

ISSUE 02 – APRIL 2017

DEVELOPMENT DIGEST

FEATURED WORK FROM THE
WORLD BANK GROUP GLOBAL KNOWLEDGE &
RESEARCH HUB IN MALAYSIA



Identifying new growth pathways



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ABOUT DEVELOPMENT DIGEST

The Development Digest is a half-yearly publication that features key works from teams based at the World Bank Group Global Knowledge and Research Hub in Malaysia.

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Notes:

In this publication, "\$" refers to U.S. dollars.

TABLE OF CONTENTS

Foreword	1
The “ new normal ” for Malaysia	3
The quest for productivity growth.....	11
The PEMANDU experience.....	19
INSIGHT: Malaysian exporters	27
Financing for Lao SMEs	35
Regulation in agriculture.....	42
Patterns of world agribusiness trade	48
Innovative financial inclusion	54
Improving remittance for migrants.....	60
Should we fear a forex drop?.....	65
Informality , development & growth.....	71
Building state capability	76



DEVELOPMENT DIGEST: ISSUE TWO

Ulrich Zachau

Selamat Datang! (Welcome!)

The World Bank Group Global Knowledge and Research Hub in Malaysia welcomes you to the second issue of the Development Digest, a publication that features frontier research on selected economic and social development topics by experts over the previous six months.

Identifying new growth pathways

THE GLOBAL economic challenges of today are complex. The World Bank Group Global Knowledge and Research Hub in Malaysia tries to bring together great ideas to come up with solutions to address these challenges. The Development Digest seeks to capture the work of the Hub, combining frontier research from the Development Economics (DEC) teams, Global Practices (GP) teams, and the Country Management Unit based in Malaysia, in one easy-to-read magazine-type publication.

The focus of this Digest is to share Malaysia's people-centered developmental expertise and to present new policy research on local, regional, and global issues.

We begin this issue with an update on the global economy and its implications for Malaysia. Then, we move into topics like increasing productivity, public service delivery, trade in Malaysia, and financing for small and medium enterprises (SMEs) in Lao PDR. Other articles include two pieces on agriculture, focusing on trade and regulation, respectively; innovative financial inclusion, with a spotlight on FinTech and Islamic Finance; migrant remittances; foreign exchange depreciation; the informal sector; and effective public sector implementation.

The collection of articles in the Digest represents the rich diversity of work from the Hub, and is testimony to Malaysia's development experience and growing role as a center of development expertise – a fitting role for a nation progressing toward high-income status.

I hope you will find moments of inspiration as you read this Digest.

ULRICH ZACHAU is the World Bank Country Director for South East Asia



MALAYSIA & THE NEW NORMAL

Faris H. Hadad-Zervos

The span of the lingering slump in the global economy is still unknown. Whether this is a passing sluggishness in an otherwise healthy path, or a correction to the rosy course of previous years, remains to be seen. Whatever the case may be, it is clear that the listless trade and investment flows seen across the world masks something else – a “*new normal*” in the global economy.

Global growth prospects and “the new normal”

THERE ARE several aspects to this *new normal*. Global commodity prices are now widely seen as settling into a new equilibrium, where the peaks of the past are long gone. China, in its new center stage as one of the key drivers of global growth, is itself evolving into a mature and consumption-driven economy with more moderate growth patterns. Similarly, recent events in the US are likely to lead to Federal Reserve normalization of interest rates.

All these and other factors – along with the subdued trade and investment flows – led the World Bank to revise its global GDP growth to 2.4 percent in 2016, and 2.7 percent in 2017¹. Another new pattern is the composition of this growth.

To the extent that the global economy has grown, this was propelled by emerging and developing economies, and not the advanced economies as was traditionally the case.

Among these emerging economies, growth was mostly driven by commodity importers, and mitigated by commodity exporters. South Asia and East Asia are the two main sources of this global growth. A collection of different countries and economic narratives, these regions share some common elements, including a growing reliance on domestic demand to drive GDP, and broadly-sound policies. Within the East Asia and Pacific (EAP) region, a closer look at the overall positive trend shows variations across countries.

China’s growth, a key driver of regional and global prospects, is moderating to a slower-but-more-sustainable pace as the economy matures, relying less on massive investment and more towards consumption, services, and higher-value-added activities. China will likely grow by 6.5 percent in 2017 and ease steadily to 6.3 percent in 2018.² Other large economies will also drive the regional trend; for example, the Philippines, Vietnam, and Indonesia.

The economic fate of these countries will depend on continued adoption of sound fiscal policies, investment, and further enhancements to their

¹ Global Economic Prospects, December 2016

² East Asia Pacific Economic Update, October 2016

business climates. Other countries in the region will also undergo some degree of growth based on a number of factors, including focused public investment (Thailand), the ability to counteract the drop in commodity prices (Malaysia and Indonesia), the ability to maintain competitiveness in exports (Cambodia), and the continued flow of foreign direct investment (FDI) and public investment (Myanmar).

Among the smaller economies in the region, the story is more varied. Commodity-dependent countries like Mongolia and Papua New Guinea are likely to be heavily impacted in 2016 and 2017, as mineral and gas export prices and/or quantities weaken. Similarly, the small Pacific Island countries that rely so much on regional fisheries and tourism are highly vulnerable to natural disasters, climate change, and trade shocks.³

Hence, insofar as the growth patterns vary across countries, so do the risks and their impact. A sharp global financial tightening, a further slowdown in world GDP growth, or a greater-than-anticipated slowdown in China will hit all, but in different ways depending on each country's exposure and ability to manage its fiscal and financial vulnerabilities. This, in turn, depends on their own fiscal space and their legacy of having so far preserved macro-financial stability, and reduced financial and fiscal imbalance in recent years.

In summary, a country's resilience is largely a result of its actions to balance short-term countercyclical policies with debt sustainability and focus on medium term growth.

Countries that have preserved room for fiscal manoeuvre by broadening their revenue sources and spending efficiently can handle the downside risks better.

This is particularly important for commodity producers, where low commodity prices have already had a significant impact on public revenue.

Another source of both historic opportunity and risk is trade, which has slowed down considerably in recent years. A cornerstone of global growth, trade in merchandise alone stood at \$16.4 trillion in 2015, three times larger in volume than in 1990. FDI, increasingly intertwined with trade, has grown almost seven-fold in the same period.

³ East Asia Pacific Economic Update, October 2016

Developing countries that have ventured into greater trade and investment flows saw longer periods of sustained growth and poverty reduction.

While the recent declines have had more impact on these open economies, their deep and structural economic gains over the years have not been reversed. Also, those who have diversified their export base are likely to mitigate the risks.

Malaysia has fared well in this regard, due to its early path as an open economy, and the recognition of what needs to be done during economic cycles. The central bank's monetary policy has continually been accommodative. At the same time, macroprudential policies have been put in place to ensure that risks of financial imbalances remain contained.

Weak external demand was largely offset by robust domestic demand, bolstered by ongoing income-supporting measures, a stable labor market and wage growth. The fiscal policy has also been pro-active in responding to external shocks, particularly the recent decline in global commodity prices. In addition, the government continues to show its commitment to fiscal consolidation, and has undertaken necessary reform measures.



Eye on the prize: Poverty and shared prosperity

The efforts of policymakers to stabilize their economies in the current environment are necessary, but alone, they are not sufficient. Stabilization should not come at the expense of keeping our eye on the prize – not just growth, but growth with equality of opportunity.

While shared prosperity cannot come without economic growth, it is possible for growth to not be accompanied by shared prosperity. Indeed, many countries have had economic growth, but a large share of the population remains vulnerable to poverty, and significant rural-urban income gaps persist. This risk is greater in this “*new normal*”.

Globally, around 100 million people have been lifted out of poverty between 2012 and 2013 alone – over a quarter of a million people every day. Similarly, global inequality has been declining over the past 25 years. Yet, almost 800 million people still live in extreme poverty (living on less than \$1.90 a day). Of these, 80 percent live in rural areas and half are children. In twenty-three countries, the poorest 40 percent are getting poorer. In thirty-four countries, the gap has widened between the richest 60 percent and the poorest 40 percent.

While about half live in Sub-Saharan Africa and one-third live in South Asia, significant challenges remain in the EAP region. In 2015, the share of the region’s population living in poverty fell to 2.6 percent, but in several of these countries the poor remain vulnerable, impacted by shocks ranging from food prices to extreme weather. Poverty continues to afflict one person in five in Papua New Guinea, the Solomon Islands, and Timor-Leste. In several other countries, disadvantaged groups such as ethnic minorities are lagging behind by an often-increasing margin. So, while they have not shared fully in their countries’ economic gains, they share disproportionately in their losses.

Staying on the long path to inclusive and sustained growth across the EAP region requires equal attention to managing the current economic downturn, while addressing vulnerability and equity.

Three areas emerge:

FIRST, human welfare needs to be at the center of policies on economic prosperity, and not a byproduct of it. High levels of undernutrition persist across developing countries in the region. Infant and child undernutrition in particular generate health and cognitive deficits that are hard to reverse, leading to lifelong disadvantage. Reducing these imbalances through early childhood development programs would increase welfare, inclusion, and economic growth in developing countries.

SECOND, technological developments can be unlocked not only for productivity-led growth but also for financial inclusion and better services for the poor. New digital technologies accessed via mobile platforms, big data, and cloud computing can not only introduce new products and business models, but also provide better ways to extend financial and other services to the poor, rural areas and marginalized groups.

These technologies can facilitate identification, increase people's voices in decision-making, facilitate remittances and enhance access to financial products, among others. While several countries still lack the proper legal and regulatory framework to exploit these technologies, the region's relatively-advanced technological infrastructure and high mobile penetration can make this a quick win.



THIRD, evolving the social protection systems can significantly reduce vulnerability to shocks and minimize their impact on the poor. In the face of major shocks, the poor and vulnerable groups are the first to cut health-care spending or educational investment, and sell productive assets, amplifying their human-development and income-earning shortfalls. Natural disasters are a particular concern to the vulnerable. Well-targeted and adaptive safety nets continue to be lacking in many countries in the region.



The Malaysian narrative: the long way home

Malaysia's economic growth storyline fits squarely within the narrative of EAP. The World Bank estimates that the country's GDP will have grown by 4.2 percent in 2016, moderating from 5 percent the year before, as a result of the weak external demand for commodities. Driven by private consumption and both public and private investment, Malaysia's well-diversified economy has been able to withstand to a large extent the challenging external environment.

While solid macroeconomic management has allowed Malaysia to weather the challenges posed by the global downturn, the country's economic storyline goes farther than this period. From commodity dependence and a poverty rate of almost 50 percent less than fifty years ago, Malaysia has transformed itself into a diversified economy, nearly eradicating extreme poverty and narrowing the gap in income equality.

Throughout this period, household incomes of the Bottom 40 percent (B40) grew faster than those of the overall population. According to World Bank calculations using data from the Department of Statistics Malaysia, after adjusting for inflation, incomes of the B40 grew at an average annual rate of 15.5 percent, compared to 9.9 percent for the total population between 2009 and 2014.

This positive economic storyline involved much more than simply the management of economic cycles. It has been deep structural reforms that propelled Malaysia from low-income to upper-middle-income status.

Moving forward, a similar investment in the next generation of structural reforms is needed in the transition to high-income status.

Key to this transformation is the creation of a new form of human capital; one compatible with a high-income economy that is competitive enough to engage in a world market bigger than itself, as well as in high-value products and services that can accommodate this new generation's workforce. Thus, the focus is both on the creation of a critical mass of demand for Malaysian high-value products and services, and the supply of skilled young Malaysians to match it.

Like its peers in the region, Malaysia's course moving forward will need to balance its quest to unlock its remaining pockets of productivity, while safeguarding the gains in inclusiveness with regards to its B40. Especially in today's waning global economy, with the constant temptation to focus on short-term management, the goal remains long-term growth that leaves no one behind. As such, prudent policies to maintain fiscal space must continue to be balanced with efforts to maintain investment and growth, while at the same time ensuring an efficient safety net system that properly targets the vulnerable.

The tension between these three priorities is ever-present, and one will inevitably be addressed at the expense of the others. Yet, all three are needed to move forward. It is the long way to go, but likely to be the only way home.

This article was first published in Issue 24 of ASIAN LINK, a flagship publication of the Asian Institute of Finance. To download the issue, visit bit.ly/AIF_AsianLink24

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THE QUEST FOR PRODUCTIVITY GROWTH

Rafael Muñoz Moreno

In pursuit of its high-income goal, Malaysia needs to increase its productivity growth and continue investing in physical and human capital, by facilitating the growth of infrastructure, closing the skills gaps, encouraging both technical and non-technical innovation, and improving the allocative efficiency of productivity factors across the economy.

Towards high income

FACTOR ACCUMULATION has been a key driver of Malaysia's robust economic growth over the past 25 years. The country's labor and real capital stocks both grew at an annual rate of two percent, which has contributed significantly to the country's economic growth. However, productivity growth over the past 25 years has been below several global and regional countries.

Malaysia's total factor productivity (TFP), which measures the efficiency with which factors of production are used to produce goods and services, has managed a growth of around 1.8 percent annually. While significant, TFP growth has been below those in several global and regional comparators (e.g. an average of 2.2 percent in Korea and Singapore). Furthermore, this has declined since the 2008 global financial crisis.

As factor accumulation is expected to slow, accelerating productivity growth is the main path for Malaysia to achieve convergence with high-income economies.

With capital and labor growth expected to slow down, rising productivity growth, greater female labor-force participation, and continued investment in physical and human capital will be necessary for Malaysia to achieve high-income status. Data from the World Bank Enterprise Surveys (ES) for ASEAN countries have shed light on how Malaysia stacks up across four major interrelated drivers of productivity; namely, infrastructure, education, innovation and efficiency.

