecommunication towers and upgrading of 1,000 existing towers to widen coverage and improve broadband quality. • Provision of a fair share of oil and gas revenues to Sabah and Sarawak in accordance with prevailing laws, and the establishment of a Special Cabinet Committee to review and monitor the proper implementation of the Malaysia Agreement 1963.
PILLAR 4 **Empowering Human Capital**	• Standardization of the monthly minimum wage at RM1,050 (subsequently adjusted to RM1,100) nationwide, effective January 1, 2019. • Review of labor laws and implementation of a comprehensive Employment Insurance System to enhance workers' rights. • Review of both the Malaysia Education Blueprints, and replacement of the Universities and University Colleges Act 1971 with an improved legislation towards ensuring academic liberty as well as freedom of speech and association.
PILLAR 5 **Enhancing Environmental Sustainability Through Green Growth**	• Increased gazettement of terrestrial, inland water, coastal and marine protected areas. • Increased contribution of renewable energy in electricity generation to reduce dependency on fossil fuels. • Integration of disaster risk reduction measures into planning and development to strengthen disaster risk management capability. • Development of an integrated system for weather and flood forecasting as well as early warning for flood to increase disaster preparedness.
PILLAR 6 **Strengthening Economic Growth**	• New target to increase SMEs' contribution to GDP to 41 percent by 2020. • Formulation of a national policy framework for the Fourth Industrial Revolution to promote innovation, creativity and competitiveness. • Upgrading of existing plants and construction of new plants to improve water supply services to states with low reserve margins. • Construction of new power plants to be undertaken through competitive bidding.

Source: Mid-Term Review of the 11th Malaysia Plan (2016-2020)



PART TWO

Realizing Human Potential

Realizing human potential

Investment in human capital is essential for enabling Malaysia's transition to a high-income and developed economy

Human capital – the knowledge, skills, and health that people accumulate over their lifetime – has been a key factor behind the sustained economic growth and poverty reduction rates of many countries in the 20th century, especially in East Asia. With rapid technological change, the wealth of nations has become even more closely tied to the human capital of its people. Automation threatens to eliminate many jobs that require only low-level cognitive skills. The global economy now increasingly places a premium on higher-order cognitive skills – complex problem-solving, socio-behavioral skills, reasoning, and self-efficacy (World Bank 2018). Production processes in industry, agriculture and services have all become highly human capital and technology intensive. Greater policy focus on human capital is needed to build the knowledge, competencies, and skills to enable an economy to achieve high rates of inclusive economic growth in this rapidly evolving context.

Education, health, and social protection all play vital and complementary roles in the development of human capital. Among high-income countries, levels of educational attainment are closely linked to economic performance. Similarly, health is critically important to the achievement of high levels of economic growth, with a healthy population capable of being more productive. Social protection also plays a crucial role in nurturing human capital, particularly but not exclusively in low income contexts. There are strong correlations between education, health and social protection. On average, well-educated individuals, especially women, take better care of the health and nutrition of their families and children. Good nutrition in utero and in early childhood are correlated with better educational outcomes and higher levels of cognitive performance. Good social protection systems provide the supportive eco-system that enable low-income families to achieve better education and health outcomes, breaking the intergenerational transmission of poverty that can have pervasive negative impacts on human capital formation and poverty reduction. In turn, these result in improved labor productivity, increased economic growth, and higher life expectancies.

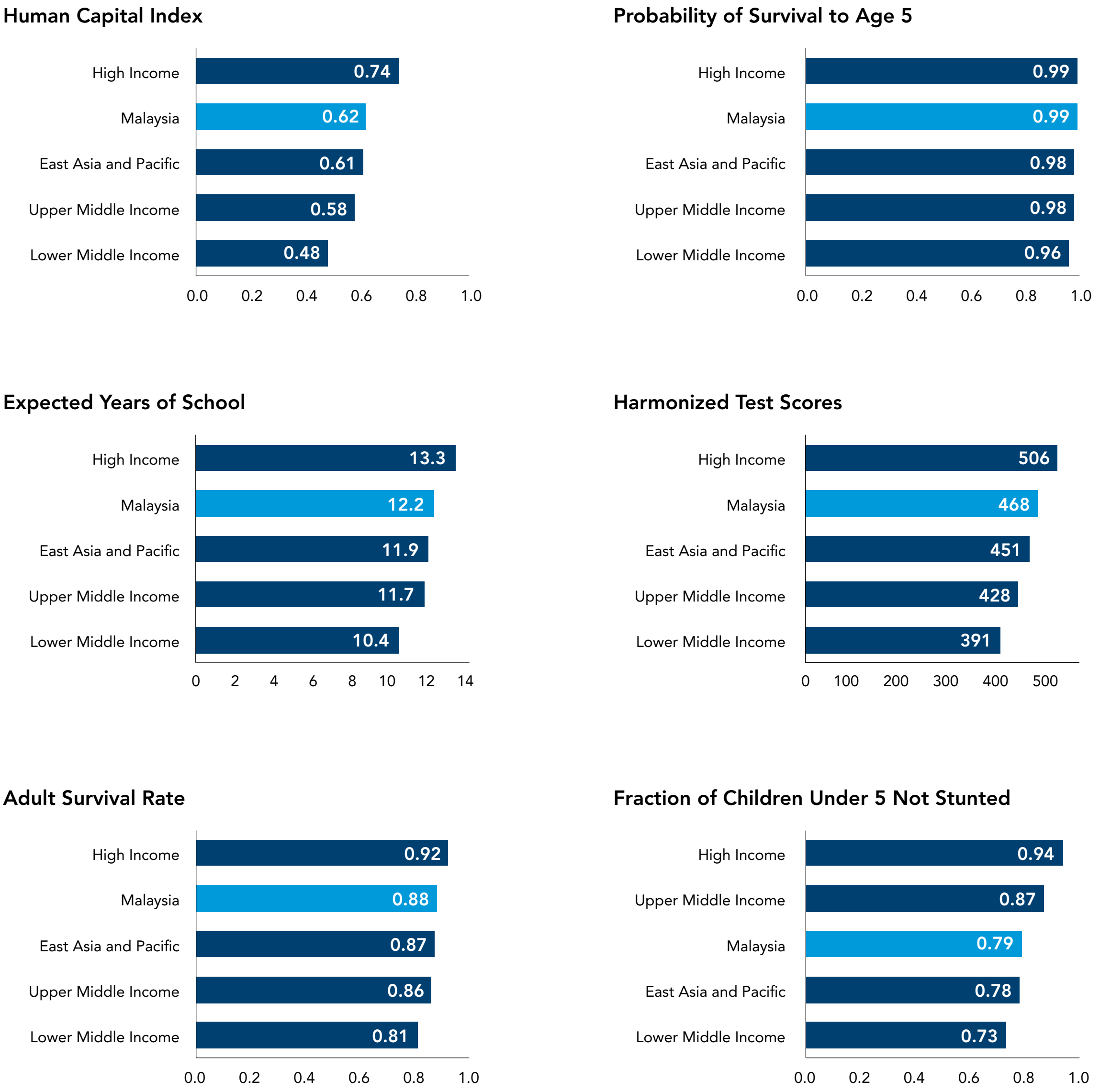
In recognition of the importance of human capital for economic growth, the World Bank has launched the Human Capital Project (HCP), through which the Human Capital Index (HCI) was introduced in October 2018. The HCI is a metric designed to forecast a country's human capital. The index tracks the future trajectory, from birth to adulthood, of a child born today. It quantifies the level of human capital that a child can expect to attain by the end of secondary school, given the risks of poor health and education that exist in that country at the time of the child's birth. There are three components to the HCI: (i) the proportion of children that survive from birth to school age (age five); (ii) the expected years of quality-adjusted education, which combines information on the quantity and quality of schooling; and (iii) two broad measures of health: child stunting rates and adult survival rates. The HCI provides countries with a mechanism for understanding the quantity and quality of their human capital, thus enabling them to navigate a path forward to develop this capital.

The HCI captures the impact of investments in children today on productivity and economic growth over the long term. According to the HCI, Malaysia has an overall value of 0.62. This indicates that children in Malaysia born today will be only 62 percent as productive as they could be in adulthood compared to optimal outcomes, given the prevailing education and health outcomes.

FIGURE 36

Malaysia's performance on the human capital index is about as expected compared to other upper middle-income economies, but falls below high-income comparators

World Bank Human Capital Index and its Components, 2017

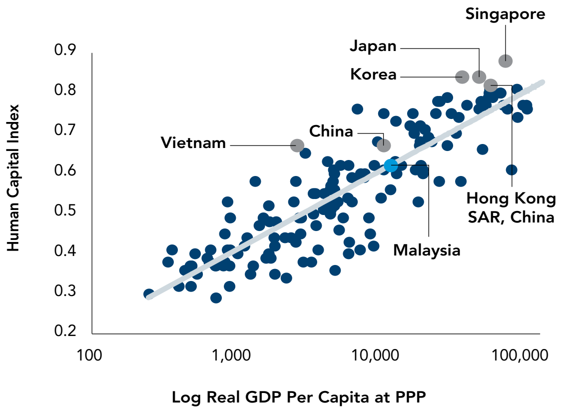


Overall, Malaysia ranks 55th out of 157 countries included in the HCI (see Figure 36, Figure 37 and Figure 38). While Malaysia performs well in some components of the HCI, it does less well in others. Relative to the other countries included in the index, Malaysia performs well on the probability of children surviving to age five, the expected number of years of schooling, and the probability of adults surviving to the age of 60 years. It does less well on rates of stunting, learning outcomes and educational attainment when adjusted for quality.

