MALAYSIA ECONOMIC MONITOR

Inclusive Growth

November 2010

THE WORLD BANK

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PREFACE

About a year ago, the Government of Malaysia and the World Bank set up a knowledge partnership centered on the policy objective of transforming Malaysia into a high-income economy. The *Malaysia Economic Monitor* series is a key pillar in this partnership and serves as a platform for public discussion, analysis, and the sharing of knowledge on the challenges facing Malaysia in achieving this objective.

This third issue of the *Malaysia Economic Monitor* is themed *Inclusive Growth*. The report reviews recent economic developments, updates the World Bank's view on the economic outlook, and analyzes—in the report's thematic section—how Malaysia can promote the objective of inclusive growth. The report is accompanied by an outreach effort to a wide audience of policymakers, private sector leaders, market participants, civil society, think tanks, journalists and the public at large. This report—as the two previous ones, namely *Repositioning For Growth* (November 2009) and *Growth Through Innovation* (April 2010)—is available at www.worldbank.org/my.

This *Malaysia Economic Monitor* was prepared by Philip Schellekens (Task Team Leader), Timothy Bulman, Ximena del Carpio, Vatcharin Sirimaneetham and Ashley Taylor, with contributions from and in collaboration with Jim Brumby, Julia Dhimitri, Richard Hemming, Tehmina Khan, Karine Marazyan, Magnus Lindelow, Tony Ollero, Dejan Ostojic, Jeeva Perumalpillai-Essex, Omporn Regel, Martin Reichhuber, James Seward, Rizal Shadiq, Neil Sood, Natsuko Toba, Marijn Verhoeven and under the overall guidance of Manny Jimenez, Vikram Nehru, Mathew Verghis and Xiaoqing Yu. An external contribution by the Economics Department and Development Finance and Enterprise Department of the Bank Negara Malaysia is gratefully acknowledged. Annette Dixon, Yukon Huang, Chanin Manopiniwes and Mathew Verghis commented on an earlier draft, Prabha Chandran and Anissa Amador Tria assisted in external relations and web production, Indra Irnawan designed the cover and back, and Angkanee Luangpenthong and Piathida Poonprasit provided program and administrative support.

The *Malaysia Economic Monitor* benefited from fruitful discussions with and comments and information from the Bank Negara Malaysia, the Prime Minister's Economic Council, the Economic Planning Unit, the Iskandar Regional Development Authority, Ministry of Finance, the National Economic Advisory Council, the Performance Management and Delivery Unit, numerous other government ministries and agencies, private sector participants, think tanks and academics. A special word of thanks goes to the State Government of Sabah, the State Economic Planning Unit of Sabah and the Ministry of Regional Development of Sabah for fruitful discussions, information and their organization of a visit to various field projects. Last but not least, the team is indebted to the Economic Planning Unit for their continued support and in particular the International Cooperation Section of the EPU for their assistance in the launch of this Monitor.

EXECUTIVE SUMMARY

RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

Following a spectacular year-on-year recovery, the growth momentum of the Malaysian economy is ebbing. After a period of crisis-related volatility, the economy transitioned into more normal patterns of growth: the pronounced inventory cycle began to subside, private consumption became more buoyant, and fixed investment picked up as capacity utilization gaps were closed. Interrupting this process was the return of external weakness, with exports slowing in the second quarter and then contracting. Since import demand for export processing did not react immediately, inventory volatility picked up again.

As growth patterns normalized, inflation has recovered. But, the small rise in inflation, reaching 2.1 percent in August, was largely due to food prices, with little impact from non-food subsidy reforms. Bank Negara preemptively responded to the recovery in activity and inflation by raising the policy rate by 75 basis points between February and July to 2.75 percent. Rates have subsequently remained flat, while a marked, yet relatively smooth, Ringgit appreciation helped contain price pressures. Asset price strength reflected resurgent investment inflows, as in the region, but outwards direct investment rose too. Steps were taken to liberalize the exchange rate regime, mainly to lower trade transaction costs.

Fiscal policy has also started to normalize. The 2011 Budget targets a deficit of 5.4 percent of GDP, down from 5.6 percent in 2010 and 7 percent in 2009. The Government embarked on a first step to systematically reform subsidies in mid-July, raising energy prices, including gasoline and household gas, and sugar prices moderately. It also announced plans to adjust regulated fuel prices monthly, as a step towards indexation, but to date there have been no further adjustments.