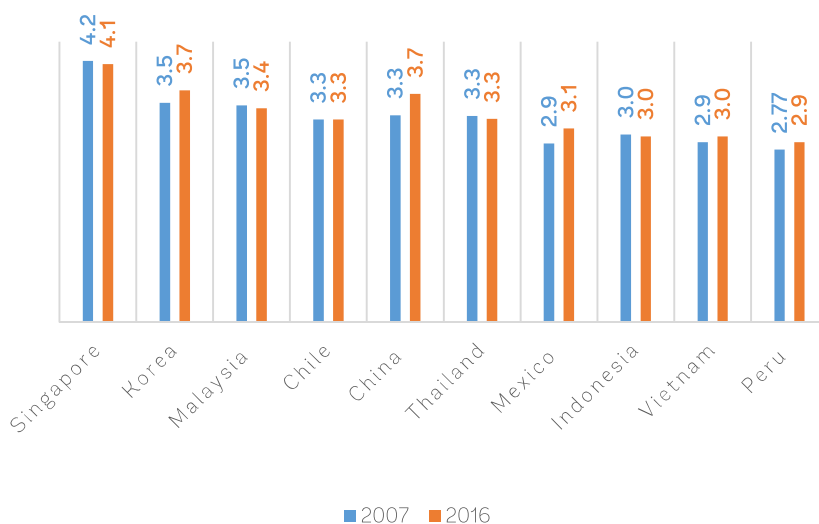
Infrastructure quality

Malaysia has performed well in terms of the quality of its infrastructure. Malaysia's public utilities and logistics services are especially strong by the standards of comparable countries. This reflects sustained public investment based on multi-year targets set forth in national economic plans, efforts to boost private investment in infrastructure through public-private partnerships, and infrastructure development initiatives by Non-Financial Public Corporations (NFPCs).

Over the last decade, other middle-income countries have also made significant efforts to increase their infrastructure stock and improve its quality. However, while the infrastructure gap between countries is

narrowing, the same is not true for logistics performance. Malaysia continues to rank above many of its peer countries on the World Bank's Logistics Performance Index (Figure 1), which includes the quality of trade and transport infrastructure and related services.

Figure 1: Compared with other middle-income countries, Malaysia performs especially well on indicators of logistics performance



Source: World Bank Logistics Performance Index.

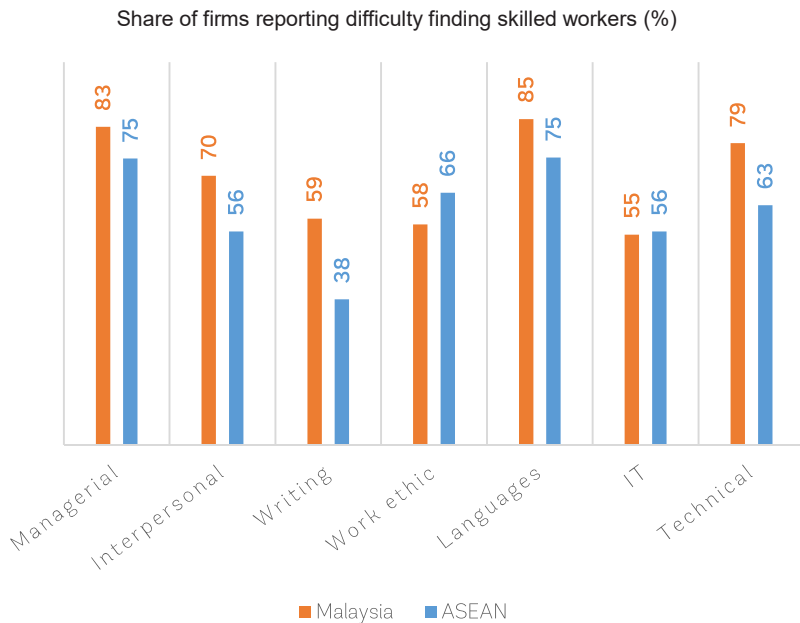
Infrastructure strategies that focus on supporting trade are key for boosting productivity. Infrastructure development can be reinforced by coordinating the appraisal and planning process for public investment, bolstering inter-agency collaboration. Maintaining the competitive edge over other middle-income countries requires trade facilitation (particularly customs clearance).

Workforce education

An effective education system that provides primary and secondary education to everyone and promotes higher education in universities and continuous training in industries is key. About 81 percent of Malaysian workers have completed secondary school, a higher rate than in some high-income and OECD economies.

However, some firms have reported challenges in acquiring specific labor skills. According to the 2011 round of the National Economic Return Survey, more than 15 percent of the surveyed employers report experiencing deficits of technical skills for technicians. There is also evidence that firms that innovate, export and invest in R&D are generally more likely to report skill deficits among their labor force.

Figure 2: Malaysian firms have greater difficulty identifying workers with adequate skills in comparison with ASEAN comparators



Source: World Bank Enterprise Surveys.

These skills gaps could be remedied through strengthened training programs. Closer coordination with the private sector (i.e. inputs in the design of curricula, provision of apprenticeship opportunities) could improve the effectiveness of existing training, and alleviate skill mismatches in the labor market.

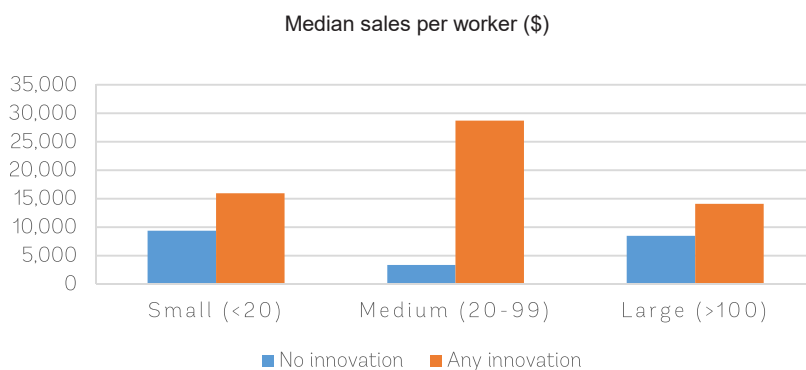
More intensive usage of labor market information to inform skill development policies and programs, and a stronger focus on spending effectiveness and efficiency, could lead to improvements in the skills of the Malaysian workforce.

Technical and non-technical innovation

Innovation includes creating and adopting new technologies, products, and processes which can lead to higher value-added economic activities. Innovation requires investment in research and development (R&D) and competent scientists and engineers to create state-of-art technologies, but also requires strengthening human capacity to be able to learn about existing technologies, products, and processes, and apply and/or develop them into new products and processes for business needs.

ES data indicate that more innovative firms tend to be more productive. While 44 percent of Malaysian firms invest in organizational and commercial innovation (compared to 32 percent in ASEAN countries), only 17 percent of Malaysian firms invest in developing new technologies (compared to 27 percent in ASEAN countries).

Figure 3: Malaysian firms that innovate tend to be more productive



Source: World Bank Enterprise Surveys.

Building innovation capacity requires strengthening the R&D ecosystem and facilitating technology absorption. Upgrading technological capability through technical innovation likely requires improved access to skills/talents and more liberal investment policies, allowing firms to deploy cutting-edge production technology with fewer restrictions. It is also important to ensure that smaller firms have access to such new technology.

Allocative efficiency

Efficiency means how effectively and timely capital and labor are allocated across firms. Capital and labor need to be reallocated to higher-value-added economic activities within and across sectors for productivity growth. For this renewal, flexibility of resource allocation and use is important.

However, the rigidity of market, labor, and trade regulations has been an obstacle in many developing countries, and impeded enterprises from starting and expanding a business and adopting new technologies. Improving allocative efficiency could increase Malaysia's TFP.

Reducing distortions to the level of the most efficient economy would boost productivity by 23 percent.

Many of Malaysia's most productive firms could be operating at an even higher level in an environment of greater allocative efficiency. The movement of resources from less-productive to more-productive manufacturing firms would drive the acceleration in GDP growth.

Panel data from 2005, 2010 and 2014 reveal that allocative efficiency across firms has remained broadly stable over the period, at a level that is around 22 percent below the U.S. level of efficiency in 1997 (which is considered as a benchmark of high efficiency) (Table 1).

Table 1: Summary of potential efficiency gains (percent)

	<i>Complete elimination of distortions</i>	<i>US level of efficiency in 1997</i>
2005	74.95	22.43
2010	75.95	23.13
2014	75.65	22.92

Source: World Bank staff calculations

If aggregate TFP of Malaysia's manufacturing sector increased to the levels of the U.S. economy, the GDP growth rate could exceed the rate forecast in the 11th Malaysia Plan by 0.1-0.4 percentage points.

Addressing market distortions

While misallocation in factor markets (capital and labor) does not seem to be the main reasons holding productivity growth, misallocation in output markets, where firms sell their final products and services, does. Some of the main reasons that can explain the distortion in output markets are competition, the role of Government-Linked Companies (GLCs), asymmetric tax or subsidy structures, and regulations. Overall, this finding underscores the importance of accelerating domestic reforms to boost productivity.

Addressing distortions in output markets where firms sell their goods and services may be achieved by reviewing policies that hamper competition.

To overcome inefficiencies in output markets, Malaysia can explore measures to strengthen its competition policy and adopt competitive neutrality in its regulatory stance, particularly with respect to GLC operations. From the regulatory perspective, amending existing policies to open markets for increased foreign private sector participation, mainly in the services sector, would also help boost productivity, by increasing the level of competitiveness in the sector.

Regulatory burdens seem to be fine overall, but are perceived by the private sector as the main business environment obstacles to firm-level efficiency. While complying with regulations requires only three percent of managers' time in Malaysia compared to 11 percent in high income economies and OECD countries, regulation-related challenges are among the most important business constraints cited by Malaysian firms. These include the prevalence of informality and corruption, as well as the burdens imposed by licensing, tax and labor regulations, among others.

Conclusion

Closing the gap with high-income countries will require accelerated productivity growth, combined with strong performance of traditional growth drivers. The scenario analysis indicates that maintaining productivity, investment and labor force growth at their current rates would bring Malaysia's GDP per capita to about 29 percent of the average GDP per capita of high-income economies in 2050.

Accelerating annual TFP growth to 2.3 percent, a target of the 11th Malaysia Plan, would boost Malaysia's GDP per capita, but the country would still reach just 40 percent of the projected GDP per capita of high-income countries by 2050.

Achieving convergence with high-income countries will therefore require accelerated TFP growth combined with the improved performance of factor accumulation and human capital formation.

The existing institutional architecture has sustained Malaysia's consistent productivity growth for more than two decades. However, its institutional and policy arrangements could be redirected towards productivity growth.

The country's existing institutional framework has maintained a consistent productivity growth for more than two decades, albeit lower than that of high-income economies. Going forward, policymakers will face a complex challenge as they strive to enhance productivity while accelerating physical- and human-capital formation.

For the full report of the Malaysia Economic Monitor December 2016: The Quest for Productivity Growth, visit bit.ly/MEM_201612

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THE PEMANDU EXPERIENCE

Jana Kunicová

Under the right circumstances, Delivery Units (DUs) can help to strengthen the link between a given policy and citizen outcomes. Malaysia's Performance Management and Delivery Unit (PEMANDU) was established in 2009. PEMANDU became the largest and one of the most prominent DUs in the world, with many countries looking to learn from this experience.

⁴ Dato' Sri Idris Jala (third from right), CEO of PEMANDU on the ground with his team during a site visit of the Greater Kuala Lumpur Mass Rapid Transit project in February 2017. Photo courtesy of MRT Corp. Other photos in this article are courtesy of PEMANDU.

Delivering Transformation

MALAYSIA'S EXPERIENCE with PEMANDU is best understood in the context of the country's broader development journey and public sector performance culture. Malaysia's public sector development, which pre-dates PEMANDU, has created an enabling environment that set the stage for PEMANDU. Since the country's independence in 1957, Malaysia's public sector focused on solving development challenges facing the newly independent country, including providing services to eradicate poverty and building up infrastructure to enable the diversified growth of its economy.

In 2010, PEMANDU introduced and implemented the National Transformation Program (NTP), a set of high-level strategic priorities of the government broken down into concrete interventions. The NTP was implemented by ministries, departments, and agencies (MDAs), while PEMANDU helped track, monitor, and de-bottleneck the process. The focus has been on achieving results from the very beginning. This performance orientation created elements of a performance culture. As the public sector developed, it also gave rise to an institutional ecosystem for performance management. These elements provided the foundations on which PEMANDU could build.

What makes PEMANDU effective?

PEMANDU's signature methodology, "Eight Steps of Transformation," ensured its focus on key tasks at every point in time. High-level priorities were cascaded into concrete interventions contained in the NTP, and created stakeholder ownership. PEMANDU's goals were granular to create maximum focus and accountability for results. These goals were defined by the NTP: seven national key results areas (NKRA), twelve national key economic area (NKEAs), and six strategic reform initiatives (SRIs). These were further detailed into projects with specific key performance indicators (KPIs) and timelines that PEMANDU follows up on. Responsibility for the implementation of the NTP projects lied with the MDAs, not PEMANDU. PEMANDU drives the NTP – through its design, adjustments, monitoring, de-bottlenecking, and communicating.

"Labs" were one of PEMANDU's signature innovations that created ownership of the NTP among a wide variety of stakeholders.

The lab is a consultative process – with deep focus on a policy area lasting six to nine weeks, where participants work together to design solutions to identified policy challenges. The participants include representatives from the MDAs, both leadership and rank-and-file, as well as representatives from the business community and civil society. These labs took strategic priorities of the new government in 2009 and unpacked them into projects and action items under each NKRA, NKEA, and SRI. Through the labs, PEMANDU ensured that the NTP was demand-driven and widely owned by MDAs.