For Malaysia to fulfil its aspiration of achieving high-income and developed country status, it will need to make further advances in all components of human capital: education, health and nutrition, as well as social protection and jobs. The following sections of this report discuss key opportunities for policy measures going forward in these three areas.

FIGURE 37
The HCI for Malaysia is lower than that of aspirational peers...

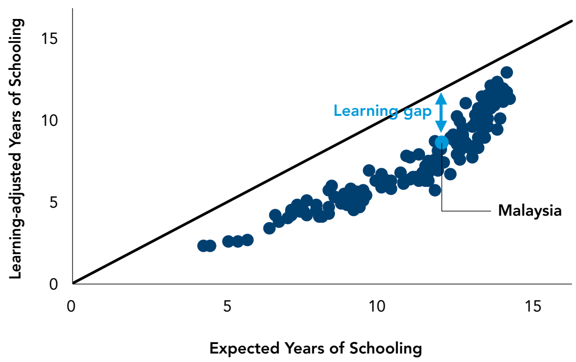
Human Capital Index Versus GDP per Capita, Selected EAP Countries, 2017



Source: World Bank Human Capital Index

FIGURE 38
...and the shortfall is especially pronounced in terms of educational attainment, with an average learning gap of 3.1 years

Expected Years of Schooling Versus Learning Adjusted Years of Schooling



Source: World Bank Human Capital Index

Malaysia has done well in ensuring access to education, but student learning outcomes fall below potential

Educational attainment and learning are a key driver of economic growth (World Bank 2018a). In particular, education has made a central contribution to the spectacular economic success of many countries in East Asia (see Box 7). For Malaysia to achieve higher levels of development in the future and to transition to a high-income economy, improving the quality of education will be crucially important.

Over the past few decades, Malaysia's education system has made significant progress in terms of increasing enrollment rates. Since the 1990s, the government has implemented a series of policy and institutional reforms covering all levels of education, from pre-school education to tertiary education. As a result of these reforms, Malaysia has achieved universal access to primary education and high levels of access to pre-school education and secondary education. The net enrolment rate for pre-school education stands at 91 percent. At the secondary level, the gross enrollment rate increased from 88 percent in 2015 to 91 percent in 2017.

However, there remains room for improvement to enrolment rates at higher levels and for preschool. The HCI measures educational performance by measuring the quality-adjusted expected years of schooling, with one component of this metric being the expected years of schooling. The expected years of schooling for an individual up to the age of 18 in Malaysia is 12.2, significantly lower than the average for high-income countries, which stands at 13.1. Malaysia's upper-secondary enrollment rates are lower than some upper middle-income and lower-middle income regional comparators, such as Thailand and Indonesia. Top-performing education systems such as those of Korea, Hong Kong SAR China, and Japan are all characterized by high upper-secondary enrolment rates. Malaysia's upper secondary (Form 4 and Form 5) enrolment rate currently stands at 85 percent. Also, it has not yet achieved universal coverage for preschool.

While Malaysia's learning outcomes are strong, they are significantly lower than the average for high income countries and standout regional peers.

BOX 7

The link between education and East Asia's extraordinary growth story

Over the past half-century, the EAP region has consistently recorded high rates of economic growth, driving its transition to high- and middle-income status. Since 1960, the East Asia and Pacific region has sustained high rates of growth, faster for longer than any other region in the world. This progress has been remarkable, especially among the region's low- and middle-income economies, with economic growth rates at more than twice the world average in the period from 1960 to 2015 (7.2 versus 3.5 percent). As recently as 1991, two-thirds of East Asians worked in agriculture, mostly as low-income smallholders. By 2012, that figure had dropped to one third.

Investments in education paid off at all education and income levels, not just for people who worked in high-tech sectors and industries

Countries in this region have pursued a broad set of complementary policies to accelerate growth, with particular emphasis on education. Policy makers have tried to reduce inequality, first by boosting rural incomes and then by promoting educational opportunity and outcomes. Policies have also been implemented to improve labor force abilities and skills, mostly through increased schooling and through measures to ensure that education is broadly relevant to current and expected future economic challenges. As a result, a number of countries rapidly transformed from rural agricultural societies to high-tech knowledge economies. Japan, the Republic of Korea, and Singapore set their education policy goals within a larger framework that sought to eliminate technology gaps with the world's most advanced countries. Their goal was to create domestic capacities to produce innovative knowledge and technology that enable them to compete at the global stage. Long-term increases in productivity depend on continuously improving and applying new technologies, which in turn increases demand for more highly skilled workers.

Average levels of educational attainment increased dramatically to converge with global averages. In 1950, the average adult in EAP had only 1.3 years of schooling – less than half the prevailing world average of 2.9 years. By 2010, the average attainment was more than six times higher than it had been at the earlier point and had converged with the world average, which had increased to eight years. This increase in average schooling occurred as the population of the region more than doubled. Average levels of educational attainment have continued to climb, with more and more students completing secondary school and proceeding to tertiary studies. Schools today provide twice as many students with more than six times as much instruction.

Improvements to education raised productivity among farmers and facilitated structural transformation. Investments in education paid off at all education and income levels, not just for people who worked in high-tech sectors and industries. Rural dwellers with education, even when limited to a few years of primary school, consistently outproduced and outlearned their less educated neighbors. Poverty rates dropped substantially as jobs and income-earning opportunities grew.

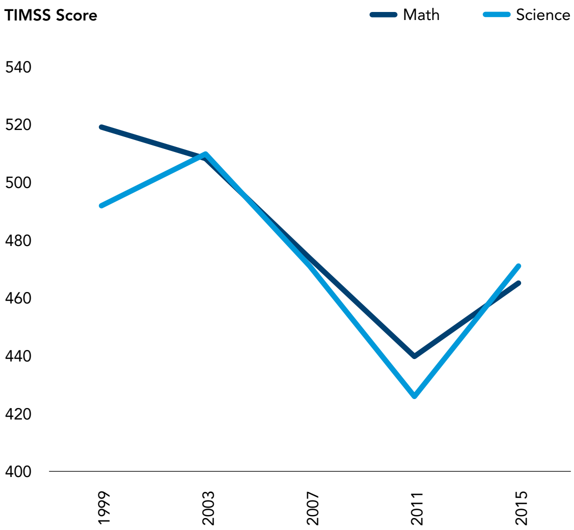
Source: World Bank 2018b

The HCI measures educational performance in terms of quality-adjusted years of schooling, with quality being measured in terms of harmonized test scores. While Malaysia's score of 468 (based on the performance in the 2015 Trends in International Mathematics and Science Study, TIMSS) is above average for upper middle-income countries, it is lower than the average of 508 for high-income countries. Vietnam (519) and the Republic of Korea (563) are among the standout performers in the region.

Malaysia's international test scores have dropped over time, although the most recent results indicate an improvement (see Figure 39). Up until 2011 there were declines in both math and science TIMSS scores with improvement in the 2015 cycle. This trajectory is in contrast to many of Malaysia's high-performing East Asian counterparts which have shown more consistent progress in improving learning, as indicated by their performance on international tests. Results from the 2018 Program for International Student Assessment (PISA) – which will be published in December 2019 – will provide the next opportunity to assess the impact of Malaysia's education policy efforts.

Policy and implementation gaps may impact the quality of Malaysia's preschool services. Malaysia's policy framework for preschool education is encapsulated in its 11th Plan and Education Blueprint 2013-2025, aiming at universal access to preschool.

FIGURE 39
Malaysia's international test scores in science and math increased in 2015 after dropping in previous years



Source: International Association for the Evaluation of Educational Achievement, TIMSS

Malaysia has been largely successful in implementing its policies to achieve this objective (see Box 8), with pre-school enrolment rates having increased considerably over recent years, although still falling short of the government's target of universal enrolment. As a result of various government programs, these rates have increased from 77 percent in 2012 to 91 percent at present. Malaysia has also established comprehensive standards to regulate the quality of preschool and to ensure that all children have access to high-quality preschool (Noor and Symaco 2017). While the Education Blueprint identifies measures to improve quality, it is unclear how these standards are enforced.

Research suggests that, on average, the quality of public pre-schools in Malaysia may be lower than that of private pre-schools. Public pre-schools have higher child-teacher ratios, lower quality teachers, and lower quality teaching methodologies (Mustafa and Azman 2013) (see Table 6). This is of concern, given that the majority of preschools in Malaysia are public, with private pre-schools being generally only accessible to those who can afford the relatively high costs.

The Malaysia Education Blueprint 2013-2025 contains a comprehensive strategy to improve learning outcomes. The Blueprint identifies a number of strategies in this regard. These include: (i) benchmarking the learning of languages, mathematics and science to international standards; (ii) launching a new secondary school curriculum and a revised primary school curriculum; and (iii) revising national examinations and school-based assessments to gradually increase the percentage of questions that test higher-order thinking. To date, the major accomplishments under this plan include the implementation of school-based assessments and the integration of higher order thinking skills (HOTS) into the curriculum, assessment, pedagogy and co-curricular activities. Efforts have also been made to improve Science, Technology, Engineering and Mathematics (STEM) education through revisions to the existing curriculum in schools.