Economic activity is expected to further decelerate in the second half of 2010. Given the low base in 2009, growth of 7.4 percent is expected for 2010, before slowing to 4.8 percent in 2011. Domestic demand is set to continue to drive near-term growth. The strength of global demand, both from the G3 and China, remains a key source of uncertainty. In addition, domestic sentiment is sensitive to reform progress relative to expectations while uncertainty over the impact of the ongoing reforms and associated investments further complicates near-term forecasting.

Achieving Malaysia's Vision 2020 goal of high-income status requires average growth of 6 percent during the 10th Malaysia Plan period — a marked improvement on the 4.4 percent achieved over 2006-2010. The challenge is not only to boost the level of growth but to ensure that growth is inclusive and sustainable. The policies and projects of the Economic Transformation Program are key to meeting this challenge through greater, and higher-quality, investment and productivity improvements.

Risks to medium-term growth remain the extent of reform implementation and progress on fiscal consolidation. The Government is taking steps to address both areas, but risks remain, both upside and downside. Until solid implementation of reforms is seen there is unlikely to be a groundswell of positive sentiment of foreign investors towards Malaysia. In addition to the sustainability of public finances, the quality of public service delivery will be a crucial determinant of the success of the Government's plans.

PROMOTING INCLUSIVE GROWTH

While Malaysia has made great strides in reducing poverty and inequality over the last four decades, significant challenges remain. Deep pockets of poverty continue to exist and, despite notable reductions in the 1970s and 1980s, inequality has leveled out at comparatively high levels. A large share of households lives on low income levels at less than half of median income.

New challenges are also emerging as Malaysia prepares itself to become a high-income economy. Raising the knowledge intensity of economic activity may accentuate income disparities across skill levels. Fostering geographical concentration may amplify urban-rural differences. Restructuring the sources of growth and introducing greater competition may raise the demand for social protection.

Given these challenges —existing and emerging—how can Malaysia fully meet the aspiration of an inclusive society? This report focuses on raising economy-wide income-earning opportunities, promoting investment in human capital, and providing social protection for the poor and vulnerable. These themes are also reflected in the Government's recently announced Economic Transformation Programme.

Raising Economy-Wide Income-Earning Opportunities

Inclusive growth rests on a vibrant economy that generates plenty of opportunities for all. To revitalize its weakening engine of growth and generate more economic opportunities, the Malaysian economy is in dire need of further investment climate improvements. Important in this respect are labor market reforms that raise the level of employment, strengthen the labor market matching process, and reduce the degree of informality.

- *Encouraging mobility of workers.* Market forces tend to encourage geographic concentration of economic activity, resulting in migration of labor to areas with better economic opportunities. Measures to reduce further the costs and barriers to labor mobility will be critical, including by improving access to employment services and enhancing the opportunities for human capital formation.

- *Increasing labor market competition.* Competitive labor markets make firms more efficient, more likely to participate in the formal economy, and more conducive to better compensation practices. Streamlining the regulatory environment for businesses, including licensing requirements and other barriers for new investment, will be key in this respect.

- *Reducing rigidities in labor markets.* Difficulties in hiring and dismissing workers in Malaysia dampen turnover and raise labor costs, which in turn reduce firm-level productivity. Mandatory firm-based severance payments, for example, currently hamper flexibility and are best replaced with alternative social protection mechanisms that protect the workers but not the jobs.

Promoting Investment in Human Capital

Many Malaysians cannot take advantage of income-earning opportunities because they lack the skills to do so. Some never got them in the first place, despite massive investments in education. For others, skill needs have changed more quickly than the availability of educational and training opportunities. This points to the need to: strengthen—the provision and quality of—basic education in underserved areas, vocational training, as well as employer and industry-led skills development.

- *Enhancing basic education in underserved areas.* Narrowing the gap in school access and quality between rural and urban communities will warrant raising public spending on rural areas. It also requires further financial assistance to poor and rural households to help them defray the—direct and indirect—costs of education. Recruiting adequately trained teachers in key subjects and giving them incentives to deliver high-quality services in rural areas remains a high policy priority.

- *Improving the structure of the vocational training system.* The currently fragmented institutional structure offers an unclear pathway to the general education system and would need to be rationalized along with accreditation and quality standards. While continuing public support to the less advantaged in accessing skills training opportunities, the provision of training could be competitively outsourced. This would encourage participation and improve quality in support of the high-income economy.

- *Strengthening employer and industry-led skills development.* An employer-led skills development system will be a crucial step in improving the performance of Malaysia's vocational training and education system. Helpful in this respect will be measures to encourage employers or industry representatives to participate in the skills standard and certification process, curriculum design, development of apprenticeship and scholarship programs.