Open Days are crucial to ensure that policy initiatives coming from the lab are communicated to stakeholders and members of the public

PEMANDU created incentives at all levels through rigorous monitoring and reporting of KPIs.

KPI target-setting for the NTP cascaded down from the Minister to the MDA staff. While the initial KPIs were set during the original labs, annual targets were revised jointly between PEMANDU and MDAs. The set of KPIs was then presented in a Minister's Scorecard. PEMANDU used a dashboard for KPI tracking that is updated weekly. Weekly monitoring often revealed implementation problems. PEMANDU would assist at the first instance of such issues, followed by technical committees. If unresolved, it was escalated to monthly steering committee meetings. If the problem persisted, a semi-annual problem-solving meeting, chaired by the Prime Minister, would then look into the matter.

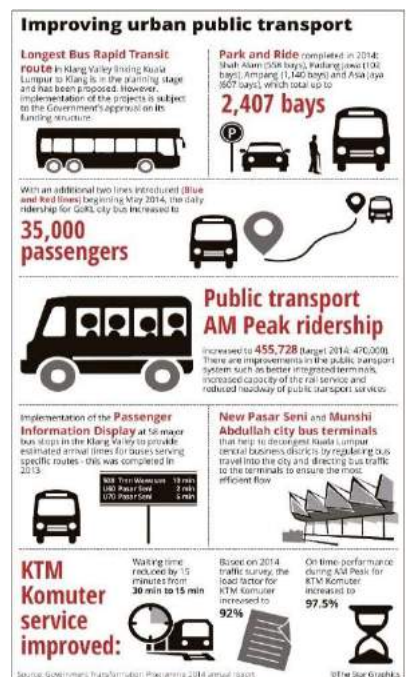
PEMANDU's institutional setup allowed it to attract talent from the private sector, introducing corporate best practices into public sector management. As a "special-purpose vehicle" in the Prime Minister's Department, PEMANDU commanded flexibility in recruitment.

PEMANDU's pay structure was outside the civil service pay scale and attracted talent from both the private and public sector. This naturally allowed for a mix of ideas and best practices to be shared and implemented.

The implementation of the NTP was enabled by institutional structures, such as Delivery Management Offices (DMOs) within ministries. These structures included MDA officials who work alongside PEMANDU staff to set, track, and adjust the KPIs. The DMOs also assisted PEMANDU to escalate, coordinate and facilitate the processes associated with the KPI reporting.

PEMANDU placed a strong emphasis on its communication function, reinforcing the ownership of the NTP and government's accountability to the public.

PEMANDU's communications plan was designed to keep stakeholders informed every step of the way: to put the strategic direction into the global perspective; highlight the subject matter, findings and progress of the labs; public engagement and communication of feedback; illustrate the accountability, commitment, and built-in flexibility of the KPI targets; highlight milestones and challenges during the implementation; emphasize that the external validation of results is achieved through the audit; and summarize what the NTP delivered in the Annual Report. Although the NTP Annual Report was one of the key outputs of PEMANDU's communication team, there were also weekly communications plans, developed a year ahead, utilizing a wide range of platforms: infomercials, social media, radio, editorials, as well as direct engagement through roundtables and workshops.



A sample infographic showing NTP results in 2014. Content courtesy of The Star Malaysia

PEMANDU's biggest challenges are a flip side of its greatest strengths

The same features that make PEMANDU effective can turn into challenges when the mix is not right, or the conditions change. This points to a set of tradeoffs that DUs must balance.

The existence of a robust institutional ecosystem focused on public sector performance is a strength until the ecosystem becomes too complex. Aside from PEMANDU's mandate, which involves reporting on the NTP KPIs, ministries had a number of other performance tracking obligations. This resulted in a heavy reporting burden for MDAs. In addition, different sets of KPIs made performance incentives complex and sometimes conflicting.

A private sector corporate culture and top talent infused innovation into the public sector management, but also created a perception that PEMANDU staff were outsiders with limited public sector exposure. The salary differential between PEMANDU staff and civil servants potentially created an additional strain. PEMANDU staff strove to counter this by focusing on areas where they can add value for MDAs, such as monitoring, just-in-time problem-solving across MDAs, and resolving bottlenecks through the escalation process. Overall, the perception of PEMANDU varies among ministries. In some MDAs, the relations are cordial and PEMANDU is perceived as an asset; in others, a more skeptical attitude prevails.

Rigorous KPI monitoring and reporting can drive performance; on the other hand, it is limited by the quality of the indicators and the data.

PEMANDU's efforts were not immune to the well-known critiques of KPI-driven efforts to improve public sector performance. If an indicator does not measure a desired outcome, then the respective MDA would have "met the target but missed the point" of a broader reform. Some parts of the NTP, particularly the NKEAs, yielded themselves to measurement; yet others, notably the NKRAAs such as reducing crime or controlling corruption, were notoriously hard to measure. There is also a more general discussion about whether the targets are meaningful, given that MDAs achieve and overachieve the majority of them. Critics have called into question the credibility of the underlying data used to

measure the KPIs, but PEMANDU's utility of a third-party audit assuaged these concerns to some degree.

Designing the transformation program through labs may have missed some important elements of project design that would allow attributing results to the NTP and not to other efforts. Because the NTP represents only a small portion of government efforts under the five-year plan, questions of attribution of the outcomes were raised. For example, if literacy improvements in Malaysia was due to the NTP interventions (i.e., the literacy and numeracy screening), or to one of the many other non-NTP initiatives (e.g., the revamped curricula, district transformation program, or others), or a combination of both. Although PEMANDU labs created stakeholder ownership, they did not build in features into the project design that would allow impact evaluations of the NTP programs.

The question often raised is whether the overall impact was a result of a narrow strategic intervention in the NTP, or of a multitude of other programs happening in parallel. At the same time, not all impact of a transformational set of initiatives such as the NTP is measurable.

Impact evaluations of NTP projects that attributed some portion of national outcomes to the NTP could have extended the credibility of PEMANDU's sophisticated communications effort. PEMANDU's critics are often skeptical about PEMANDU crediting the NTP for Malaysia's aggregate achievements. They emphasize that the NTP represents only a narrow set of priorities, while many initiatives under the Malaysia five-year plan worked toward the same goals. Impact evaluations can serve as the empirical evidence to allay the concerns of critics. This implies that careful prioritization and thorough communication work of a DU should, where possible, go hand-in-hand with meticulous evidence to demonstrate that related interventions are responsible for downstream outcomes.

At the same time, the NTP interventions are meant to be catalytic and not all encompassing. Shifting the emphasis to impact evaluations for the sake of clear attribution may be missing the point of a transformation exercise. The impact of a transformational program such as the NTP is by design expected to be more than the sum of the impact of its projects. Impact evaluations will only be able to show part of the picture.

However, they can help build the overall support for the DU efforts, maintain the MDA buy-in, and also establish the cost efficiency of the priority interventions.

Learning from the PEMANDU experience

Replicating the whole structure of PEMANDU in its entirety may not be feasible, but using some of its innovative approaches and tools can serve as solutions for many countries. Among the existing delivery units around the globe, PEMANDU is an outlier in size. Few developing countries will be able to afford such a large DU.

In addition, many contextual factors, such as a relatively developed institutional ecosystem and performance culture, contributed to PEMANDU's ability to drive performance. Finding the right balance is key.

The features that played to PEMANDU's strengths and challenges point to the following lessons and tradeoffs for countries considering establishing a DU:

- » **Secure strong backing and involvement of top leadership:** PEMANDU's success critically depended on the Prime Minister's direct involvement in its routines. Problem Solving Meetings and performance reviews with the Prime Minister proved effective for implementation and clearing up bottlenecks between MDAs. The tradeoff is the potential politicization of the technical implementation process.
- » **Create a focused and granular results platform linked to an overarching national results framework:** Just like PEMANDU did with the NTP, successful DUs generally focus on a limited number of well-defined and operationalized strategic priorities. While this may raise questions about the attribution of national outcomes to the narrow interventions facilitated by the DU, achieving the transformation outcomes is often more important than attributing them. However, building in ways into project design to ascertain such contributions *ex ante* can build the credibility of the DU efforts.

- » **Combine top-down control with bottom-up voice:** PEMANDU is embedded within a top-down, command-and-control system. Yet through the labs, the design of the NTP included the voice from the rank-and-file MDA staff who became the eventual implementers. This process has also built in some responsiveness to the line MDAs' objectives, issues, and challenges.
- » **Create institutional interface between the DU and MDAs:** PEMANDU's role as a driver of MDAs' performance is greatly facilitated if there is an institutional interface with MDAs, such as DMOs within MDAs or specialized Monitoring and Evaluation (M&E) divisions. Because MDAs are the implementers of government's top priorities, the real action takes place on their turf, not at the Prime Minister's office.
- » **Optimize the amount of reporting by MDAs:** Whenever possible, build KPIs around the existing indicators that MDAs already report on. Work across the performance ecosystem to create synergies with prevailing reporting structures, such as existing performance-based budgeting or national development plan reporting. For instance, the Ministry of International Trade and Industry (MITI) has a single M&E division responsible for all reporting.
- » **Strengthen impact evaluations to ensure credible attribution of results and cost effectiveness of interventions:** Build in impact evaluations into the program design. Impact evaluations can help resolve problems of attribution through comparing treatment and control groups, as well as cost effectiveness of various initiatives. This has implications for program design, as such evaluations must be built into the design from the get-go.

This article is adapted from the Executive Summary of the report, "Driving Performance from the Center: Malaysia's Experience with PEMANDU" which will be launched at the World Bank Spring Meetings in April 2017.

JANA KUNICOVÁ is Senior Public Sector Specialist at the World Bank



INSIGHT: MALAYSIAN EXPORTERS

Mohammad Amin, Jean Arlet and Hulya Ulku

Malaysia has been one of the biggest beneficiaries of global economic integration during the past decades, ranking 14th in 2015 in merchandise trade share of GDP among 165 economies. But how do Malaysia's exporting firms perform in areas key to the long-term competitiveness of the country, such as productivity or innovation? What obstacles do they face? This note aims to provide some insights into these questions using recent Enterprise Surveys of the World Bank.

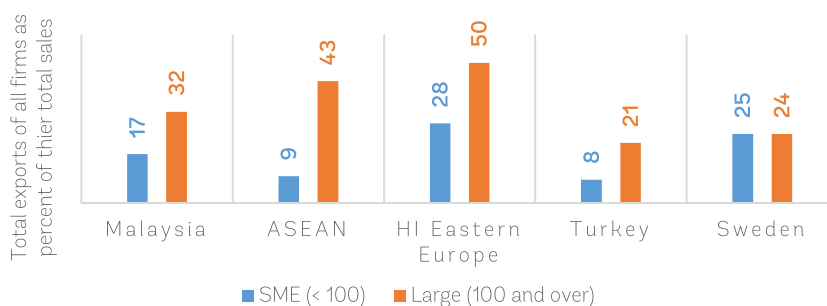
What do Malaysian exporters look like?

SEVERAL INSIGHTS can be gathered on Malaysian exporters based on an analysis of the World Bank Enterprise Surveys (ES). For instance, are they more productive and innovative than non-exporting firms? Is foreign ownership positively associated with the exports of large and small firms equally? Are some aspects of business regulations more troublesome to exporters? Comparisons are drawn between Malaysian firms and those from ASEAN (excluding Malaysia, Singapore, Myanmar and Brunei), high-income Eastern Europe, Turkey and Sweden. The comparator economies are selected based on their comparability to Malaysia and the availability of recent ES data. Sweden is included in the analysis as a benchmark for a frontier economy.

Manufacturing firms in Malaysia export only one-third of their sales

About 30 percent of the total annual sales of all formal private manufacturing firms are exported, higher than Turkey (14 percent) and Sweden (25 percent), but lower than ASEAN (35 percent) and high-income Eastern Europe (37 percent). Malaysia's performance here is average not because it has fewer exporters; in fact, Malaysia has the highest share of exporting firms compared to other economies in the study. The average performance is because the exporting activity in Malaysia is less inclined towards large firms compared with ASEAN and high income Eastern Europe (Figure 4). The importance of large firms in exporting activity around the globe is well documented in the literature.

Figure 4: Exporting activity in Malaysia is less biased towards large firms than in some of the comparators



Source: Enterprise Surveys 2013-2015, World Bank Group.

Notes: ASEAN excludes Malaysia, Singapore, Myanmar and Brunei.

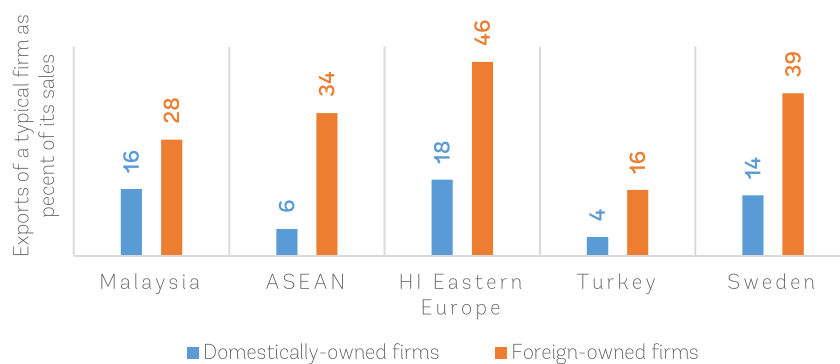
Exporting activity is highly concentrated among high-tech firms in Malaysia, more so than in other countries

An overwhelmingly large proportion of exporting activity in Malaysia is done by high-tech firms, which include both traditional exports of electrical equipment and chemical products. High-tech firms in Malaysia are more than twice as likely to export than low-tech firms (64 percent of high-tech vs. 31 percent of low-tech firms' export), a ratio that is larger than in other comparators.