The most successful education systems align all elements towards improving student learning outcomes. Global experience has consistently demonstrated the importance of distinguishing between schooling and learning. It is clear that schooling is not identical to learning: countries that prioritize learning rather than schooling create a more conducive environment for development and progress. As Figure 40 indicates, all the main elements of the system, including teachers, learners, school management and school inputs, must be aligned to facilitate learning. This alignment involves three key

BOX 8

Malaysia's remarkable success in increasing access to preschool education

Over the last decade, Malaysia has achieved a remarkable increase in the enrolment rates for preschool education. The preschool enrolment rate has increased from 67 percent in 2009 to 91 percent at present. This remarkable achievement is a result of the government's commitment to ensuring that all children in Malaysia have access to preschool education. A succession of policies and strategic plans have been implemented since the 1990s to facilitate increased enrolment in preschool education. These policies and plans have been outlined in instruments including the Education Act 1996, which formally recognized preschool education as part of the school system; the Government Transformation Program 2009-2012 and 2012-2017; and the Malaysia Education Blueprint 2013-2025, with the latter two instruments outlining priorities and strategic goals to improve access to preschool education.

These various national strategic instruments have contained a number of key measures to propel increased access to preschool education, including the following: a) promoting the establishment of private preschools through the provision of foundational grants to about 2,000 private preschools in the period from 2010 to 2015; b) providing private preschool fee assistance for children from low income families, with approximately 257,714 children having benefitted from this form of his assistance in the period from 2010 to now; and c) community outreach programs for districts with low enrolment rates to increase parental awareness on the importance of early childhood education. As a result, the number of preschool classes increased from 38,118 classes in 2009 to 53,920 classes in 2018 (with approximately 70 percent of the additional classes being provided by private preschools).

The government has long recognized the importance of setting standards for preschools. In 1996, the National Preschool Curriculum was established and quality standards were formulated. In 2003, the National Education Act mandated a national preschool curriculum and the National Preschool Curriculum Standards (NPCS) were developed by the Ministry of Education. The NCPS was revised in 2010, with all public and private preschools being mandated to follow the national curriculum and to meet the established standards.

A succession of policies and strategic plans have been implemented since the 1990s to facilitate increased enrolment in preschool education, which has increased from 67 percent in 2009 to 91 percent at present

With Malaysia's strong progress towards increasing its pre-school enrolment rate, it is likely to achieve its goal of universal enrolment by 2020, thereby meeting the goal established by the Malaysia Education Blueprint 2013-2025. Malaysia is now paying increasing attention to ensuring that all public and private preschools meet quality standards. To this end, the government has mandated that by 2020, all preschool teachers must possess a minimum qualification of a diploma in early childhood education. This is a strong step towards improving the quality of preschool education, but further steps need to be taken to ensure that all Malaysian children have access to high-quality preschool education services.

Source: L. Foong et al. (2018) and Mustafa and Azman (2018)

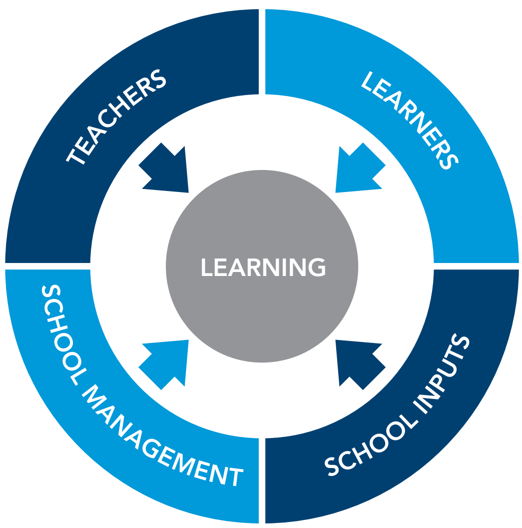
TABLE 6
Differing characteristics of public and private pre-schools in Malaysia

Item	Public Preschool	Private Preschool
Teaching and Learning	• Teacher-centered • Drill technique • Limited learning materials and facilities	• Child-centered • Classroom conducive for learning • Appropriate learning materials and facilities
Teacher Qualification	• Locally trained • Lacks professional development • Some not qualified to be an early childhood teacher	• Trained locally and abroad • Professional in dealings with parents and children • Mostly highly qualified
Teacher-Child Ratio	1:25	1:15
Curriculum	• Emphasizes social and emotional development • Follows the government goals and objectives • Intermediate Language: Malay • Funded by the government • Program organized and controlled by the government	• Emphasizes cognitive development • Adjustable goals and objectives by the potential of children • Intermediate Language: Malay, English, Chinese and Tamil or mixed languages • Run by NGOs or individuals, for profits or welfare purposes • Enriched programs such as Qur'an recitation, martial arts, ballet, drama, modern dance and art
Operation Schedule	Only one option, 8 a.m. – 12 p.m.	Many options provided; 7 a.m. – 12 p.m. 7 a.m. – 3 p.m. 7 a.m. – 6 p.m.
Rules and Regulations	Government authorities	Each private institution authorities

Source: Mustafa and Azman (2013)

actions. First, the educational assessment system must be given high priority. Without an adequate educational assessment system, there is no means of determining the extent to which schools are really working to ensure that students learn. Second, there must be a commitment to acting on the evidence from assessments. Without this commitment, real progress towards improving learning outcomes is restricted. Finally, there must be a concerted effort to ensure that the actions of all stakeholders in the education process are aligned to ensure that the education system facilitates learning. Technical and political barriers can divert schools, teachers and families from a focus on learning. It is vital that concerted efforts are made to overcome these barriers to ensure that the objective of improving learning outcomes is achieved.

FIGURE 40
The main elements of an education system should be aligned towards learning



Source: World Bank 2017

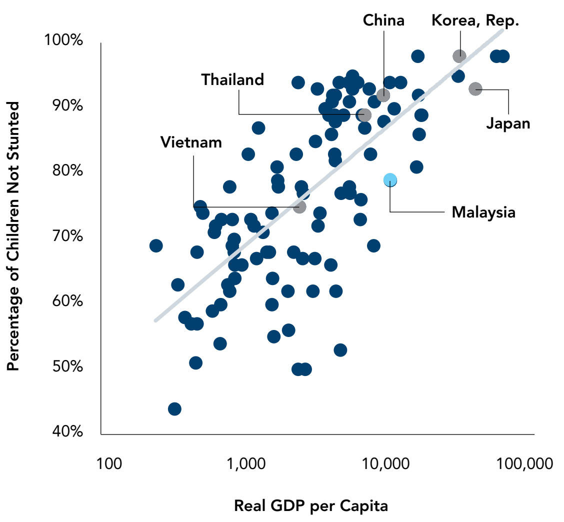
Malaysia has made strong progress in health outcomes, but child stunting rates and the burden of NCDs remains high

Over the past half century, Malaysia has achieved remarkable success in improving population health outcomes. Life expectancy at birth has improved steadily from just 59 years in 1960, shortly after independence, to 75 years in 2016. Malaysia's life expectancy at birth today is comparable to the average for upper middle-income countries (also 75 years). Mortality rates have also declined significantly, with infant mortality rates at 6.7 per 1,000 live births and under-five mortality rates at 7.7 per 1,000 live births. According to the HCI, 99 out of 100 children born in Malaysia survive to age five, with roughly identical outcomes for boys and girls. The successful control of communicable diseases and improvements to Maternal and Child Health (MCH) services have contributed to the improvements in terms of these outcomes.

FIGURE 41

The proportion of children under five who are not stunted in Malaysia is lower than expected compared to peers

Fraction of Children Under Five not Stunted vs. Log of Real GDP per Capita, PPP Terms, Selected EAP Countries, Most Recent Year Available



Source: World Development Indicators

Malaysia has also made significant progress towards Universal Health Coverage (UHC). The country fares well in terms of the UHC service coverage index, with a score of 70 out of 100. This compares favorably to the average score for the Southeast Asian region (59) and the global average score (64). Malaysia only lags slightly behind the average score for East Asia (77) (WHO and World Bank 2017).[11]

Malaysia's stunting rate for children under the age of five stands at one in five, which is high for the country's level of GDP per capita. Malaysia's National Health and Morbidity Survey (NHMS) 2016 estimated the stunting rate for children in this age bracket to stand at 20.7 percent (IPH 2016). This is considerably higher than the average rate of 7 percent for upper middle-income countries (World Bank 2018). It is also one of the highest rates amongst countries in the same income group (see Figure 41), and is higher than some lower-middle- and low-income countries in Sub-Saharan Africa, such as Ghana (18.8 percent) and Senegal (17.1 percent). In addition, a comparison with NHMS 2006 shows that the rate has actually increased since that time, going up from 17.2 percent.

While stunting is more prevalent in households with lower socioeconomic status, it is also high among better-off households. Moderate to high rates of stunting are evident in both urban and rural areas, across all states, ethnicities, and income levels. For example, the stunting rate is 17.4 percent for children in households with monthly incomes of RM5,000 or more (see Figure 42). Although maternal education is associated with lower levels of stunting, elevated rates of stunting are observed even among children whose mothers have completed higher education (see Figure 43). With Malaysia aspiring to achieve high income status in the coming years, it will need to continue to make strong efforts to address childhood stunting and other health and nutrition outcomes. Further analytical work is needed to understand the drivers of stunting and to identify the most important policy channels to reduce undernutrition.