Providing Social Protection For The Poor And Vulnerable

Even if plenty of income-earning opportunities exist and access to them is broadly adequate, some Malaysians will inevitably remain excluded or require temporary support. Social protection schemes are aimed to provide assistance to the poor and vulnerable, who have no other sources of support. Important elements of a social protection system are in place in Malaysia, but significant gaps remain. Social safety net programs could have a stronger poverty focus, targeting mechanisms could be improved and fragmented programs could be replaced by a well-coordinated social protection system.

- *Strengthening the poverty focus of social safety nets programs.* It is recognized that social safety nets should not be universal but targeted to the neediest. It appears however that the poverty focus of Malaysia's social safety net could be strengthened. Gaps in the assistance provided to the poor and vulnerable could be addressed. The savings of reducing price subsidies further, which primarily benefit the better off, could be used to scale up and strengthen programs targeted on the poor.

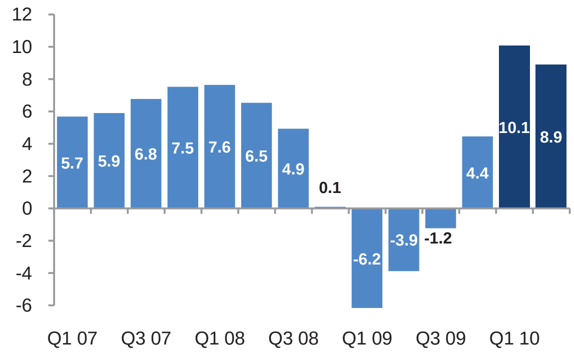
- *Refining targeting mechanisms to reach and benefit the needy.* Establishing clear indicators and—based on these—an adequate targeting system poses a challenge to many countries. Malaysia could consider targeting on the basis of proxy means tests, which is appropriate when income information is unreliable and alternative characteristics correlate well with poverty. The objectivity of the system reduces discretion and abuse and can build upon the centralized, yet flexible, approach of targeting of e-Kasih to reduce error and waste.

- *Moving from fragmented programs to a coordinated social protection system.* The current fragmentation of programs could be reduced by introducing a well-coordinated system that packages the programs, balances them and realizes synergies. One possible framework would consist of a poverty-targeted cash transfer program as the backbone of the social safety net component, supplemented by labor market programs, unemployment insurance to protect against employment shocks, and pension insurance to ensure old age security.

THE MALAYSIAN ECONOMY IN PICTURES

The Malaysian economy recorded a spectacular year-on-year recovery…

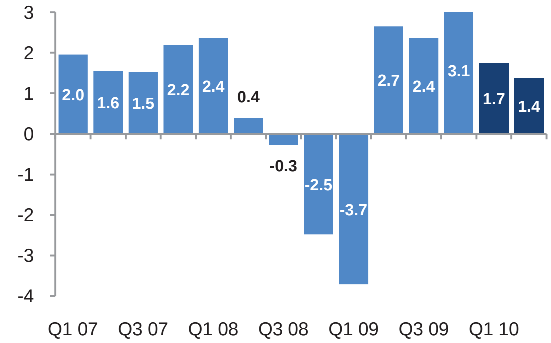
Real GDP growth, year-on-year, percent



Source: CEIC, Haver and World Bank staff calculations.

…but quarterly comparisons suggest the pace of growth has weakened

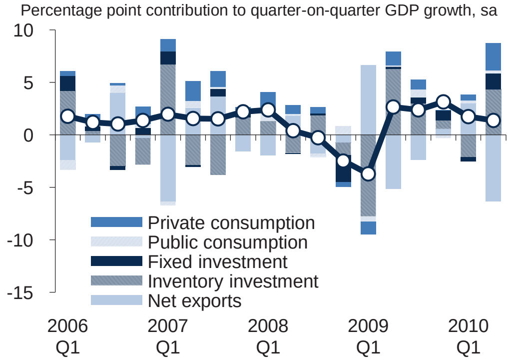
Real GDP growth,quarter-on-quarter, seasonally adjusted, percent



Source: CEIC, Haver and World Bank staff calculations.