Foreign-owned enterprises (i.e. firms with foreign ownership) tend to improve the productivity of local exporters through demonstration effect and knowledge spill-overs. These enterprises would also have better information on foreign markets, thanks to their global distribution networks and ties with firms abroad. In Malaysia, foreign-owned enterprises are much more likely to export than firms that are domestically owned (81 percent vs. 42 percent, respectively).

However, the contribution of foreign-owned firms to exports vis-a-vis domestically-owned firms is much smaller in Malaysia than in other economies (Figure 5). There are several potential reasons why this is so. Foreign investment may simply displace domestic savings, or it may be concentrated in sectors where the country does not necessarily enjoy a comparative advantage. It may also be the case that technology transfer via foreign investment is restricted to low-end technology.

Figure 5: Difference between the exports of foreign-owned and domestically-owned firms is much smaller in Malaysia than elsewhere



Source: Enterprise Surveys 2013-2015, World Bank Group.

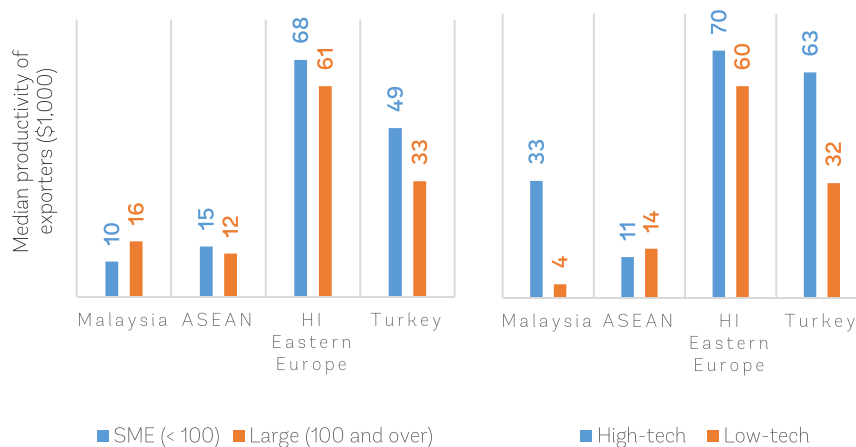
Notes: ASEAN excludes Malaysia, Singapore, Myanmar and Brunei.

Both large and high-tech exporters in Malaysia are more productive than their non-exporting counterparts as well as exporting SMEs and low-tech firms

Literature provides strong evidence for a positive association between exporting and productivity. Some studies show that productive firms self-select themselves into exporting, while others demonstrate that exporting causes firms to become more productive due to greater competitive pressure and learning-by-exporting.

In Malaysia, large and high-tech exporters are on average two and 1.5 times as productive as their non-exporter counterparts. In contrast, SME and low-tech exporters are only about two-thirds and half as productive as SME and low-tech non-exporters, respectively. There are also sharp differences within the group of exporters in Malaysia. Large and high-tech firms are about 1.6 and 8.7 times more productive than SMEs and low-tech firms, respectively – a gap that is more pronounced than in other countries (Figure 6).

Figure 6: Large and high-tech exporters have the highest productivity among Malaysia's firms



Source: Enterprise Surveys 2013-2015, World Bank Group.

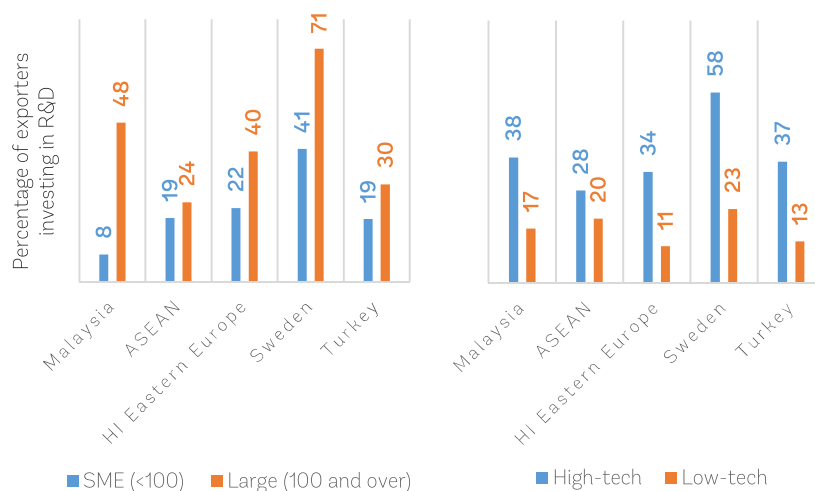
Notes: ASEAN excludes Malaysia, Singapore, Myanmar and Brunei. Median productivity of Sweden's exporting firms are as follows: SMEs: 281, Large firms: 406, High-tech: 262, Low-tech: 503.

Large and high-tech exporting firms in Malaysia invest in R&D and introduce innovation more than other firms

Available evidence suggests that Malaysia does well in R&D activity, ranking 33rd out of 129 and 43rd out of 116 countries in terms of average R&D share of GDP and number of researchers during 2004-2014, respectively – placing second in ASEAN after Singapore.

Consistent with the literature showing a positive link between exporting, R&D and innovation activities, the ES data reveal that exporting firms in Malaysia and elsewhere are at least twice as likely to invest in R&D as non-exporting firms. Among exporters, large and high-tech firms outperform SMEs and low-tech firms in all countries. Interestingly, Malaysia's large and high-tech exporters have the second-highest share of firms investing in R&D after Sweden (Figure 7), while large and high-tech non-exporters have the third-highest share.

Figure 7: Malaysia's large and high-tech exporting firms have the second highest percentage of firms investing in R&D after Sweden



Source: Enterprise Surveys 2013-2015, World Bank Group.

Notes: ASEAN excludes Malaysia, Singapore, Myanmar and Brunei.

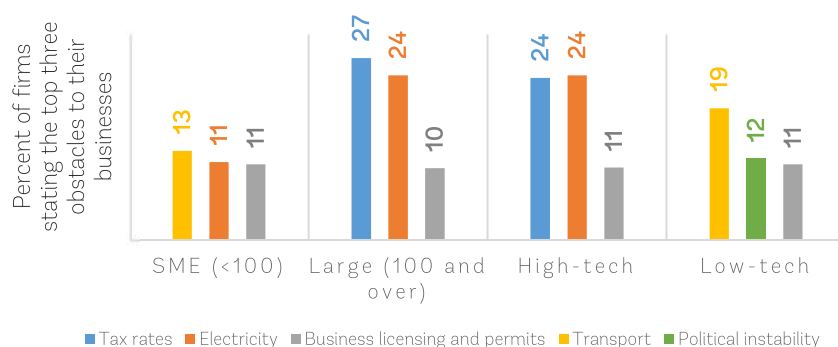
ES also provide information on whether a firm is involved in product, process or organizational innovation during the last three years. All three types of innovation tend to be more likely among exporters than non-exporters in Malaysia and comparator economies. Much like the results on R&D presented above, large and high-tech exporting firms of Malaysia have the second highest share of innovators after Sweden. One exception concerns product innovation, where exporters and non-exporters in Malaysia lag behind other countries.

High tax rates and inadequate power supply are the two most commonly chosen top obstacles by exporting firms in Malaysia

For exporting firms, the top most commonly chosen business obstacle is high tax rates (chosen by 19.2 percent of the firms), closely followed by inadequate power supply (18.7 percent) and obtaining business licenses and permits (11 percent). High tax rates and inadequate power supply are not as troubling to non-exporters; 10.9 percent of them see the former obstacle as their biggest concern and 1.9 percent select the latter.

Firm size and industry seem to play a critical role in exporting decision and behavior. Hence, it is not surprising that the problems faced by exporters vary sharply depending on their firm-size and industry (Figure 8). Notably, high tax rates – the most commonly chosen top obstacle by large exporters and high-tech exporters – does not figure among the top 3 obstacles for SME and low-tech exporters.

Figure 8: The top obstacles for Malaysian exporters vary depending on size and technology class



Source: *Enterprise Surveys Malaysia 2015, World Bank Group.*

Examining further firms' perceptions of the top obstacle, inadequate power as an obstacle stands out in sharp contrast between exporters and non-exporters. For instance, large exporters are about three times as likely to rank inadequate power supply as the main constraint than large non-exporters (24 percent vs. 8 percent). This is surprising given that power outages typically affect all firms in a given area.

A possible explanation is that relative to non-exporters, exporting firms are disproportionately located in areas with worse reliability. Moreover, Malaysian exporting firms may be engaged in sectors where electricity is more critical, arguably industries such as chemicals and chemical products. The ES data confirm these explanations; once differences in firms' location and industry are taken into account, the proportion of exporting vs. non-exporting firms perceiving electricity as the top obstacle is similar.



Conclusion

Findings from recent Enterprise Surveys provide interesting insights into the manufacturing exporters in Malaysia. Surprisingly, a lower share of Malaysian firms exports their sales than in other countries. This appears to be mainly driven by the fact that Malaysia's exporting firms are less likely to be large businesses, adversely affecting export volumes.

Large and high-tech exporters of Malaysia are more productive and more likely to invest in R&D and introduce innovation than other firms in Malaysia and in comparator economies, except Sweden. Regarding the obstacles faced by exporters, inadequate power supply is a much greater concern to exporting firms in Malaysia compared to non-exporters.

Several questions remain to be explored. For instance, why are Malaysia's exporting SMEs and low-tech firms underperforming in terms of productivity and innovation; why is the contribution to total exports of foreign-owned firms' low in Malaysia; and why do electricity and business licensing stand out as major preoccupations for the country's exporters?

This article is based on a more detailed Enterprise Note to be published by Enterprise Analysis, World Bank Group.

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FINANCING FOR LAO SMEs

Learning from Malaysia

Djauhari Sitorus

Developing environments in which SMEs can grow and excel is pivotal in achieving shared prosperity. Governments need to strike the right balance between effective and restrictive regulation of business activities. A live World Bank project in Lao PDR looks into bridging access to finance for SMEs. In February 2016, a delegation led by Lao PDR Deputy Minister of Planning and Investment Dr. Khamlien Pholsena visited Malaysia to learn about the country's best practices in grooming SMEs.

Getting financing for Lao SMEs up to speed

BUSINESS IS thriving in Lao PDR. The number of SMEs in the country has been sharply growing in recent years. According to the Lao PDR Steering Committee on Economic Census in 2006, there were 126,913 enterprises in the country – 90 percent were SMEs. Furthermore, SMEs have played an important role in socio-economic development in Lao PDR, and they provided 63 percent of all jobs in 2013.

However, a large number of these SMEs face difficulties to access financing and while the ASEAN region is fast integrating as an economic bloc, SMEs in the country are largely unready for regional and international integration, as adapting to high competition remains a big challenge. The Lao government is cognizant of this.

In recognition of the important roles of SMEs the government of Lao PDR is developing a policy to promote SMEs and provide aspiring entrepreneurs access to finance and other facilities.

The World Bank is also working in partnership with the government towards this end. In 2014, the World Bank's Board of Executive Directors approved a \$10 million grant and a \$10 million credit from the International Development Association (IDA) to support the growth and expansion of SMEs in Lao PDR by providing access to long-term credit.

The project will provide long-term funding sources for banks so they, in turn, can provide long-term credit to SMEs. This will enable SMEs to purchase new equipment, expand their business premises, upgrade their technology, and scale up their business operations. The project is implemented by the Ministry of Industry and Commerce (MOIC) through the Department of Planning and Cooperation (DPC).

FACTSHEET: Small and medium enterprise access to finance project

Project ID	P131201
Country	Lao People's Democratic Republic
Status	Active
Approval Date	June 9, 2014
Closing Date	June 30, 2019
Total Project Cost	\$20 million
Commitment Amount	\$20 million
Borrower	Government of Lao PDR
Implementing Agency	Ministry of Industry and Commerce

The objectives of the project will be achieved by increasing the supply of long-term finance provided by commercial banks and by strengthening the capability of the Department for Small and Medium Enterprise Promotion to formulate and implement public policies that promote access to finance for Small and Medium Enterprises (SMEs). This project comprises two components.

FIRST, a line-of-credit facility, which aims to alleviate the lack of long-term sources of funding that prevents commercial banks from providing long-term credit (more than two years) to SMEs.

SECOND, technical assistance (TA), which will help strengthen the capacity of the Department for Small and Medium Enterprise Promotion and other agencies in areas such as formulation and implementation of a SME development strategy, SME census, design of new SME lending and non-lending products, impact assessment, SME business advisory services, as well as project implementation and monitoring and evaluation, including outsourcing of procurement, financial management functions to the National Implementation Unit of the Ministry of Industry and Commerce. The Project will also provide TA to PFIs and other commercial banks in improving their SME lending business, such as the design of SME banking strategies and new SME banking products, and compliance with the Bank's environmental and safeguards standards etc. Further, TA will be available to SMEs to improve their business skills, operations and productivity.

For more information, visit,

<http://projects.worldbank.org/P131201/?lang=en>

From Vientiane to Kuala Lumpur – Seeking growth pathways for SMEs



In February 2017, a Lao delegation led by Lao Deputy Minister of Planning and Investment Dr. Khamlien Pholsena visited Malaysia to observe the internal operations of leading financial institutions and learn about international trends and best practices in SMEs financing. The delegation comprised 17 senior officials from the Ministry of Industry and Commerce, Ministry of Planning and Investment, Ministry of Finance, Bank of Lao PDR, Prime Minister's Office, National Assembly, Chamber of Commerce and Industry, and commercial banks.