[11] The UHC service coverage index is a single indicator computed from tracer indicators of coverage of essential services. The index was developed to monitor SDG indicator 3.8.1. The South-eastern Asia region includes Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, Timor-Leste, and Viet Nam. The East Asia region includes China, Democratic People's Republic of Korea, Japan, Mongolia, and Republic of Korea. Average scores for other regions are: Northern America and Europe (77), whereas sub-Saharan Africa has the lowest index value (42), followed by Southern Asia (53). More information can be found at http://apps.who.int/iris/bitstream/handle/10665/259817/9789241513555-eng.pdf?sequence=1

Further analytical work is needed to understand the drivers of stunting and the most important policy channels to reduce undernutrition

The underlying causes for Malaysia's high rate of childhood stunting are not fully understood. A small study in Kelantan (one of the poorest states in Malaysia and with the highest rate of stunting) found that children in food-insecure households were three times more likely to be stunted than children in food-secure households (Ali Naser et al 2014). Despite the low average rate of stunting in Kuala Lumpur, a study of households in low-income areas in that city found that rates of stunting and wasting among children were twice as high as the citywide average. This suggests that a closer examination of multi-dimensional child poverty, including in pockets of urban areas, is needed (UNICEF 2018). Other studies have found correlations between socioeconomic variables and anthropometric status of children (Marjan et al 1998, Khambalia et al 2012), although these studies have had a limited scope, pointing to the need for further research. Similarly, the efficacy of interventions to reduce stunting and to improve nutritional status of Malaysian children has not yet been thoroughly studied.

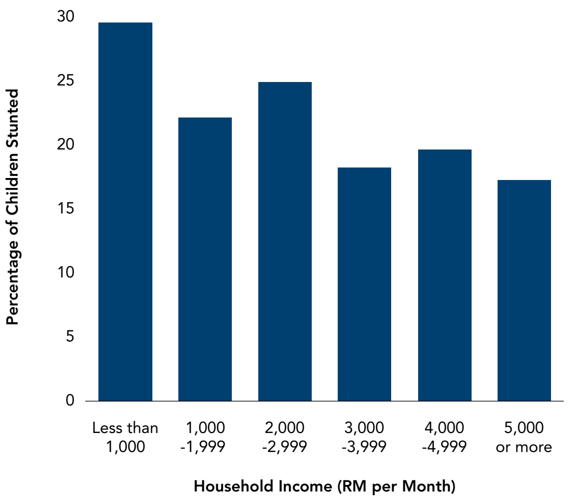
Malaysia's Adult Survival Rate (ASR) is comparable to countries with similar income levels. In the HCI, the ASR serves as a proxy for the overall health environment. This metric captures the range of fatal and non-fatal health outcomes that a child born today could expect to experience as an adult under current conditions. The ASR for Malaysia estimates that 88 percent of 15-year olds will survive until age 60, with the survival rate being higher for women than for men (92 percent for women compared to 85 percent for men). While the ASR is comparable to other countries at similar levels of income, Malaysia still has significant room for improvement.

National data show that there has been very limited progress in improvements to Malaysia's average adult life expectancy. This reflects the high and increasing burden of noncommunicable diseases (NCD) and the high level of avoidable premature deaths from such diseases (GoM and Harvard 2016). The government projects that the NCD burden will increase in the future (MOH 2016a). Malaysia is also set to age rapidly over the next two decades, placing increased pressure on health services to meet the changing health needs of the population. As in other upper middle-income countries, advances in medical

FIGURE 42

Stunting declines as incomes increase, but remains high even among the highest-income households...

Fraction of Children Under Five Stunted by Monthly Household Income

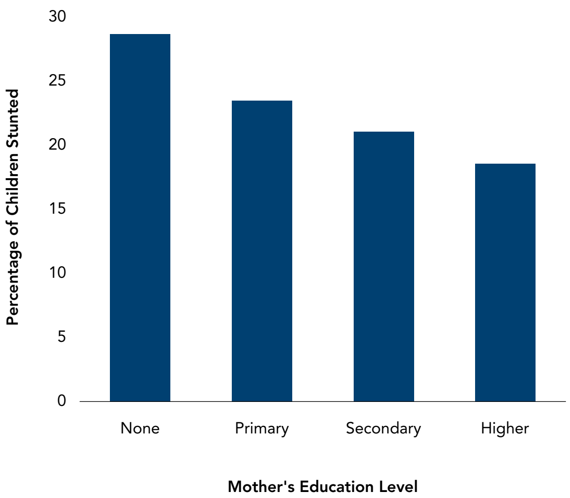


Source: MOH, National Health and Morbidity Survey 2016

FIGURE 43

...with a similar pattern emerging with respect to mother's education.

Fraction of Children Under Five Stunted by Mother's Educational Attainment



Source: MOH, National Health and Morbidity Survey 2016 technology and increasing demand for health care from a growing middle class will also contribute to rising health expenditures.

With a shift in Malaysia's disease burden towards NCD, its health sector will face new challenges. Having effectively controlled many infectious diseases in the decades following independence, Malaysia has already experienced a shift towards a disease burden consisting mostly of NCDs. In 1990, NCDs already accounted for 60 percent of Malaysia's burden of disease, with this figure increasing to three-quarters by 2016. At this point, lifestyle-related factors (e.g. diet, high blood pressure, and tobacco use) comprising the top risk factors for death and disability in Malaysia (IHME 2018). Almost all adults (98 percent) have at least one risk factor for NCDs, with a large proportion having multiple risk factors.

At present, while access to health services is broadly equal across different income groups, utilization patterns differ significantly across socioeconomic groups. Lower-income households predominantly seek care at public facilities, while higher-income households account for the majority (two-thirds) of visits at private facilities (IHSR 2013). Despite these differences, there is reasonably good physical access to health services for most of the population.

Despite equitable physical access to health services across socio-economic groups, there are gaps in service coverage for more advanced services and specialist care, especially in rural areas, and for NCD care at the primary care level. Public clinics, whose service coverage mostly includes MCH services and basic curative services, can meet essential health needs. Nonetheless, several shortcomings exist, particularly in the distribution and technical capacities of health professionals. Doctors, nurses, and midwives at lower-level primary care facilities typically do not have sufficient training to provide NCD screening, counseling, treatment, and referral for the populations they serve (GoM and Harvard 2016). The recruitment and retention of health professionals in rural areas, especially in East Malaysia, also continues to be challenging. Thus, effective access for lower-income households who predominantly use public sector health facilities is, in practice, limited to the scope of services and competencies of health professionals in these settings (Yap et al 2018).

With the increasing burden of NCDs, it is important to increase the responsiveness of the public-sector health system to enable it to meet emerging health needs. Equitable access is only achieved to the extent that the care provided by public sector health facilities is of adequate quality to effectively meet people's health needs. While the clinical quality of public and private facilities has been found to be comparable, the comprehensiveness and continuity of care in the former have been found to be of lower quality (GoM and Harvard 2016). Many NCDs and chronic conditions are better managed in the community, where care is closer to home, more appropriate, and often cheaper.

Increasingly, the service offering and competencies of health professionals in the public sector will need to shift to enable the early detection and effective treatment of NCDs and chronic conditions

Given Malaysia's changing health context, a review of the healthcare system is needed to improve health outcomes into the future (see Box 9). Stagnating health outcomes are symptomatic of the limits of the current service delivery system and of the current level of health expenditure. Increasingly, the service offering and competencies of health professionals in the public sector will need to shift to enable the early detection and effective treatment of NCDs and chronic conditions. These illnesses are more complex to treat than MCH and infectious diseases, and often involve recurrent costs over long periods. If left undetected or untreated, they can lead to complications which result in higher costs for both the health system and individual patients.

BOX 9

Malaysia's evolving health service delivery system

With Malaysia's wide network of health facilities, its health service delivery system has served its population well in the years since independence. One factor that has supported the current effectiveness of Malaysia's health system is the high level of government investment to improve access to health facilities over the decades. Since independence, the government has played a strong role in economic and social development, with high levels of investment in the health sector. Up until the 1980s, to improve healthcare facilities, the government implemented an "expansion phase," with a concomitant increase in the number of health professionals deployed throughout the country (Savedoff and Smith 2011). During these decades, Malaysia built more than 2000 new clinics, explicitly prioritizing rural areas and MCH services (Yap et al 2018; Pathmanathan and Liljestrand 2003; WHO 2012). By the 1990s, physical access to health services came close to being universal, with around 90 percent of the population living within 5 kilometers of a health facility, and 81 percent living within 3 kilometers. Since the 1980s, private sector healthcare providers have proliferated, in part due to government policies to encourage private sector investment in the health sector. These policies have included tax concessions, exemptions from import duties on medical equipment, direct investment by state development banks, and the creation of corporatized health facilities (Savedoff and Smith 2011).