Domestic private demand is a key driver of growth again…

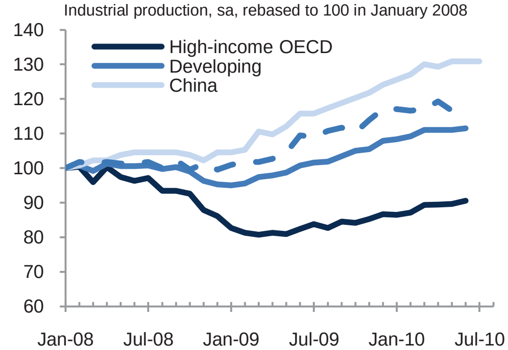
Percentage point contribution to quarter-on-quarter GDP growth, sa



Source: Haver and World Bank staff calculations.

… as the uneven recovery in external demand continued

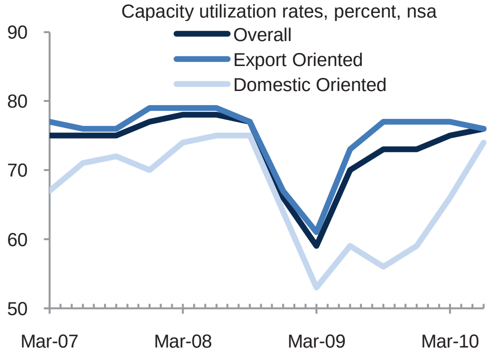
Industrial production, sa, rebased to 100 in January 2008



Source: World Bank.

Capacity utilization returned to more typical levels

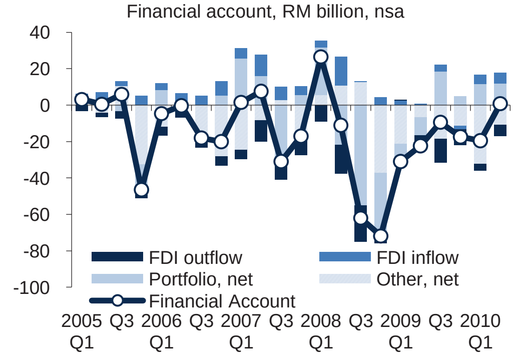
Capacity utilization rates, percent, nsa



Source: CEIC.

A return of investment inflows brought the financial account back to surplus

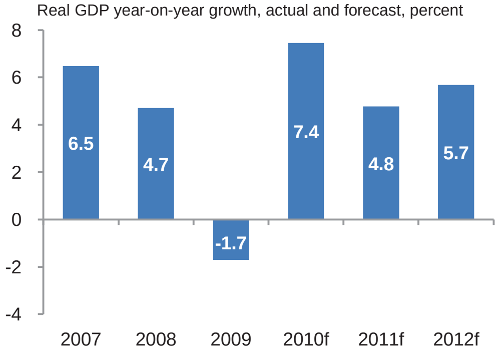
Financial account, RM billion, nsa



Source: CEIC and World Bank staff calculations.

Near-term growth is expected to soften

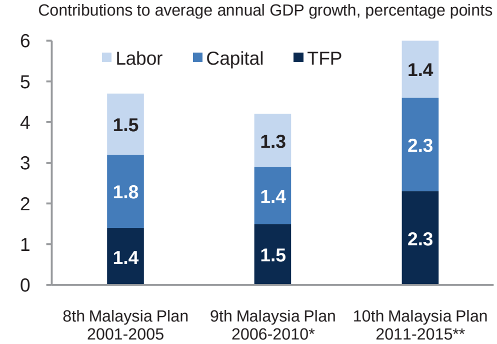
Real GDP year-on-year growth, actual and forecast, percent



Source: CEIC and World Bank staff projections.

Medium-term growth targets will require a significant rise in productivity and investment

Contributions to average annual GDP growth, percentage points

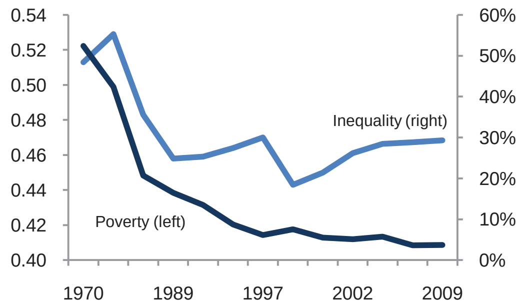


Note: * estimate, ** target. TFP is total factor productivity.
Source: Economic Planning Unit (2010a).