The study visit program was to enhance the Lao participants' knowledge and understanding of SME financing with the particular experience of Malaysia. This included efficient SME financing tools, strategy, policy, regulations, banking system and other public support schemes. The program served as a platform for members to exchange information, experiences, and best practices in the area of SME financing.

Lao officials spent four days with their Malaysian counterparts, learning relevant and practical approaches to SME financing and development through a number of briefings, direct interaction with policymakers, institutional visits to channels of SME funds, and project site visits. This has led to a fuller understanding of the significant roles that financial institutions can play in the development of the SME sector in their country.

This included visits to the Ministry of International Trade and Industry (MITI), Bank Negara Malaysia (BNM), SME Corporation Malaysia (SME Corp.), Credit Guarantee Corporation of Malaysia, Malaysia SME Bank, and banks as recommended by BNM.

SME development in Malaysia – A sector gaining momentum

Like Lao PDR, SMEs in Malaysia are also critical to Malaysia's economy. They represent 97 percent of registered businesses and 65 percent of employment. In 2014, SMEs contributed to 36 percent of GDP. Challenges faced by SMEs in Lao PDR are not alien to Malaysia. Historically, Malaysia faced the same challenges and constraints which have been addressed thanks to forward-thinking policies and programs undertaken by the government.

In 2004, the Malaysian Government formed the National SME Development Council (NSDC) which spearheaded the development of SMEs in Malaysia. Chaired by the Prime Minister and comprising ministers and the heads of key agencies, SMEs became a feature of the national economic agenda. SME Corporation was formed as a dedicated agency for SME development and secretariat to the NSDC.

Key learnings for Lao PDR from the Malaysia experiences in SME finance

SME development takes time and requires multi-stakeholder or inter-agency involvement and collaborations. Malaysia has been successful on this journey. This experience can be categorized in three main themes:

Firstly, sound policy and planning. It is important to have a clear vision, target and programs to develop SMEs in the medium- and long-term. In 2012, SME Corp devised a long-term master plan for SME development in Malaysia (2012-2020). The master plan sets out the vision, goals, and focus areas of government intervention in developing SMEs which are then implemented through programs. The strong intervention and guidance from the government of Malaysia in pursuing the development agenda of SMEs has resulted in tangible results and outcomes.

Secondly, the SME finance ecosystem. Financing is well-known to be one of the major constraints of SME growth, but SME finance goes beyond provision of credit from commercial banks or other lenders. SMEs require other types of support and services which together form the ecosystem of SME finance. The Malaysia experience provides excellent examples of efforts to establish and sustain such an ecosystem. In this endeavor, Bank Negara Malaysia has clearly identified the ecosystem of SME financing in Malaysia which consists of five pillars; (1) financial infrastructure; (2) financing and guarantee schemes; (3) avenues

to seek information and redress; (4) debt resolution and management; and (5) outreach and awareness programs. The ecosystem appears to be relevant for other countries as well.

Thirdly, a well-developed financial market to complete all pillars of the SME financing ecosystem. In Malaysia, a wide range of financial products and other supporting services are offered to cater for different financing needs of SMEs. The type of financing available can take the form of a simple working-capital bank loan, or of venture capital funds. Financing for new businesses in emerging and new sectors (e.g. green technology) are also provided by both the public and private sector. Various types of guarantee schemes are also available to meet specific risk-sharing arrangements for SMEs and commercial banks. Malaysian banks and other financial institutions have deep experience in serving SMEs and have provided deep knowledge of SME business models and their associated business risks. These paved the way for the creation of an efficient and competitive credit market for SMEs in Malaysia.

DJAUHARI SITORUS is Senior Financial Sector Specialist with the World Bank Group

From the desk of Dr. Khamlien Pholsena
Lao PDR Vice Minister of Planning and Investment



THE MALAYSIA experience of SME development over the years has been remarkable. Through the World Bank Global Knowledge and Research Hub, we have been connected with our counterparts in the Malaysian government and have observed and picked up useful insights that will be pertinent in shaping the SME agenda back in Lao PDR.

A particular point that came across through this exchange was on raising capital for SMEs, which has been traditionally an impediment for SMEs to flourish. We have seen first-hand new SME lending trends and mechanisms that will empower our SMEs to expand their products and services via innovative credit facilities that can be set up in similar fashion.

This is also contingent on the second learning point that we are going back with. We have gained a deeper understanding of the banking sector, with particular emphasis on SME banking practices and responses to financial criteria. While we recognize the importance of capital extension to SMEs, we will need to ensure that the financing parameters are robust and enforced accordingly.

We have seen, with great enthusiasm, Malaysia's SME Masterplan. It is a pioneering blueprint which, if implemented correctly, will be the 'game changer' to accelerate the growth of SMEs to achieve high-income nation status by 2020. From a public policy standpoint, the Masterplan captures the critical leverage points that synergizes policies, strategy and programs for supporting SMEs access to finance and development. This is an approach that the Government can take to establish a clear agenda for SMEs in Lao PDR.



REGULATION IN AGRICULTURE

Raian Divanbeigi and Federica Saliola

The agricultural sector has been rediscovered as a sector with great potential of contributing to countries' economic growth. Through a new examination of both the quality and the efficiency of business regulations, findings reveal agricultural productivity is on average higher where transaction costs are lower and countries adhere to a higher number of regulatory good practices.

Regulation and the transformation of agriculture

TODAY, AGRICULTURE is seen to play a role in triggering growth, reducing poverty and inequality, providing food security, and delivering environmental services. An important prerequisite is the creation of an enabling business environment to spur agricultural sector performance. Government policies and regulations play a key role in shaping the business environment through their impacts on costs, risks, and barriers to competition for various players in the value chains.

The idea behind regulation is to correct structural market failures arising from informational asymmetries, economies of scale in production, fragmented markets, and externalities.

Business regulation's impact on economic performance depends on the balance between the market failures it is able to correct and the costs it imposes on economic agents. These include monetary costs of complying with regulations, which divert resources from productive activities; and efficiency costs, as regulations influence the allocation of resources across firms and sectors.

There are unique and evolving dimensions through which agriculture interacts with relevant laws and regulations. These include regulations of agricultural input markets such as seed and fertilizer, as well as regulations that enable small-scale and remote farmers to access finance. Moreover, they include product quality, sanitary and phytosanitary standards, as well as trucking licenses. Regulations in these areas play a particularly critical role in connecting farmers to domestic and international markets.

Agricultural transformation

The structural transformation or change of an economy marks the change from an agrarian society to an industrial one. As economies grow and urbanize, services from commerce, finance, and the state become increasingly important. However, no country has undergone a successful structural change towards higher levels of income per capita without also

transforming its agricultural sector, which plays a central role in the broader structural change, by supporting other sectors through strong growth linkages and multiplier effects.

Agricultural transformation has been shaped by three interrelated processes:

- » **FIRST**, higher yields and lower costs from farming lands have increased productivity. Since 1960, agricultural output has expanded by over 250 percent.
- » **SECOND**, the types of agricultural products have changed, from subsistence to cash crops; from food staples to intermediate inputs; and from low-value/low-risk to high-value/high-risk varieties.
- » **THIRD**, agricultural market transactions have become more integrated with the rest of the economy, more dependent on finance, and more oriented to international trade.

Much of this transformational success has been generated by the combination of high rates of investment in crop research, infrastructure, and market development, and appropriate policy support that took place during the Green Revolution (1966 to 1985) and the two decades that followed.

The provision of public goods – including physical and institutional infrastructure – is another driver of agricultural transformation. Similarly, by setting the right institutional and regulatory framework, governments can help increase the competitiveness of farmers, enabling them to integrate in regional and global markets. Land rights and water property rights are good examples of governments supporting agricultural competitiveness.

Sustained trade liberalization over the past five decades also supported agricultural transformation by expanding opportunities for exporters of agricultural products.

In the past 50 years, exports of agricultural products from developing countries have multiplied eight-fold while those of agriculture-based manufactured products increased ten-fold. Largely thanks to an increase in prices, exports of agricultural products nearly tripled between 2000 and 2012, while also increasing in volume by around 60 percent.

Business regulations and agricultural transformation

Agriculture's nature warrants a fresh and comprehensive examination of what constitutes an enabling regulatory environment. Regulation in agriculture is critical in a number of areas, including biosafety, food safety, grades and standards, intellectual property protection, agricultural input quality, groundwater extraction, and environmental protection.

Due to agriculture's importance for human health and food security, political stability and environmental sustainability, it is not unusual for governments to implement more stringent agricultural regulations. More pervasive regulations demand continual evaluation to ensure effectiveness in correcting market failures and monitor their implications for firms.

Business regulations for agriculture are also relevant to manage risks and ensure greater predictability. Farmers face considerable risk due to their susceptibility to elements such as weather, plague of insects, and diseases, all of which play a fundamental role in production. Predictability is critical in the farming business where risk is typically inherent.

Regulations can enable businesses to operate in a context where the outcomes of their decisions are more predictable by setting clear and easily enforceable rules.

Well-designed regulations can support farmers by limiting their transaction costs in accessing transportation, marketing and financial services. Transport costs can make up one-third of the farm gate price in some Sub-Saharan African countries, and prevent farmers from specializing in the goods where they have a competitive advantage. High marketing costs due to isolation from markets and roads, lack of means of transport, or inefficient transport services often discourage farmers from commercializing their production. Finally, credit is often rationed in rural areas and financial services are often low quality and do not respond adequately to the demand of producers.

Many elements of an enabling regulatory environment for agriculture are not sector-specific. A more market-friendly regulatory environment

contributes to higher agricultural productivity. Further, private agroenterprises that provide inputs and other services such as handling, processing, transportation, marketing, and distribution of food and other agricultural products, would benefit from secure property rights, efficient taxation, increased access to finance, and the balanced entry and operational standards that a supportive investment climate offers. In light of widespread concerns for quickly growing concentration in the agribusiness sector, minimizing regulatory barriers to competition is particularly important.

What initial data suggest

Economic research is key in guiding evidence-based policymaking towards more effective regulations. This relies critically on the availability of firm-level data as well as data on the quality and efficiency of regulatory practices.

The World Bank Group's Enabling the Business of Agriculture (EBA) dataset provides benchmarks on regulations that impact firms along the agriculture value chain. EBA features two types of indicators. Quality indicators reflect the text of laws and regulations, assessing their conformity with a number of global regulatory good practices. Efficiency indicators measure the transaction costs of firms complying with national regulations, expressed in time or monetary units.

Both regulatory good practices and transaction costs display substantial variation across the sample. Averaging them over income groups, there is a positive association between income levels and the supportiveness of countries' regulatory environment.

Countries with higher income per capita have in fact more efficient and higher quality agricultural regulations.

On average, the regulatory environment for agriculture is more supportive in countries that have successfully shifted their economic activities to services and manufacturing.

The association between regulatory quality and efficiency and agricultural output are positive and significant. This result suggests that both dimensions matter. Where regulatory transaction costs are higher agricultural productivity is on average lower. Similarly, given same amounts of agricultural inputs, economies that adhere to a higher

number of regulatory good practices display higher average agricultural output.

Conclusion

The development of the agricultural sector has been considered a key priority for all developing countries. Economists and policymakers have devoted their attention to improving agricultural technologies, physical infrastructure and education. More recently, interest in the role of institutions such as governance and regulations on economic development has increased.

Looking at both quality and efficiency related aspects, and using new cross-sectional data, the relationship between the heterogeneity in countries' agricultural productivity and their policy and regulatory environment was examined, and the results indicate that agricultural productivity is on average higher where transaction costs are lower and countries adhere to a higher number of regulatory good practices.

This paper, which focuses on governance and rural development policy, was presented at the technical workshop held on 19-20 September 2016 at the headquarters of the Food and Agriculture Organization (FAO) in Rome. For more information, visit bit.ly/fao092016

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PATTERNS OF WORLD AGRIBUSINESS TRADE

Fabian Mendez-Ramos and Nina Paustian

Growth of the agribusiness sector plays a major role in overall growth and poverty reduction. Evidence shows that growth in sectors intensive in unskilled labor, such as agriculture and manufacturing, particularly contributes to reducing poverty, and can be fostered through a dynamic agribusiness sector that efficiently links farmers and consumers. Measuring and analyzing global agribusiness trade flows sheds more light on the composition and development of agribusiness.

Agribusiness trade around the world has been growing

AGRIBUSINESS TRADE has expanded substantially around the world in the past few decades. To account for the heterogeneity of the agribusiness sector, it is useful to distinguish between primary and manufacturing agribusiness products. In this analysis, primary agribusiness includes three categories (agriculture; livestock; forestry), whereas manufacturing agribusiness includes 10 categories to reflect the variety of traded products (canned; cereals; drinks; leather; meat; oils; paper; tobacco; wood; others).

Figure 9: The links between agribusiness (in the intersection of agriculture, manufacturing and services) and internationally traded agribusiness (yellow text in dark green ellipse)



Source: World Bank staff.

From 1990 to 2014, primary agribusiness trade grew from \$195 billion to \$963 billion of constant 2010 U.S. dollars, while manufacturing agribusiness trade soared from \$498 billion to \$2,812 billion for the 184 countries included in the study. Primary agribusiness trade therefore rose at an annual average rate of 6.9 percent, while manufacturing agribusiness trade increased annually by 7.5 percent.

While growth rates for primary and manufacturing agribusiness have been high, the primary and manufacturing agribusiness shares of total trade have been mostly stable over the 1990 – 2014 period. The shares in total trade shrank by only one percentage point, from 6 to 5 percent, in the case of primary agribusiness, and by two percentage points, from 16 to 14 percent, in the case of manufacturing agribusiness. The small decrease in trade shares of agribusiness goods might be associated with the long-term decline of the contribution from the agricultural sector.