Malaysia has achieved good health outcomes and a high level of access to health services given the level of spending. In 2015, Malaysia's total expenditure on health stood at RM52.6 billion, or RM1,687 per capita (MOH 2017). Total health expenditure was 4.6 percent of GDP in 2015, with public expenditure on health standing at 2.2 percent of GDP. In the period from 2000 to 2015, the composition of Malaysia's health spending barely changed, with public expenditure constituting slightly more than half of the total throughout. In this same period, total health expenditure has increased almost four-fold in nominal terms, or about double in inflation-adjusted, per capita terms.[12] Nonetheless, total health spending and public spending on health in Malaysia are considerably lower than the average for upper middle-income countries, which stood at 6.0 percent and 3.3 percent respectively (MOH 2017; WHO 2017).

> While Malaysia has achieved good health outcomes with a relatively low-cost public sector health system in the past, this system may not be adequate to meet its future needs.

Despite Malaysia's relatively low level of public expenditure on health, its health financing system has effectively provided households with protection from the financial risks associated with high healthcare costs. Across countries, out-of-pocket expenditure on health is a critical determinant of the level of the household financial burden. As such, a higher level and larger proportion of public spending on health is associated with greater levels of financial protection (WHO 2017). However, in this regard, Malaysia has bucked international trends. Despite its relatively low level of public expenditure and high out-of-pocket share (38 percent of total health spending in 2015), it has recorded impressive performance in the area of financial risk protection. Based on analysis of the most recently available data, only 1.4 percent of households in Malaysia experience catastrophic health expenditure (larger than 10 percent of total household expenditure), with only 2.5 percent experiencing health expenditures greater than 15 percent of non-food expenditure. out-of-pocket spending in Malaysia is also strongly progressive, with expenditure increasing with income and with 60 percent of out-of-pocket expenditure

[12] This analysis is limited to a 15-year time series because a consistent record of national health accounts only began in the late 1990s.

being incurred by the richest quintile (IHSR 2013). Catastrophic health expenditure is also concentrated among the top two quintiles of households, with few lower-income households incurring unaffordable healthcare costs.

Malaysia's integrated system of financing and service provision has enabled it to achieve both universal access to health services and high levels of financial protection. Given the patterns of health service utilization described above, lower-income households benefit from government expenditure on public health facilities, where care is provided free-of-charge. Higher-income households voluntarily choose to use the services of the private sector, thereby ensuring that public services preferentially serve the poor (Rannan-Eliya et al 2016).

While Malaysia has achieved good health outcomes with a relatively low-cost public sector health system in the past, this system may not be adequate to meet its future needs. This has significant implications for financing. Malaysia's health financing system has resulted in "implicitly-rationed universalist health coverage" (Yap et al 2018). In theory, the public health system provides comprehensive coverage and effective access to health services, paid for by the public purse. In practice, however, service availability and readiness are constrained by the adequacy of public financing and provider capacity.[13]

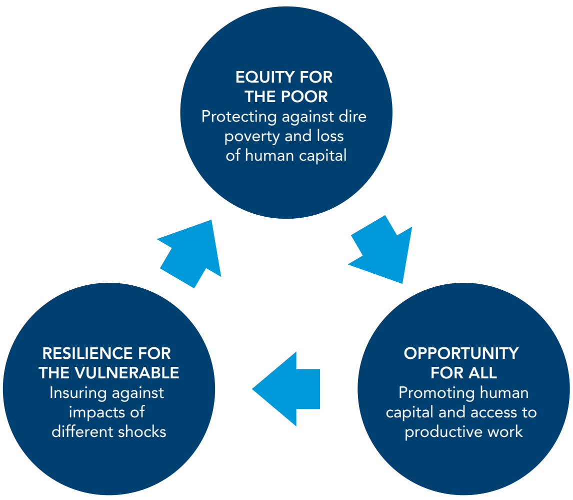
[13] At the time of writing, the Government of Malaysia had proposed the introduction of a Health Protection Fund scheme for households in the bottom 40 percent income level. The scheme is intended to provide financial coverage for four critical illness and hospitalization income coverage. Further details of the scheme are not yet available. Its effectiveness in improving protection against the financial risks associated with health spending will depend on a range of factors, including the manner in which the scheme will be implemented, service utilization patterns by eligible households, and cost coverage under the scheme relative to total healthcare costs. Reviewing the scheme in the broader health service and financing context would help to better assess its potential efficacy and impact.

Malaysia's social protection system remains relatively underdeveloped, particularly in terms of depth

By complementing educational, health and nutritional interventions, social protection can contribute to poverty reduction and human capital development. Social protection programs generally include social assistance programs to protect the poorest and most vulnerable households; social insurance programs to promote household level resilience; and labor programs to support sustained movement out of poverty (see Figure 44). While labor programs have the direct objective of building human capital, the indirect but significant impact of social assistance and social insurance programs on building this capital is often overlooked.

Social assistance programs can provide households with the necessary income support to invest in human capital formation. Social assistance programs enable families to spend more on goods and services that are conducive to this development. They can also enable members of households to better utilize their time to facilitate this development. For example, these programs may enable children to allocate their time to learn at school rather than working, or enable parents to provide better care for their children. In addition, social assistance programs can decrease stress levels and improve the quality of personal interactions between family members by reducing the pressures associated with financial strain and deprivation. A comprehensive social safety net may include measures to encourage behavioral changes that further enhance human capital formation.

FIGURE 44
A holistic framework for social protection



Source: World Bank (2012)

> While *Bantuan Sara Hidup Rakyat* is expected to have a broad and progressive coverage, the depth of the program is relatively limited, resulting in only a modest effect on overall inequality

At present, there are a number of social safety net programs in Malaysia, administered by various ministries. Malaysia's social safety net programs include the BSH cash transfer program, which recently replaced the *Bantuan Rakyat 1Malaysia* (BR1M) program, and a number of core social welfare programs (e.g. Senior Citizen's Aid, Children's Aid, and Disabled Workers Allowances) implemented by the Ministry of Women, Family and Community Development.

Historically, a significant proportion of Malaysia's social assistance expenditure has been allocated to the education sector. A number of social assistance programs have been implemented to provide in-kind or cash assistance to students in schools or to expand educational opportunities by providing scholarships. As a means of promoting human capital development, this aspect of Malaysia's social safety net has been productive. However, recently, there has been a relative shift away from targeted support towards more universal programs, such as the School Student Allowance. This shift suggests that there is a need for greater clarity in balancing assistance based on merit and financial need.

Compared to other countries in East and South Asia, Malaysia's social safety net system remains relatively underdeveloped, particularly in terms of its depth. Malaysia's core social welfare programs have generally been underfunded, despite having better targeted outcomes than many other programs in the country. The relatively underdeveloped state of Malaysia's social safety net system becomes apparent by comparing the breadth and depth of the social assistance it provides to that of many other countries in East and South Asia. Malaysia performs relatively well in terms of the breadth of coverage, as measured by the percentage of potential beneficiaries covered by the social safety net. However, it lags far behind countries with more developed social safety nets such as Korea, Singapore and Thailand in terms of depth of coverage, as measured by the average expenditures per beneficiary relative to GDP per capita (see Figure 45). This limits the effectiveness of the program.

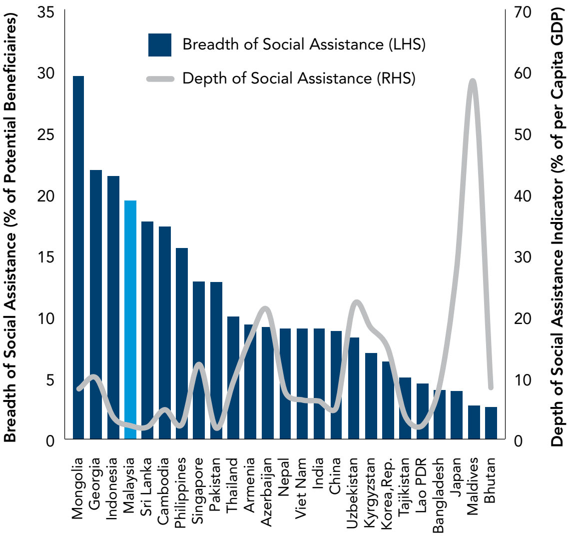
A stylized simulation of the performance of the BSH cash transfer program using data derived from the Household Income and Expenditure Survey shows that the program is expected both to achieve a wide coverage and to be progressive. According to the analysis, BSH coverage rates in the poorest decile of households according to their post-transfer income per capita is expected to be in excess of 90 percent, while in the second poorest decile, it is expected to be in excess of 70 percent. Taken together, without counting administrative expenses, more than 70 percent of the program budget allocated for BSH is expected to go to the bottom 40 percent (B40) of the population according to income per capita, with the balance mostly going to the middle 40 percent (M40), with a very small proportion going to the top 20 percent (T20) (see Figure 46).

While BSH is expected to have a broad and progressive coverage, the depth of the program is expected to be relatively limited, resulting in only a modest effect on overall inequality. The amount of the BSH benefits is a relatively small increment to household incomes even for the poorest 20 percent. BSH's impact on reducing income inequality could be improved marginally – without increasing the total amount of benefits paid – by improving the targeting formula to account for the number of children in the household when determining program eligibility, instead of only at the stage of determining benefit levels. To achieve a substantial reduction in inequality the total outlay for benefits would need to be increased.