THE INCLUSIVE GROWTH CHALLENGE IN PICTURES

Poverty has declined markedly, but inequality remains at high levels

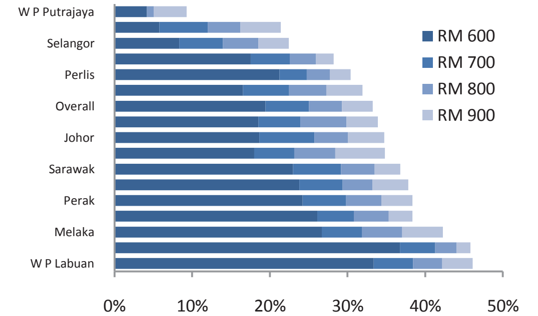
Gini coefficient of inequality and poverty incidence in percent



Source: DOS, EPU and World Bank staff calculations.

Further progress will require: (1) Boosting economy-wide wage levels

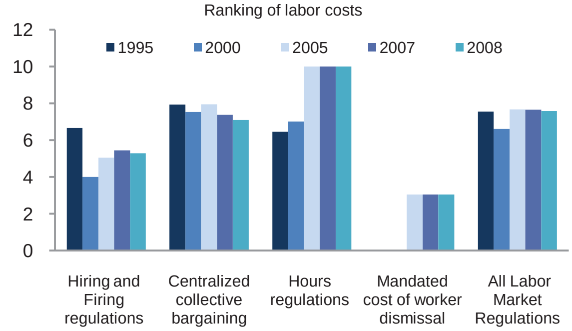
Diversity in wage levels in construction and manufacturing



Source: World Bank Enterprise Surveys and staff calculations.

… including through labor market reforms to raise productivity and mobility

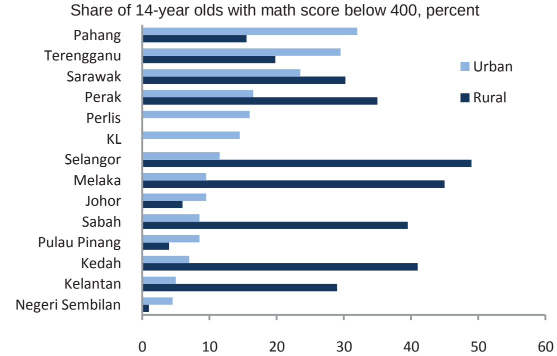
Ranking of labor costs



Source: Frasier Index (2009).

(2) Reducing disparities in human capital formation

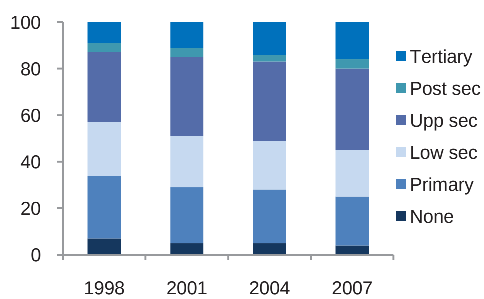
Share of 14-year olds with math score below 400, percent



Source: TIMMS (2007).

… and lifting individual capabilities by strengthening higher and vocational education

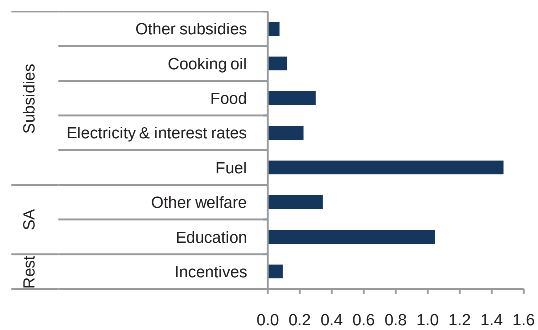
Share of students in education category, percent



Source: Economic Planning Unit (2009).

(3) Modernizing the existing system of social protection

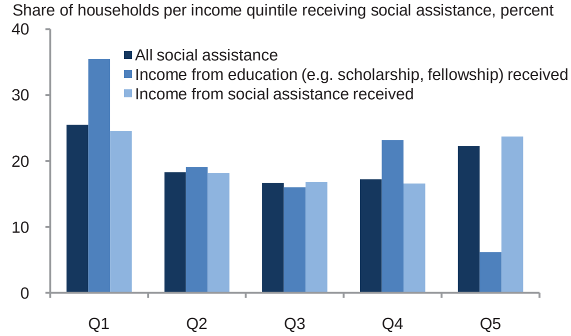
Percentage of GDP spent on each category



Source: Ministry of Finance Malaysia (2010).
Note: SA = social assistance.