Agribusiness operations expansion and modernization typically stimulate productivity, process and product innovation, as well as ancillary services for domestic and export activities that foster competitiveness and stronger linkages within the agro-food system.

More sophistication in agribusiness trade in higher-income economies

More sophisticated economies tend to favor exporting manufacturing agribusiness over primary agribusiness goods. Less sophisticated economies, however, tend to import more manufacturing than primary agribusiness goods, given their economic and capacity constraints.

As national income increases, countries tend to decrease imports of manufacturing agribusiness goods and increase their exports of manufacturing agribusiness goods, relative to primary agribusiness imports and exports, respectively.

Overall, from 1990 to 2014, the share of manufacturing agribusiness in exports and imports has been greater than the share of primary agribusiness goods in high-income and middle-income countries. Manufacturing agribusiness imports are also higher than primary agribusiness imports in low-income countries. However, primary agribusiness exports have played an important role in these economies, greatly exceeding the export shares of manufacturing agribusiness. As countries increase their income, the trade balance of both manufacturing and primary agribusiness narrows.

Manufacturing agribusiness shares of total imports have consistently been smaller in high-income and middle-income countries than in low-income countries, with those in middle-income countries slightly lower than in high-income countries since the mid-2000s. The share of manufacturing agribusiness exports in total exports has been more uniform among income groups, averaging 15.8 percent for high-income countries, 16 percent for middle-income countries, and 15.5 percent for low-income countries from 1990 to 2014.

Primary agribusiness export shares have been lower in high-income countries than in the other two income country groups. Even though low-income countries' primary agribusiness share in total exports shows a decreasing trend over time, their average export shares remain large: 57 percent in 1990 and 31 percent in 2014. Shares of primary agribusiness imports were mostly consistent across the three income groups, ranging from 5 to 6 percent from 1990 to 2014.

Developing countries have the incentive to export and import more for a variety of reasons, such as to grow faster.

In addition, low-income countries have the economic motivation to import agricultural products, given low productivity levels in local production sectors. Furthermore, many low-income economies struggle with food security concerns; basic and cheap agricultural imports can augment supplies and reduce food vulnerabilities.

Despite the strong reasons to import, evidence suggests that developing countries are not making full use of the trade channel; instead, they are constrained in importing primary agricultural products because of supply restrictions and high trade costs. In addition, low-income countries have the highest shares of manufacturing agribusiness imports across income groups. Some substitution effect of goods might be a partial explanation of the high import shares of manufacturing agribusiness and low import shares of primary agribusiness in low-income countries. The share of manufacturing agribusiness imports accounts for almost 25 percent of total imports in low-income countries on average in the 1990 – 2014 period. Despite existing trade constraints, the high shares of both primary agribusiness exports and manufacturing agribusiness imports in low-income countries indicate some level of integration with regional or global trade frameworks.

The composition of international agribusiness trade has moved unevenly

The increasing importance of the agribusiness trade sector for growth and poverty reduction is associated with the evolution and expansion of agricultural goods and farm-related activities. The structural transformation of the agricultural sector is characterized by improvements in productivity, the change in composition of produced goods from low-value and low-risk to high-value and high-risk, and the increased integration of the agricultural sector into regional and global markets. This development generates demand for agribusiness products in non-agricultural sectors, particularly for fertilizers, transportation, commercial services, and machinery.

Despite structural transformation, agricultural outputs – and their trade – continue to rise in absolute value.

Across all country-income classifications, the growth rates of imports and exports of all subcategories have been positive. These growth rates across varieties of agribusiness subcategories indicate a consistent expansion of the sector, in keeping with the aggregate global trend, and demonstrate that all the subcategories are part of the impressive agribusiness trade expansion.

The expansion of primary and manufacturing agribusiness has been uneven across goods' subcategories and country-income groups. On average and across income groups, growth rates in primary and manufacturing agribusiness imports and exports are higher in low-income countries than in high-income countries or middle-income countries, and lowest in high-income countries.

Conclusion

Studying agribusiness trade flows and their patterns across countries and regions and understanding the reasons behind those patterns can give governments some indications on major constraints as well as the potential of the sector and its components. However, more empirical evidence and analytical work is needed in order to improve respective policies in the sector. This includes, for instance, the impact of the regulatory framework on agribusiness trade, the role of infrastructure and institutions on the business environment in agriculture and the

effects of trade-partner diversification on trade volume and composition. The **World Bank's Enabling the Business of Agriculture (EBA)** initiative is an example of an attempt to identify laws and regulations that support agribusiness.

For the full text of the Research Policy Brief, diagrams and reference list, visit bit.ly/DECRG_agribusiness

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INNOVATIVE FINANCIAL INCLUSION

José De Luna-Martínez, Wei Zhang and Sergio Campillo-Díaz

Innovation in financial services has the potential to enhance financial inclusion in terms of access, quality, and usage in a cost-effective manner. Two big themes resonated at the 2016 Global Symposium on Innovative Financial Inclusion jointly organized by Bank Negara Malaysia and the World Bank Group Global Knowledge Research Hub in Malaysia – **FinTech** and **Islamic Finance**.

The FinTech revolution: A perspective from Asia

FINTECH IS changing the way people and firms save their money, make payments, invest, borrow, and acquire insurance products. Nowadays, millions of people around the world perform a wide range of financial transactions through their smartphones with no need to go to a bank branch. New financial products and mobile wallets targeting low-income households are emerging in Africa and Asia. Technology is making it possible to do practically any type of financial transactions – savings, payments, lending – in remote villages with the use of smartphones. FinTech can accelerate financial inclusion especially for poor people around the world.

Technology giants such as Apple, Google, Facebook, Amazon, and Alibaba are infringing on traditional financial institutions by offering convenient and well-interconnected financial solutions to their customers. And new online platforms offer people and SMEs attractive options to invest and lend with one another in a rapid and cost-effective manner. All these technological breakthroughs are enabling new technologies to fill the gaps in SME finance.

The benefits of FinTech are enormous not only for consumers, but also for financial institutions in managing risks and securing efficiency gains.

For example, with the use of technology, loan applications can be appraised, approved, and disbursed much faster thanks to new ways to encode, share and analyze data. FinTech also shortens the time to trade and settle securities transactions. For financial institutions, it offers shorter, speedier transaction chains, greater capital efficiency, and stronger operational resilience.

But FinTech also brings risks and challenges that must be understood properly. FinTech can be a source of increased risks for stability, integrity, and market conduct. Risks may present themselves in various forms. Personal information of customers, for example, may be lost or stolen. When the IT system of a financial service provider is attacked, large-scale loss of personal data may occur. IT systems may also be accessed and manipulated to effect criminal payments.

The rapid pace of innovation is not only posing challenges to financial institutions, but also to financial sector regulators. The legal and regulatory frameworks in which FinTech players operate can be outdated, leaving room for regulatory arbitrage and uneven playing fields. Supervisory capacity may not yet be adequate to understand, identify, and monitor emerging risks.

Looking forward, the challenge for financial sector authorities is to foster innovation and establish an enabling regulatory environment for FinTech.

There is a need to properly standardize the regulatory approach for FinTechs by allowing them to experiment with new technologies in a safe environment.

Several countries in Asia, such as Australia, Malaysia, Singapore and Thailand are adopting the regulatory sandbox approach to FinTech. This is a safe and conducive space to experiment with FinTech solutions, and where the consequences of failure can be contained. The sandbox cannot remove all risks, as failure is an inherent characteristic of innovation. In this regard, the sandbox aims to provide an environment where if an experiment fails, its impact on consumers and on financial stability will be limited.

In order for the FinTech industry to succeed, dialogue and collaboration between emerging FinTech companies and authorities are needed. We all must understand and be prepared to embrace disruption and innovation that technology is bringing to our lives. The nascent FinTech industry requires a proper enabling environment to continue growing.



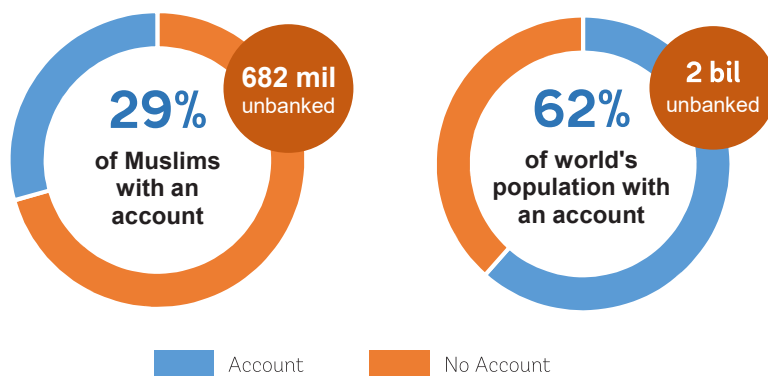
Islamic finance in Malaysia: Filling the gaps in financial inclusion

ISLAMIC FINANCE has grown by double digits in the past decade despite the weak global economic environment. By 2020, the Islamic finance industry is projected to reach \$3 trillion in total assets with 1 billion users. However, despite its rapid growth and enormous potential, 7 out of 10 adults still do not have access to a bank account in Muslim countries. This means that 682 million adult Muslims still do not have an account at a banking institution. While some Muslim countries have high levels of account ownership (above 90 percent), there are others with less than 5 percent of their adult population who reported having a bank account.

The need to scale-up financial inclusion

The use of financial services is still developing in Muslim countries. According to the 2014 Global Findex, 40 percent of adults reported having borrowed and saved any money in the past 12 months. And only 9 percent of adults saved at a formal financial institution. In comparison, in high-income OECD countries 52 percent of adults saved formally.

Figure 10: Adults with a bank account



Source: Global Findex Database, World Bank staff estimates.

Thus, Islamic finance can play a significant role in narrowing the gap of financial inclusion in Muslim countries. Historically, Malaysia has been a leader in developing innovative savings, credit, and investment instruments that are Sharia-compliant for low-income households.

Moreover, Malaysia has established specialized financial institutions offering only Islamic finance products, such as Bank Rakyat, the largest Islamic cooperative bank in the country.

Incorporating new digital technologies

Technology has the potential to drive change in the Islamic finance industry, especially for the 2.3 million SMEs located in the Middle East and North Africa (MENA).

FinTech companies are using innovative solutions to make access to financial services more efficient. Despite the fact that 76 percent of enterprises in MENA has a bank account, only 26 percent reported having credit from a financial institution. Given this low credit penetration at the corporate level in Muslim countries, some solutions have been implemented to narrow the credit gap, which is estimated to be more than \$140 billion.

In the case of Malaysia, an Investment Account Platform (IAP) was implemented in the beginning of 2016. Through this solution, Islamic banks match investors with projects in need of funding. The innovation of this approach is that after the bank screens the project, a credit rating is assigned, and then the project is uploaded to a platform where the investors can select the investment according to their risk appetite.

Addressing regulatory challenges

Authorities not only in Muslim countries but also in other jurisdictions are still addressing the challenge of revising regulatory standards in order to foster innovation in alternative finance platforms.

The current debate is centered on how to regulate non-financial institutions that are receiving money from global investors and lend it to local companies or entrepreneurs through the Internet.

In July 2016, Bank Negara Malaysia launched a discussion paper on the FinTech Regulatory Sandbox. The Sandbox will allow both FinTech companies and financial institutions to experiment with FinTech tools. The introduction of this initiative represents a progressive regulatory response that aims to foster the value of technology in financial services.

In the region, Singapore issued FinTech Regulatory Sandbox Guidelines in June 2016 to encourage more FinTech experimentations. Indonesia is also preparing its FinTech legislation that will be ready in December 2016.

Another challenge for Muslim countries is to upgrade their financial standards to common international principles that are applicable in all Muslim jurisdictions. There is still no consensus on whether a financial product such as an investment account or bond is compliant in all Muslim territories. This generates uncertainty in non-Muslim investors that are willing to finance infrastructure projects but are not sure that their investments are 100 percent compliant with the generally-accepted principles of financial securities.

The Islamic finance industry is well positioned to seize the opportunities to embrace new market technological developments.

The need to create new products to attend the unbanked population, such as zero-fee accounts, small loans, or family insurance, could open a new window to provide formal financial services to the unserved populations in Muslim countries.

Two published works by the Finance and Markets Global Practice team in Kuala Lumpur – bit.ly/fintechrev and bit.ly/isfinFI – highlighted key ideas raised at the 2016 Global Symposium on Innovative Financial Inclusion: “Harnessing Innovation for Inclusive Finance”. For more information on the symposium, visit bit.ly/GSIFI2016

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IMPROVING REMITTANCES FOR MIGRANTS

Isaku Endo and Dieter J De Smet

“Project Greenback 2.0 – Johor Bahru”, launched in November 2015, is the product of a partnership between the World Bank and Bank Negara Malaysia. The project aims to increase efficiency in the market for international remittances by promoting changes inspired by the real needs of the ultimate beneficiaries of international money transfers: the migrants and their families at home.

Piloting Greenback 2.0 in Johor Bahru

MIGRANTS REPRESENT 15 percent of Malaysia's workforce, making Malaysia home to the fourth-largest number of migrants in the EAP region. The migrant population is diverse and includes workers from Indonesia, Bangladesh, Nepal, Myanmar, Vietnam, China and India, among other countries. They have become an integral part of Malaysia's economy and on a yearly basis remit substantial amounts of money to their dependents in their home country through various remittance channels. The amount of remittances sent by migrants from Malaysia has significantly increased since 2006 with growth of more than 500 percent in the past 10 years, according to BNM data of 2016.