FIGURE 45

Compared to countries in East and South Asia, Malaysia's social safety net system remains relatively underdeveloped in terms of its depth

Breadth and Depth of Social Assistance Programs, Selected Countries in East Asia and Pacific

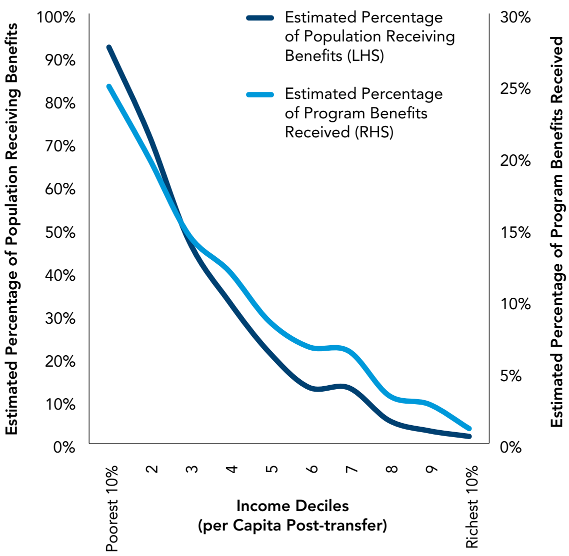


Source: ADB 2016

FIGURE 46

Simulations suggest the BSH could achieve a wide coverage and be progressive

Estimated Percentage of Population Receiving Benefits[14]



Source: World Bank calculations based on DOSM data

[14] Notes: For the simulations, no variable for income from BSH was available in the HIES data set, so it was necessary to approximate the amount of BHS income for each household based on program income eligibility thresholds and benefit amounts. This is an imperfect approximation. It should also be noted that the analysis only considers the benefits side of the equation but does not examine distributional impacts of the revenue side.

What can Malaysia do to fully realize its human potential?

The preceding analysis of key aspects of human capital development in Malaysia shows that while the country has made remarkable achievements, it also faces major challenges. Addressing these challenges will facilitate the economic transformation that Malaysia requires to successfully make the transition to a high-income and developed country. Malaysia will need to achieve this transition in the context of a global revolution in technology that is dramatically transforming jobs and the future of work (see Box 10).

Looking to the future, how can Malaysia continue to improve education, health and nutrition, and social protection outcomes to contribute to the development of human capital and to increased national productivity? To achieve these goals, three key priority areas can be identified:

1. Learning outcomes in the education sector must be enhanced.

2. Nutritional outcomes must be improved to reduce stunting.

3. Social welfare programs must provide adequate protection to enable households to invest in human capital formation.

Initiatives to address challenges in each of these priority areas and thereby to promote optimal development are described in the following sections.

Improving access and quality of early childhood education to ensure that learners are ready to learn

A key measure to improving educational performance in Malaysia is to provide universal access to high-quality early childhood education to ensure that children are "ready for school." School readiness at the earliest stages is strongly correlated with a student's educational performance at later stages of education. Evidence from high-performing countries, including Korea, Japan and Singapore, indicates that their efforts in providing universal access to preschool services to ensure that children are "ready for school" contributed to their remarkable educational performance (World Bank 2018b). High-quality perschool programs have significant benefits throughout a student's life cycle (see Box 11).

Malaysia can improve the quality of its early childhood and preschool education programs, with a particular emphasis on improving the monitoring of the quality of these programs. There is strong evidence to show that the quality of early childhood and preschool education programs is directly linked with the better development of cognitive and social skills by children. The World Bank's Systems Approach for Better Education Results (SABER) framework suggests that there are three important policy levers by which a country can monitor and assure quality: (i) data availability; (ii) quality standards; and (iii) compliance with standards (World Bank 2013). Data-availability refers to the capacity of a system to facilitate the accurate, comprehensive and timely collection of data. This enables more effective policy-making to design new early childhood education services or to modify existing ones (World Bank 2013, Naudeau et al, 2011). Standards for early childhood service delivery are essential to provide guidance and continuity and to guarantee a minimum level of quality for all children. Finally, all systems must have mechanisms in place to monitor compliance with established standards. While this may be challenging, the top performing education systems have developed solid mechanisms for monitoring the quality of their early childhood education programs.

Improved provision of high-quality early childhood care and education programs will also enhance women's access to the labor market and allow them to make productive use of their human capital. In spite of an increase in recent years, at 55.5 percent in Q3 2018, Malaysia's female labor force participation rate continues to lag behind the rates in most comparator countries. The insufficient availability of high quality childcare options is a key factor behind women's decision to stay out of the labor force. The provision of childcare would need to cover all children for ages ranging from 3 months to 16 years. As a result, even though women outperform men in terms of educational attainment (in 2017, gross enrolment in tertiary education was 45.5 percent for women and 38.6 percent for men), they make relatively less productive use of their human capital. As demonstrated by international evidence, further improving access to and quality of early childhood care and preschool programs will almost surely have significant positive impacts on the female labor force participation rate.

BOX 10

Technological change and the future of work in Malaysia

Recent and emerging technological breakthroughs, including breakthroughs in the area of artificial intelligence and robotics, have prompted fears that human workers will be replaced by machines and an era of mass joblessness and even wider income inequality will ensue. Prior to the opening of borders to trade, such technological developments were led by and largely confined to advanced economies. However, greater trade linkages and the pervasiveness of the global communication infrastructure mean that Malaysia and other emerging economies are increasingly exposed to these more sophisticated technologies and their potential for disruption. Indeed, Malaysia and other emerging economies are becoming active participants in their development, commercialization, and adoption.

The anxiety surrounding technological change can be ascribed to three broad developments: the large number of jobs potentially affected, the falling labor share of income, and the changing nature of work arrangements. Estimates regarding the number of jobs exposed to automation technologies vary significantly. While some suggest that as many as half of all jobs are at risk, including in Malaysia, constraints related to technological diffusion, cost, and norms and laws that favor humans over machines mean that not all or even most jobs exposed are likely to disappear in this country in the near-term future. The falling labor share of income is a phenomenon that is for now considerably more pronounced in advanced economies.

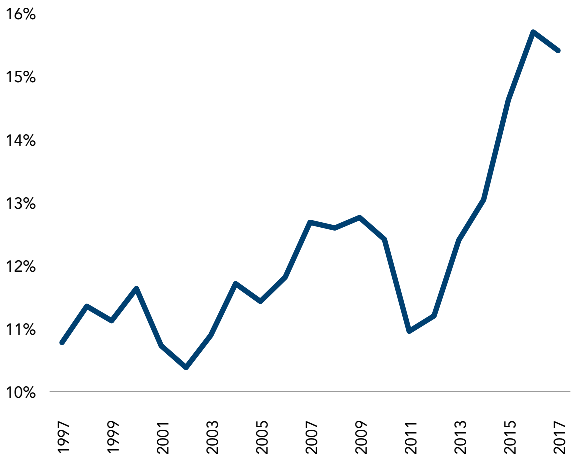
However, new technologies are already creating uncertainty regarding the nature of work arrangements in many different countries. There are already indications that the "gig" economy is starting to challenge the standard employer-employee model in Malaysia. For instance, the share of "own account workers," who are self-employed but do not have any employees is growing in Malaysia (see Figure 47). Even though the flexibility of such new work arrangements may have a number of advantages, such work frequently lacks financial and job security.

While these issues are real, technological change also creates the potential for gains in productivity and welfare. Previous industrial revolutions in which significant economic advancements were made were all associated with large increases in productivity. The new technologies being developed today are also likely to improve productivity, which will imply new job opportunities that cannot be foreseen today.

Complementary policies will be needed across both developed and developing countries to ensure that the benefits of disruptive technologies with regard to jobs are maximized, and the risks are minimized. Maximizing these gains requires policies that facilitate labor market flexibility and mobility; that introduce and strengthen safety nets and social protection; and that provide strong human capital foundations through the provision of effective basic education and retraining and upskilling programs.

FIGURE 47
The "gig economy" is growing in Malaysia

Share of Own Account Workers in Urban Areas, Percentage of Total Employment in Malaysia



Source: Murugasu (2018)

Educational reform that emphasizes the development of both scientific and mathematical abilities and higher-order cognitive skills such as complex problem-solving, socio-behavioral skills, reasoning and self-efficacy is crucial to develop the complementary skills that workers need to benefit from the evolving technological context and to utilize the associated machines and equipment. Complementing basic education with active labor market policies, workforce training, and the provision of other opportunities for lifelong learning can encourage workers to stay engaged and to continue to participate in evolving labor markets.

The future of work also necessitates more in-depth collaboration between industry and learning institutions, with this collaboration including, but not being limited to, the development of curricula that match the latest industry needs. Two types of intervention in Malaysia appear particularly promising.

The first intervention involves embedding more practical exposure within post-secondary education through mandatory apprenticeships for students and frequent secondment of training instructors to industry actors. The former approach has been implemented in a relatively limited form through the Ministry of Higher Education's 2u2i program (which involves 2 years formal training on campus + 2 years internship with industry). The second type of intervention involves the arrangement of more structured internship opportunities, including with SMEs. Internship programs should include clear learning outcomes and well-defined scopes. This will encourage firms to actively build a sustainable talent pipeline, especially SMEs, which are responsible for around 60 percent of employment in Malaysia, but which tend to lack linkages with training providers. More in-depth collaborations between industry and learning institutions are also crucial to ensure that the education system remains relevant and agile to meet evolving labor demands.

Source: Chua, Loayza and Schmillen (2018) and Murugasu (2018).

BOX 11

A life-time of benefits from early childhood education

Preschool programs targeting children aged from 3–6 can foster foundational skills and boost children's ability to learn. Children who attend preschool have higher attendance rates and better achievement levels at primary school. Moreover, they are less likely to repeat, drop out, or need remedial or special education. Not only does this benefit the students themselves, it also results in increased efficiency and reduced costs for the education system. Across countries at all income levels, the most disadvantaged children benefit to the greatest extent from early childhood education programs of sufficient quality.

Not all early childhood programs are equally effective. Overly academic and structured programs for children under five may undermine their cognitive and socioemotional skills, and their motivation to learn. Rather, young children learn best are being encouraged to explore, play and interact with others. Key elements of programs that have led to strong preschool outcomes include curriculums that foster crucial pre-academic abilities (emotional security, curiosity, language, self-regulation) through play; professional development and coaching that enables teachers to effectively implement relevant curriculums; and positive, engaging classrooms that promote children's innate drive to learn. For early child education gains to be sustained, the content, budget, and capacity of providers of preschool programs should be integrated into formal education systems. In addition, the quality of subsequent learning environments in primary school is an important determinant of the long-term effects of preschool programs.

Source: World Bank (2017)

Developing a high-quality assessment system that focuses on learning

A high-quality learning assessment system is an essential ingredient to improve Malaysia's learning outcomes. The quality of an education system can only be accurately determined by an effective system of educational assessment, which can include classroom-based assessments, national assessments and international assessments, amongst other methods. The Malaysia Education Blueprint 2013-2015 has highlighted the need to enhance the quality of assessments to meet international standards. The Education Blueprint outlines plans to revamp national examinations and school-based assessments to target higher-order thinking skills. Moreover, Malaysia has already taken a significant policy decision to decrease the number of national assessments from three to two, in order to address the issue of high-stress levels among school students. These are the types of policy changes which are critical to developing a high-quality learning assessment system.

Properly designed assessments can have a significant positive impact on student learning. There is strong evidence to indicate a link between high-quality, formative classroom assessment activities and better student learning outcomes, as measured by student performance on standardized tests of educational achievement (Clarke 2012, Black and William 1998). A review of high-performing, highly effective education systems, such as those of Singapore and Finland, found that effective assessment systems share a number of common characteristics. The characteristics of these systems are as follows:

1. They demonstrate the importance of assessment for student learning, rather than as a disconnected element of the education system;
2. They provide students and teachers with information regarding what has been learned;
3. They are closely aligned with curriculum expectations, performance criteria and learning outcomes;
4. They engage teachers in the assessment development process;
5. They engage students in understanding how the assessment process can improve their learning;
6. They advance higher order thinking skills by using a range of instructional and assessment strategies; and
7. They use open-ended performance tasks and school-based assessments that give students an opportunity to write extensively (Clarke 2012, Darling-Hammond and Wentworth 2010).

TABLE 7
High performing education systems in East Asia use performance assessments

Country	Assessment	Year Introduced	Target	Sample	Subject Areas
China	China National Assessment	Piloted in 2008, formally rolled	Fourth-and eighth-grade students	Sample based	Chinese, math, science, physical education, art, moral education
Japan	National Assessment of Academic Ability	2007	Sixth-year primary and third-year middle school students	Alternates between census and sample	Japanese, math, science
Korea Rep.	National Diagnostic Assessment of Basic	2002	Year 3 students	Census	Reading, writing, math
	Competency National Assessment of Educational Achievement	2000, extended to all students in 2008	Years, 6, 9, and 11 (assessment in sixth grade abolished in 2013)	Census	Korean language, arts, math, social studies, science, English

Source: Liang, Kidwai, and Zhang 2016 for China; Kuramoto and Kolzumi 2015 for Japan; OECD 2014 for the Republic of Korea, World Bank 2018

In Malaysia, the enabling environment for assessment should be reviewed to ensure that the assessment system is properly aligned with the other parts of the education system. The experiences of top-performing education systems around the world demonstrate that assessments are most effective when the right assessment tools are used in the right context and for right purposes. They also show that it is important that the education system is sufficiently flexible to adapt on the basis of the findings from these assessments (World Bank 2018a; Clarke 2012). Top-performing systems are characterized by an education eco-system that is able to identify which assessments are appropriate and how they are to be utilized. In order for this eco-system to be present, assessments must be supported by the right policies and frameworks (Clarke 2012). In other words, mechanisms should be in place to ensure that assessment results feed back into the policies and practices relating to teachers, students, school governance and curricula (World Bank 2018a).

Malaysia must also identify which range of assessments best suit its educational needs. Assessment quality refers to the psychometric quality of the instruments, processes, and procedures used to conduct the assessments (Clarke 2012 from AERA, APA, and NCME, 1999). Two technical issues that need to be considered in any review of assessment quality are reliability and validity. Research suggests that teacher-based assessments have higher validity than external assessments. Teacher-based assessments often allow for student achievements that may not be captured in a final, high-stakes examinations to be measured (OECD 2018). At the same time, teacher-based assessments are often perceived as unreliable due to the risk of teacher bias and other factors (OECD 2018). The opposite is considered true of external or standardized assessments (OECD 2018). Accordingly, experts agree that a strong assessment system requires the appropriate balance between school based and national and/or international standardized assessments. Most top-performing education systems rely to a greater extent on teacher developed/school-based assessments than on standardized assessments, although all regularly participate in international standardized assessments. The use of national standardized assessments varies, although many top-performing systems, including those of Japan and Korea, implement national assessments to gauge the learning outcomes of students at various stages of the education system (World Bank 2018a) (see Table 7). Reviewing a range of school-based, national and international assessments to find the right mix may enable Malaysia to improve its learning outcomes.

Making better use of assessment data and integrating assessments into the teaching process

To improve learning outcomes in Malaysia, it will be necessary to develop systems to ensure that assessment data is used effectively. Measures to assess learning come in many forms, with different measures serving different purposes for different actors, with these measures including simple classroom based oral assessments to large-scale international assessments, amongst other instruments (World Bank 2018a). If the various instruments and measures complement each other well, they can serve to provide input for policy makers to take action to improve learning outcomes. The effective use of data requires the establishment of connections between assessment activities and system learning goals, standards, curriculum, and pre-and in-service teacher training opportunities (Clarke 2012, Fuhrman and Elmore, 1994; Smith and O'Day, 1991). This is especially important to ensure that assessment activities provide useful input for policy makers to improve the quality of education (Clarke 2012). The World Bank has substantial experience in supporting the implementation and utilization of international assessments (such as PISA), including in countries such as Hungary and Poland, both of which are striving to improve learning outcomes and thereby to upskill their workforce. The World Bank's assistance includes facilitating the deeper analysis of data and exploring the policy implication of the results. Improving the use of assessment data to inform the teaching and learning processes may facilitate the achievement of Malaysia's education goals.

Given that integrating assessments into the teaching process is critical for high performance, teachers must be properly trained to implement classroom-based assessments. The available evidence indicates that all top performing education systems have systematically linked assessment with teaching processes (World Bank 2018). In these systems, formative assessments are used to guide the teaching process as a means by which teachers can obtain continuous feedback on the what students are learning. In turn, this is used to guide the instructional process. Formative assessments will enable teachers to adapt teaching methods to the varying abilities of students in Malaysia. In some countries, more innovative methods of classroom assessment are being developed. For instance, the Escuela Nueva initiative implemented in several countries, including Vietnam, emphasizes teacher observation rather than continuous testing. Regardless of which methods are used, to be effective, teachers must be trained on how to develop, implement and use classroom assessments to improve instructional quality and learning outcomes. Malaysia's educational system would benefit from a review to ensure that the assessment process is sufficiently integrated into the teaching process and that teachers are trained on how to implement and use assessments to improve the learning process.

Addressing the high level of childhood stunting with multisectoral solutions

Unless Malaysia's high rate of childhood stunting is addressed effectively, it will continue to act as a significant constraint on increasing human capital and achieving productivity gains in the long run. There is overwhelming evidence that stunting during early childhood limits a child's physical and cognitive development, with ongoing impacts throughout that child's life cycle, including that child's level of productivity as an adult.

Evidence from around the world shows that the key determinants of child malnourishment and stunting are multi-faceted, requiring multisectoral solutions. Immediate determinants include a child's health status and dietary intake. Underlying determinants are much broader and more varied, including levels of maternal education, monetary poverty, maternal nutrition during pregnancy, access to and availability of affordable and nutritious foods, access to safe water supply and adequate sanitation, parental knowledge and beliefs regarding nutrition, caregiver status and dynamics, and marital and employment status of parents (Smith and Haddad 2000; UNICEF 2018).

While some of these factors may continue to pose significant challenges to nutritional outcomes in Malaysia, anecdotal evidence suggests that it has made notable progress in certain areas. For example, Malaysia's campaign to promote breastfeeding through a range of initiatives since the 1990s has been highlighted and documented in a regional report on nutritional security (ASEAN, UNICEF, WHO 2016). In 2014, Malaysia's National Nutrition Surveillance study found that Malaysia's rate of exclusive breastfeeding at six months stood at 44 percent, higher than the average global rate at the time, which stood at 38 percent. Malaysia's rate has since increased to 47 percent (IPH 2016).