Johor Bahru is the first Greenback champion city in Asia and was selected based on a number of factors, including its vibrant economic development, especially in property development, plantation, and manufacturing sectors, which host the third largest migrant community in the country.

In 2016, a survey was conducted to explore the migrant workers' level of financial inclusion and their prevalent practices and needs in remitting money to their origin countries. 401 migrants working in urbanized areas and remote plantations were surveyed to determine their specific remittance behavior. The main survey results entailed the following:

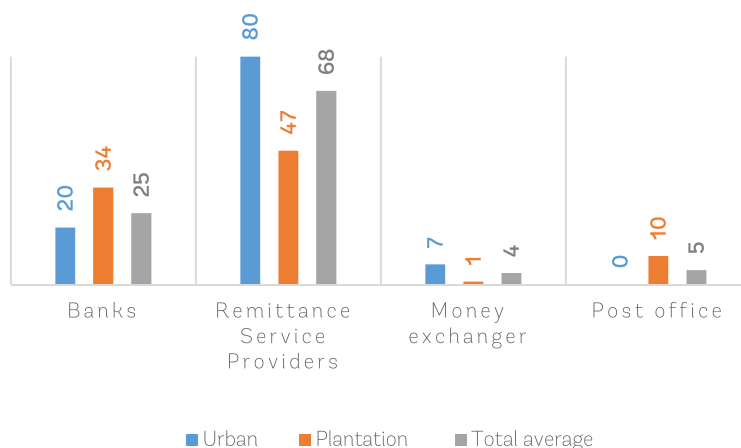
1. Income and savings rate

On average, urban workers earn 46 percent more than plantation workers (RM 1,544 vs. 1,056 per month). However, even though plantation workers earn substantially less, they save 11 percent more than urban workers. This can be attributed to the fact that the cost of living at remote plantations is much lower than in urban areas. For both surveyed segments of migrant workers, higher education levels are positively correlated with higher incomes, but this positive correlation stops at the secondary school level, since the type of work performed by migrant workers typically does not require a skill set for which a secondary school education is needed.

2. Remittance behavior

Migrant workers' main reason to send money home is to support the purchase of basic goods/services by their dependents back home. The dominant remittance frequency for plantation workers is once every three months (35 percent) whereas urban workers mainly remit every month (55 percent). Word of mouth is the main source of information on remittance services among migrants. Two-thirds of the migrant workers use non-bank remittance service providers (e.g. Western Union, Moneygram etc). Banks are the second-most preferred remittance option, while money exchangers and post offices are used by less than 5 percent of the surveyed migrant workers (Figure 11).

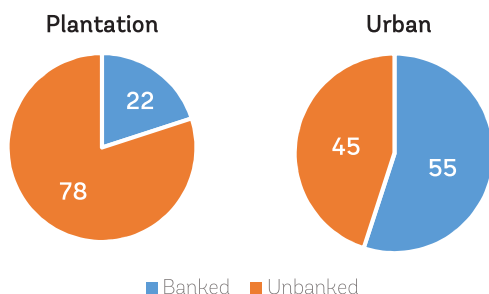
Figure 11: Remittance channels used



The basic factors in selecting a remittance channel are the same among all migrants: safety, ease of transaction, speed and reliability. Nonetheless, the first determining factor for choosing a specific (regulated or unregulated) remittance channel is the convenience of location, after price and trust. Noteworthy is the fact that apart from the standard transaction fee, most migrant workers were not aware of the other remittance fee cost components, such as the foreign exchange cost and costs charged to the recipient. The level of financial inclusion/bank account ownership is low: 22 percent for plantation workers and 55 percent for urban workers (Figure 12).

Certain workers cannot comply with the basic requirements to open a bank account due to a lack of proper documentation.

Figure 12: Bank account ownership among migrants (%)



However, the factors that had the biggest impact are the habit to pay wages in cash and the remoteness of plantations, making traveling to banks not only a hazardous (cash is carried on one's person) but also a time-consuming undertaking. This is especially applicable to plantation workers, 25 percent of whom replied they had to travel at least 30 km to gain access to a bank or other regulated remittance channel.

Those who have a bank account mainly use it to save money, and this trend is stronger with urban migrants than plantation workers. However, only half of the migrant workers use their bank account to remit or receive money. As a result, only one out of every four urban workers and one out of every ten plantation workers use banks to remit or receive money.

3. Use of information and communication technologies

74 percent of the surveyed migrants own a smartphone and 90 percent of them access the internet via their smartphone. These numbers are high and present a tremendous business opportunity for technology-driven remittance services providers who invest in educating their consumer base and provide reliable and competitive remittance services. To reach out to this large segment of migrant workers, the World Bank has developed a smartphone/tablet app ("Pick Remit") to help them make the most advantageous choice when sending money back home to their families. By choosing the

most favorable remittance service provider, migrants can save and keep more money in their pockets or just send a little more to their dependents.

Conclusion

The implementation of Greenback 2.0 in Johor Bahru revealed a number of important issues which can be addressed by the private sector or the Malaysian government (e.g. through tailor-made comprehensive educational and awareness activities or regulatory changes to promote financial inclusion of migrants) resulting in a greater transparency of the remittance market to the benefit of migrants and their families.



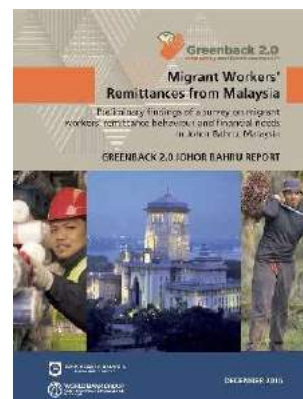
The impact of Greenback 2.0 in Johor Bahru has been substantial. Average remittance fees pre-Greenback 2.0 (before December 2015) in Johor Bahru **decreased by 40 percent from 3.33 percent prior to December 2015 to 2.02 percent⁵ in December 2016.**

As a result, Malaysia is one of the cheapest remittance-sending corridors in the world today.

This article and all charts depicted are derived from the report “Migrant Workers’ Remittances from Malaysia: Preliminary findings of a survey on migrant workers’ remittance behavior and financial needs in Johor Bahru, Malaysia”. The report will be published in Q2 2017.

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⁵ Bank Negara Annual Report 2017



SHOULD WE FEAR A FOREX DROP?

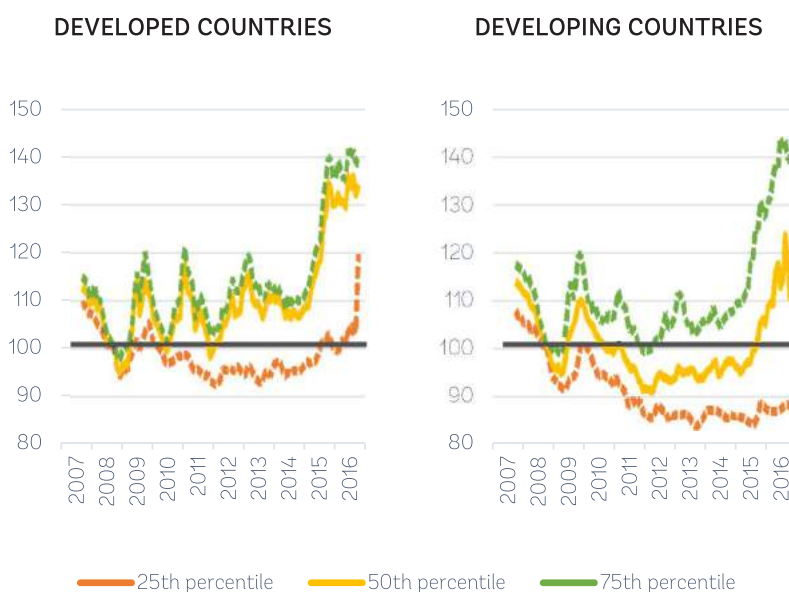
Norman Loayza and Fabian Mendez-Ramos

Moderate and gradual changes of the real exchange rate are beneficial for the economy to help it attain domestic and external equilibrium, and **should not be feared**. However, large and sharp devaluations can lead to insolvency and even systemic crisis. They should be prevented by macroprudential policies and by avoiding unsustainable fixed-exchange-rate regimes. Central bank intervention to avoid a secular depreciation is useless: it only leads to massive losses of foreign reserves.

Real exchange rate and its ups and downs

MANY CURRENCIES around the world across all national development tiers have depreciated with respect to the U.S. dollar in the last few years. Governments, entrepreneurs, and households are concerned because drastic depreciation of the national currency could lead to bankruptcy and even economic crisis. Below, the reasons and evidence for both potentially negative and positive effects of real exchange rate (RER) depreciation are examined; and the effectiveness of policies in reversing depreciation or mitigating its negative impact are discussed.

Figure 13: Real exchange rate (RER) has depreciated in most countries, and sharply so in some cases



Source: Haver Analytics monthly data and World Bank staff estimates⁶.

⁶ Data is derived from a complete monthly sample over the period January 2007–March 2016 for 72 countries. Aggregations use 2016–17 World Bank income definitions. RER is a nominal exchange rate adjusted for relative movements in national price or cost indicators of the home country and the United States. The real exchange rate index (RERI) is the ratio of the real exchange rate with respect to a base period of the real exchange rate. January 2008 is used as the base period, such that RERI = 100. A decrease in the RERI denotes an appreciation.

What does this mean for the different stakeholders?

Sudden and drastic depreciations of national currencies can generate a chain of liquidity constraints and insolvency at different economic levels, from households to firms and governments. These effects can be compounded as different sectors affect one another, decreasing consumption, restricting credit, increasing interest rates, and limiting investments.

For consumers or users of foreign products, a depreciation of the RER will increase their costs, often without a matching increase in their revenues. For them, a depreciation will likely have a negative impact on income, inducing a substitution away from foreign goods and services and toward domestic ones.

For people and institutions that owe foreign currency debts, depreciation increases the real value of their debt, possibly resulting in repayment difficulties, a deterioration of their balance sheet, and the risk of bankruptcy.

The effect on firms seems to depend on their intrinsic characteristics. If they are importers, the effect will tend to be negative; if they are exporters, the effect will tend to be positive. A 2002 Forbes study suggests that firms in crisis countries have lower rates of capital growth, and worse stock return performance after devaluations, if they are capital-intensive and if their cost of capital increases.

Governments can also be negatively affected by sharp devaluations, but this depends on their exposure to foreign currency.

When depreciation leads to a crisis

A sharp depreciation can cause more than isolated cases of illiquidity and insolvency. It can produce a systemic crisis if these instances of insolvency are closely connected, or if it sufficiently affects the financial system, which in many economies is the center of interconnection between businesses, consumers, and government. A financial system is vulnerable to a depreciation shock directly if its assets and liabilities are mismatched in terms of currency of denomination, and indirectly if its debtors become insolvent.

Governments can be the source of a systemic crisis if they are unprepared to absorb the depreciation shock and become insolvent or strapped for liquidity. Governments with high levels of foreign debt or with contingent liabilities on foreign exchange movements are particularly vulnerable to a depreciation shock; those that insulate against exchange rate fluctuations (by keeping a fixed exchange rate or by providing price and profit guarantees in foreign exchange) are among the most vulnerable.

Evidence suggests that currency crises are sometimes related to banking crises and sovereign debt crises. In the 1980s, currency crises were especially linked to sovereign debt crises, while in the 1990s currency crises occurred in closer connection with banking crises. Importantly, the frequency of these crises decreased markedly in the 2000s, despite the strong international shocks experienced in the second half of the decade.

Currency crises and systemic crises disrupt employment, induce poverty, and create uncertainty, being associated with negative effects on output growth, as well as on its components related to public and private consumption and investment. A 2006 study by Hutchison and Noy⁷ finds that after a currency crisis, GDP declines around 2–3 percent. However, if the currency crisis is accompanied by a sudden stop of foreign investment, and if it leads to a systemic financial crisis, the cumulative effect is a 10–15 percent decline.

The silver lining

However, not all depreciations should be avoided. Gradual and moderate depreciations (and appreciations) usually denote an orderly movement toward a new domestic and external equilibrium.

This entails restoring potential employment and growth, and resolving balance of payments gaps when there are changes in fundamental factors (such as productivity growth and demographic changes) and shocks of various types (such as terms of trade, commodity prices, and global financial crisis). Thus depreciations can help reduce trade deficits and prompt domestic growth.

In the face of exchange rate fluctuations, it should be kept in mind that the RER is a relative price whose flexibility and movement is essential to avoid large imbalances and distortions. To obtain this flexibility, the

⁷ Hutchison, M. M., and I. Noy. 2006. "Sudden Stops and the Mexican Wave: Currency Crises, Capital Flow Reversals and Output Loss in Emerging Markets." *Journal of Development Economics* 79: 225–48.

exchange rate, as a national currency price, can serve the function of coordinating a (very) large set of individual prices in both labor and output markets. An exchange rate depreciation, for instance, can achieve the same objective as a reduction of domestic prices in a large variety of goods and services.

Flexible exchange rates are shock buffers and effective coordinating mechanisms, and both currency depreciations and appreciations are just a reflection of such flexibility. Countries with flexible exchange rates tend to adjust better to external or internal economic shocks.

The flexible-exchange-rate regime allows a faster and more sustainable recovery from trade and current account imbalances; from natural disasters; and from a variety of shocks that produce internal and external imbalances. Moreover, this regime is less vulnerable to speculative attacks, especially as they become financially developed.

Conclusion

On balance, moderate and gradual depreciations and appreciations of the RER are beneficial for the economy to help it attain domestic and external equilibrium. These are long-term phenomena and a reflection of a healthy economy. It can be argued that the best policy in this case is to allow the exchange rate to move in a flexible way, without undue interference by monetary or fiscal authorities.