Malaysia's National Plan of Action for Nutrition (2016-2025) defines a vision to improve nutritional outcomes and to address stunting. The plan focuses on improving food and nutrition security, aiming to improve the availability, accessibility, affordability and utilization of food. This plan builds on a number of successful initiatives, including the initiative to promote breastfeeding, while at the same time acknowledging and seeking to address the challenges identified during the previous plan period (2006-2015). These challenges include a lack of intersectoral and multi-stakeholder coordination, insufficient funding, human resource shortages, and poor monitoring and evaluation systems (MOH 2016b).

Addressing these challenges and achieving an improved understanding of the underlying causes of childhood stunting would help to facilitate the effective implementation of the National Plan. Measures to achieve this could include in-depth analysis of existing data to better understand the correlates of childhood stunting, as well as qualitative analysis to determine the underlying environmental, behavioral, or cultural factors that contribute to undernutrition and stunting. A holistic review of existing interventions on nutrition and the development of a multi-pronged, multi-sectoral strategy to tackle stunting, such as was implemented in Peru (Marini et al 2017), could help to reduce the rate of stunting in Malaysia.

At a broader level, meeting Malaysia's evolving needs into the future may require different modes to deliver services, which in turn may require increased public investments. Further improvements in health outcomes and effective access to health services, including for NCDs and chronic conditions, will require a shift in how health services are delivered. Going forward, the reform agenda will need to focus on improving equity and quality of care. In order to maintain a high level of financial protection, the costs associated with these emerging health needs will need to be financed, in large part, through public sources. In turn, this suggests that a review of the level and share of public financing for health is necessary to continue to improve the health status of Malaysia's population and to ensure that the gains achieved in the past will be sustained.

Expanding social safety nets and linking them to measures to promote human capital formation

An expansion of core social welfare programs could provide beneficiary households with income support to enable them to invest in the human capital of their members. Rigorous evidence demonstrates that social assistance programs can provide households with the income support to fight poverty and invest in the human capital of their members. Income support can enable families to spend more on human-capital-enhancing goods and services; allow a better time-use for learning or nurturing; and increase human and social capital accumulation by reducing the pressure of financial strain and deprivation (see Box 12).

The expansion of core social welfare programs should integrate the appropriate mixture of mandates and incentives. Most rich countries impose some form of conditions on beneficiaries of cash transfers if these beneficiaries are not in employment, education or training but are capable of working. Most frequently, these conditions include job search requirements, a requirement that could be considered in Malaysia. In addition, the range of social welfare benefits and services could be expanded to include specific investments to increase the employability of beneficiaries. These approaches should be tailored to meet the specific needs and context of specific groups. For example, urban youth in low-cost public housing may benefit from programs that focus on developing vocational skills, while members of rural indigenous communities may need programs that promote entrepreneurship and agricultural activities. Social welfare delivery systems could also be more closely linked to the delivery of education, health or nutrition interventions.

Malaysia's new BSH Program has the potential to more actively facilitate human capital development. BSH recipients could benefit from information provided through accompanying measures, such measures to raise parents' awareness of best practices for providing nurturing care, to support family members to make better choices, to increase the use of services provided by other agencies and of new services directly provided by or linked to the program, including training to further enhance human capital formation.

BSH payments might also be directly linked to measures that promote the achievement of human capital formation. For instance, payments for households with members of upper secondary school age could be made conditional on proof of school enrolment and attendance (see education section). While this would create some additional administrative demands, it's could be an effective tool to deepen Malaysia's human capital base. The exact nature of the linkages is a matter for further discussion, but the basic idea is that BSH should have specific objectives that encompass wider socio-economic and human capital outcomes to justify the significant expenditure on the program.

Malaysia's social insurance programs could also be more effectively leveraged to support human capital formation. The recent introduction of the Employment Insurance System (EIS) creates a window of opportunity to allow Malaysian workers to mitigate the impacts of jobs loss. At the same time, it will be crucially important that training interventions and other active labor market programs envisaged for beneficiaries are implemented in an effective and coordinated fashion so that the EIS can improve the probability that workers are reemployed in the short term and strengthen human capital formation in the medium and long term. Other social insurance programs, such the Employees Provident Fund (EPF), already provide many Malaysians with resources that can be invested in human capital. However, the coverage of EPF and the adequacy of its members' balances continue to be constraints on the achievement of this goal. Greater efforts will be required to continuously increase them.

If Malaysia's social safety net system is strengthened along the lines proposed in this section, it could facilitate the greater development of human capital, particularly within lower income households. Inequality and rising costs of living remain a challenge for many low-income households, who without adequate support may not be able to make sufficient investments in education and other necessities that enable them to break free from the poverty cycle. A well-designed and strengthened social safety net is vital to enable Malaysian households to build the human capital of all their members through actions implemented at their early years and continuing throughout their entire life-cycle.

BOX 12

International evidence on the impact of social assistance programs on human capital outcomes

Rigorous evidence demonstrates that social assistance programs can support poor households to build human capital through the entire life-cycle of their members. Contrary to popular belief, a comprehensive review (Evans and Popova 2014) of both conditional and unconditional cash transfer programs in Africa, Asia, and Latin America found no evidence that transfers increase the consumption of alcohol or tobacco. Rather, cash transfers are widely used in all these areas by beneficiary households to invest in the human capital of their members. To have an optimal positive impact, social assistance programs need to effectively reach the poorest households and to involve the payment of regular, predictable transfers of sufficient value. Well-designed programs can also leverage investments from the health and education sectors. For instance, they can increase the utilization of health and education services by the most disadvantaged population and therefore maximize the impact of those services (see Figure 48).

Social assistance programs have successfully facilitated an increase in the uptake of prenatal health services and in the diversity of young children's dietary intake, which can improve children's health and nutritional outcomes. In a recent review of 156 studies of both conditional and unconditional cash transfer programs in 30 countries, Bastagli et al. (2016) reported that nine out of 15 studies found evidence of increased health service use, while seven out of 12 studies found evidence of increased dietary diversity. Another review that focused on child outcomes (de Walque et al. 2017) found evidence of improvements in prenatal care and increases in the presence of skilled birth attendants, of growth monitoring, and of children's food consumption.

There is also evidence that social assistance programs have facilitated increased school enrolment and attendance rates amongst children and adolescents and improved learning outcomes.

FIGURE 48
A social assistance theory of change

INPUTS

INCOME SUPPORT
- Cash
- In-kind
- Vouchers

ACCOMPANYING MEASURES
- Information
- Services
- Nudges
- Conditions

OUTPUTS

Goods: more/better food, water, soap, medicines, books or toys

Services: more health care, education

Time Use: reduce child labor, allow for more and higher quality caring hours

Socio-emotional functioning: reduced stress and depression, greater bandwidth for parenting

Prevention of risks: diversification of income sources, better employment opportunities

Parenting: breastfeeding, nutrition education, early childhood stimulation

Health care: pre-natal, attended deliveries, vaccines, weight checks, growth monitoring

Education: preschool, primary, secondary Training: job skills, adult literacy, socio- emotional skills, entrepreneurship skills

OUTCOMES

- Reduced poverty and vulnerability
- Increased savings
- Higher birthweights
- Lower morbidity
- Better nutrition
- Higher enrollment
- Better grade progression
- Higher completion rates
- Better test scores
- Better cognitive/ non-cognitive skills
- Better labor market outcomes
- Reduced stress and depression

Bastagli et al.'s review (2016) also found evidence of positive impacts on school enrolment and attendance rates. The impact on enrolment rates in secondary schools was more significant than for primary schools. Overall, social assistance programs can have a significant positive impact on access to education by removing binding financial barriers. A less clear-cut pattern of impacts emerges for learning outcomes (as measured by test scores) and cognitive development outcomes, partly because these result from a dynamic interaction between biological, social and environmental factors. Nevertheless, when Bastagli et al. (2016) examined the overall effect of social assistance programs, they found positive impacts on math and language test scores and cognitive development outcomes.

When cash transfer programs are accompanied by measures such as training programs, these measures can further enhance human capital formation. Training programs might include vocational, noncognitive skills, and entrepreneurship training. Similar programs (with or without cash transfers) are offered through active labor market programs (ALMPs). Over the last decade, the number of experimental evaluations of ALMPs in developing countries has increased. Typically, their impacts depend on the economic context, target groups, design elements and implementation. ALMPs can produce good results when they are appropriately designed and effectively target disadvantaged groups of people, helping these groups to become more competitive in the labor market.

While the most direct effect of social pension programs is to alleviate poverty and to improve shared prosperity, they can also contribute to household human capital investment. Across the world, social pension systems are rapidly expanding. They can enable older people to gain access to health care and to increase their well-being (better health, better mental status, healthy and active aging, decreased disability and mortality, etc.). They can also offset the cost burden of the medicines on which many older people depend. Social pensions also provide resources (money and time available) that can be invested in the human capital of older people's family members or productive enterprises. For instance, the expansion of South Africa's social pension system led to an increase in school attendance and to a reduction in child labor (Edmonds 2006).

Source: World Bank (2018c).

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