However, when RER fluctuations are abrupt or highly volatile as a result of either a large and sudden shock or the unraveling of an unsustainable policy, they can cause insolvency for various economic agents (from households and firms to banks and governments) and even systemic financial crises. They should be mitigated through short-term crisis management measures, including deploying previously determined prudential policies such as short-term capital controls and central bank interventions as lender of last resort. In addition, if adverse international conditions exacerbate financial frictions, the central bank's sale of foreign currency (held as international reserves) can be effective—albeit only in the short run—in preventing negative real impacts and systemic crises.

Beyond these short-term crisis management measures, the evidence indicates clearly that there is no large or long-lasting impact of foreign exchange interventions on the real exchange rate.

In the face of fundamental forces driving the exchange rate, “defending” the national currency does not prevent its depreciation and only leads to massive losses of foreign reserves.

Although little can be done to avoid large external shocks, much can be done to prevent crises. This starts by avoiding unsustainable policies. For exchange rate matters, the worst of these policies are keeping a fixed-but-misaligned exchange rate (sooner or later, it will burst), and providing implicit or explicit insurance on undue or excessive risk taking (by intervening against a clear exchange rate trend, by subsidizing foreign exchange transactions, and by bailing out financial institutions). These only invite speculative attacks, unwarranted risk taking, and losses of foreign reserves.

For the full text of the Research Policy Brief, diagrams and reference list, visit bit.ly/DECRG_forex

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INFORMALITY, DEVELOPMENT & GROWTH

Norman V. Loayza

The informal sector forms 35 percent of gross domestic product (GDP) and employs 70 percent of the labor force in developing economies. There are trade-offs between formality and informality in terms of labor, capital, and productivity growth. Formal firms confront higher labor costs, while informal firms face higher capital costs and lower productivity. Informality, regulations, migration, and economic growth are all interlinked, and government intervention should be in the form of making formal organization more attractive.

Informality in the process of development and growth

“**INFORMALITY**” IS a term used to describe the collection of firms, workers, and activities that operate outside legal and regulatory frameworks or outside the modern economy. While it offers the benefits of avoiding the burden of regulation and taxation, its participants suffer the costs of not having the protection and services that the law and the State can provide.

Informality is a fundamental characteristic of underdevelopment. A complex, multifaceted phenomenon, it is determined by both the inherent characteristics of developing economies (such as low physical and human capital) and by the relationship that the State establishes with private agents (through regulation, monitoring, and the provision of public services). The evidence suggests that the relative size of the informal sector declines with overall development, rises with the burden of regulation, and decreases with the strength of enforcement.

Informality implies misallocation of resources and entails losing the advantages of legality, such as police and judicial protection, access to formal credit institutions, and participation in international markets, which can then lead to slow capital accumulation, low economic growth, and sluggish migration to more productive areas. Informal firms tend to be smaller and have lower productivity, and differences in the size of the informal sector can account for a significant portion of differences in output per capita between rich and poor countries.

Informality is widespread in the majority of developing countries. It is a substantive and pervasive phenomenon that must be explained and addressed, particularly in the design of development policies. The goal of reducing informality can shed new light on the relevance of short-run policies – such as streamlining regulations and strengthening monitoring and enforcement – and long-run strategies – such as improving judicial services, providing public infrastructure and services, and contributing to human capital formation.

Informality is likely to appear as one of the most difficult challenges facing developing countries, and is often at the top of policymakers' priorities.

Coming to a conceptual landing

There remains much confusion on basic definitions and measurement of informality and about its causes and consequences. In turn, confusion on definitions and causes can lead to misguided advice about confronting informality. For instance, if it is perceived as solely the result of weak enforcement, the advice may be to strengthen monitoring and harden penalties against informal firms, which could result in worse problems – unemployment, self-employment, and further reductions in the size of firms. Likewise, if informality is perceived as purely the result of State regulations, the recommendation may be to lift them, only to realize that the consequent reduction in informality is limited and small.

In the late 1980s, the informal sector had been presented as the private sector's response to an over-regulated economy and an inefficient State. This approach departed from the then-prevailing one, in which informality was regarded as merely a symptom of underdevelopment, rather than the result of misguided policies. This tension between development and policies as determinants and constraints of informality is present, in one way or another, in all modern studies of the subject.

Studies on informality can generally be divided in two basic strands, according to the trade-offs that generate the informal sector. One strand takes a public finance perspective, emphasizing the trade-off between taxes and public services; informal firms avoid taxes at the cost of reduced access to public services and being subject to penalties. The other takes a labor perspective, focusing on the trade-off between labor and capital costs; informal firms avoid mandated labor costs at the cost of higher capital costs. The two trade-offs are related, but choosing one of them provides tractability and emphasis: if the interest is in understanding tax evasion, the first trade-off is the obvious choice; if informal labor is the primary interest, the second approach is more suitable.

Illustrating informality from a labor perspective

Consider the case of a policy-driven urban bias and a permanent minimum wage. This case can represent labor markets in developing countries in the last 50 years in regions as diverse as Africa, East Asia, Latin America, the Middle East, and South Asia. In the 1960s, these countries were characterized by a large rural population, most of which was employed in a rudimentary, subsistence economy. In contrast, the

modern economy, where industrialization was taking place, was mostly based in urban areas. The most significant migration consisted of people moving from rural to urban areas. There are three phases that can be described in terms of the relative size of the informal economy in the modern economy.

IN THE FIRST PHASE, there is an expansion of modern informal employment. Urban-bias policies are gradually implemented by pushing down the rural-urban terms of trade and decreasing the urban cost of living. This encourages rural-urban migration, and an urban labor force that grows faster than capital. In turn, the declining capital-labor ratio produces an expansion of the relative (and absolute) size of modern informal employment.

IN THE SECOND PHASE, the relative size of the modern informal sector remains stable. As urban-bias policies are curbed, rural-urban migration continues, but at a slower pace. When the adjusted rural wage is stable, the urban labor force grows at the same rate as the capital stock does. Thus, the urban capital-labor ratio remains constant, even in the face of capital accumulation, for as long as rural-urban migration continues. During this period, the relative size of informal employment remains unchanged. The greater the pool of rural workers, the larger will be the phase of stability in the relative size of the informal sector.

IN THE THIRD PHASE, there is a contraction of informal employment. Provided that the rate of natural increase in the rural population is not greater than the migration rate, rural-urban migration comes to a halt. At first, the formal and informal sectors coexist. The capital stock accumulates at a constant rate; and, as long as the rate of natural increase in urban population is not too large, the aggregate capital-labor ratio steadily increases. This produces a gradual decline in the relative (and absolute) size of the modern informal sector until it disappears, when the minimum legal wage is no longer binding.

When the economy is fully formal, capital accumulation produces a decrease of the capital rental rate, reflecting the relative scarcity of labor. Capital growth slows down as the rental rate approaches the subjective rate of time preference plus the depreciation rate.

Conclusion

To understand how informality changes in size and type, it is necessary to relate it to the long-run phenomena of labor migration and economic growth. It is also necessary to realize how informality derives from both lack of development and biased policies. Informality should then be understood as both a symptom and a consequence in the process of economic development.

Different types of policies to address informality have different outcome possibilities and limitations.

For instance, improving financial and contractual participation for informal firms will increase informal wages, but will also cause an expansion of the informal sector. Streamlining labor regulations will expand the formal sector in the modern economy, but will not eliminate informal labor in the rudimentary economy in the short run. Sustained improvements in labor productivity in the modern economy, through capital accumulation and total factor productivity growth, will lead to a reduction in informality across all areas, but only in the long run.

Taking into account that informality can also manifest in the rudimentary economy (as self- or sub-employment) should make policy makers realize the futility of formalization plans based on penalties to firms. It should help them understand the advantages of programs that make formality more attractive to both workers and firms

This paper was presented twice in 2016. The first was held at the World Bank headquarters in Washington D.C as part of the Policy Research Talks in June. The second was held at the World Bank Group Global Knowledge and Research Hub in Malaysia in October. Both engagements were organized by the Development Economics Research Group (DECGR). To download the full paper, visit bit.ly/DECGR_informality

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BUILDING STATE CAPABILITY

Michael Woolcock

Articulating a reasonable policy is one thing; actually implementing it successfully is another. Rarely is there a follow-up on who will implement these “implications,” or if an administration charged with implementing any policy can actually do so, or whether a given policy success or failure actually stems less from the quality of its “design” and more from the willingness and ability of the prevailing apparatus to implement it.

The “long voyage of discovery”

ONE OF the great paradoxes of contemporary development is that this wondrous project – to bring a measure of prosperity and peace to the whole world – has both succeeded spectacularly and failed miserably.

It has succeeded spectacularly because, by many measures, the world has never been in better shape. Despite what one might infer from the daily headlines, on average we live longer, have higher incomes, are better educated, enjoy more political freedoms, and are physically safer than at any point in human history.



Large-scale famines, pestilence, and plagues, long the scourge of human existence, have mostly been consigned to history books. Even wars are smaller scale, resulting in vastly fewer deaths than those of the first half of the twentieth century (and before). But we have also failed miserably, because we have done the easy part, and because the key to taking the next vital steps – building institutions able to implement increasingly complex and contentious tasks, under pressure and at scale – is not only not improving, but in most developing countries steadily declining.

The “easy” part of development entailed stopping doing awful things (genocide, gulags, apartheid, exclusion) and then going from nothing to something in the provision of positive things: from essentially no public services of any kind to the provision of a building called a school, occupied by a person called a teacher deploying some resources called textbooks. Such provisions constituted, mathematically speaking, an infinite improvement and together they generated correspondingly real advancements in human welfare. As important as these achievements have been, however, they are the beginning, not the end, of “development”.

To complete the development journey, we now need to do the hard part

We need to ensure that buildings, teachers, and textbooks routinely combine to produce actual learning, generating the knowledge and problem-solving skills that enable students to become functioning members of the twenty-first-century global economy, and to become informed citizens meaningfully participating in domestic political debates. Having defined education as enrollment, and gender equality as enrollment equality, it has been possible to declare victory.

These “inputs,” however, are necessary but very insufficient for taking the next steps toward establishing a high-capability education system, one able to assure the reliable provision of high-quality public services for all. Moreover, beyond services that enjoy broad support, development also entails the crafting of a state able to legitimately and equitably impose difficult obligations – taxation, regulation, criminal justice – that everyday citizens (let alone powerful interest groups) may have occasion to actively resist.

Delivering on such tasks requires a mutually binding and broadly legitimate “social contract” between citizen, state and provider, and a state that itself has the organizational capability to implement such tasks.

On these development tasks, unfortunately, the empirical record in recent years is much less sanguine; indeed, in most developing countries, the quality of institutions presiding over such tasks is flatlining or actively declining. Even delivering the mail – a non-controversial and almost entirely logistical task – seems to be beyond the capability of many countries (and not just the poorest ones).

Too often, countries are being asked to run before they can walk. They are being tasked to implement “green growth”, to build an effective justice system, and to introduce a progressive tax code and pension systems before they even have the resources or capability to fix potholes in the roads. In the face of such challenges, the prevailing development literature and policy discourse is conspicuously silent or at best confused.

Reports, papers, and memoranda are of course replete with strident calls for enhancing “development effectiveness” and “good governance” for

promoting “the rule of law,” “social accountability,” “transparency,” “participation,” and “inclusion” as a basis for building “sound institutions,” but relatively little attention is paid to the mechanisms and logics by which such activities are justified, enacted, and assessed.

Even if seasoned practitioners readily concede that *bona fide* “tool kits” for responding to these challenges remain elusive, our collective response seems to have been to double down on orthodoxy – on measuring success by inputs provided, resources transferred, “best practices” replicated, rules faithfully upheld – rather than seeking to forge strategies that respond to the specific types of development problems that “building effective institutions” necessarily requires.

We contend that such strategies produce administrative systems in developing countries that look like those of modern states but do not (indeed, cannot) perform like them; reforms yield metrics that satisfy narrow bureaucratic scorecards in donor capitals (and thus enable funds to continue to flow and legitimacy to be sustained), but mask a clear inability to actually implement incrementally more complex and contentious tasks.

What systems look like (their form) and what they can actually do (their function) are often conflated; the claim or hope, in effect, is that good form will get you good function. We argue, on the contrary, that success (effective functioning) stems less from “good institutions” (form) but that success builds good institutions. The challenge is thus how to enhance the frequency, quality, and robustness of this success.

Beyond mere critique of orthodoxy, we seek to outline a strategy and collection of tactics that we believe – on the basis of the historical record, contemporary evidence, and our own hard-won experience – offers a coherent and supportable strategy for nurturing this success.

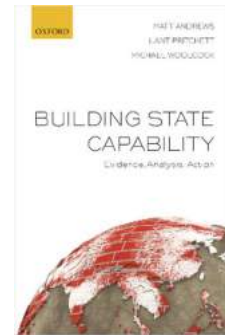
Rather than “selling solutions” (or a “tool kit” of universal “best practices” as verified by “rigorous evidence”), strategies that begin with generating locally nominated and prioritized problems are proposed to identify customized “best fit” responses (sometimes by exploiting the existing variation in implementation outcomes), in the process working with an expanding community of practice to share and learn at scale.

We call this approach problem-driven iterative adaptation (PDIA). We are very conscious that others before us and around us today have articulated similar diagnoses and prescriptions, but we like to think the PDIA approach is unique in providing a detailed explanation of the problem, a pragmatic and supportable response to it, and a commitment to building an expanding social movement that can adopt and adapt it in practice. As such, it's the second word – not the first or final word – on a long journey of discovery.

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For more information, visit buildingstatecapability.com

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