… by shifting from social assistance to social insurance, particularly for the less needy

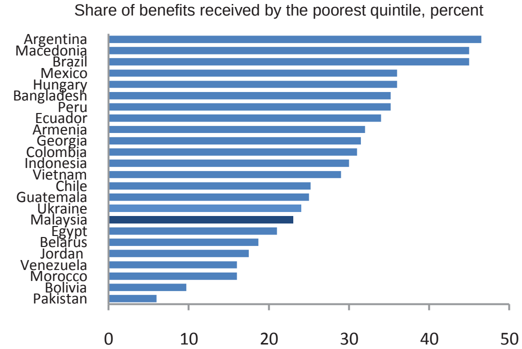
Share of households per income quintile receiving social assistance, percent



Source: EPU ,HIS, World Bank staff calculations.

… and enhancing the targeting of the social protection system to the needy

Share of benefits received by the poorest quintile, percent



Source: EPU, HIS, World Bank staff calculations.

1. RECENT ECONOMIC DEVELOPMENTS

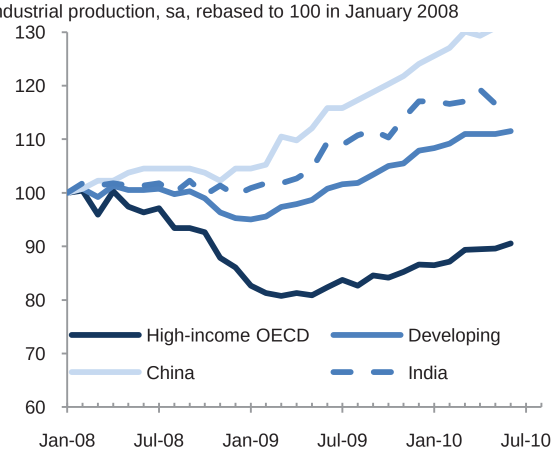
Malaysia's economy has transitioned from the rebound to more sustainable growth. This has brought a recovery in employment and new investments, and healthier domestic private demand and activity. Capacity use has returned to normal levels and prices are rising. Investment inflows returned, seeking both the relatively higher returns in Malaysia's financial markets and longer-term investment opportunities. With these capital inflows, the Ringgit recorded the strongest appreciation in the region from the start of 2010 to Q3 against the USD. But, similar to the global economy, Malaysia's recovery remains tentative. Exports and some industrial production indicators weakened mid-year, and this appears to have surprised producers, who continued to restock their inventories in anticipation of future production. In light of this tentativeness, monetary policy was tightened but still remains supportive, and the government made the first moves to reduce the budget deficit, most notably through initial steps to align some regulated prices with their market value.

AFTER SHARP REBOUND, GLOBAL RECOVERY REMAINS TENTATIVE

Most major economies expanded strongly in the first half of 2010, faster than most expectations. This rebound is amplified in the year-on-year growth rates by the base effects of the contraction in early 2009. Those economies that suffered the deepest declines in output during the global recession also generally experienced the sharpest recoveries. For example, Singapore's GDP contracted by nine percent year-on-year (yoy) in 2009 and subsequently rebounded by 18.7 percent in the year to Q2 2010; in contrast Indonesia's fell only to 4.1 percent and recovered to 6.2 percent. The most notable upside surprise for growth was in the Eurozone, especially Germany, despite the financial turbulence affecting the region's southern economies and the volatility in the Euro exchange rate. Even with the sharpness of the rebound, many economies' output remains below pre-crisis peaks, and most continue to operate significantly below capacity – with exceptions, most notably of China (Figure 1.1).

Figure 1.1. The global economy slowed in the first half of 2010

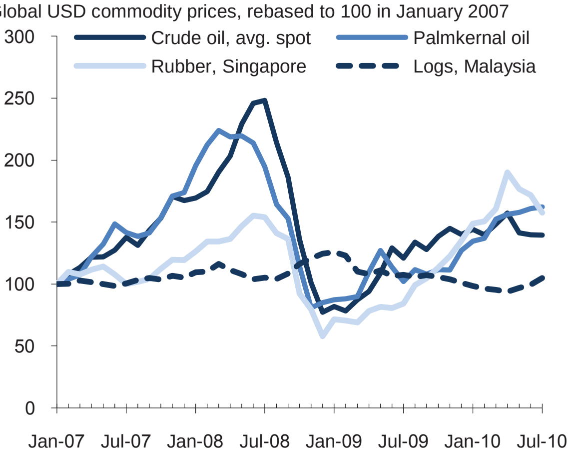
Industrial production, sa, rebased to 100 in January 2008



Source: World Bank.

Figure 1.2. Commodity prices, including those of Malaysia's exports, stabilized at late 2007 levels

Global USD commodity prices, rebased to 100 in January 2007



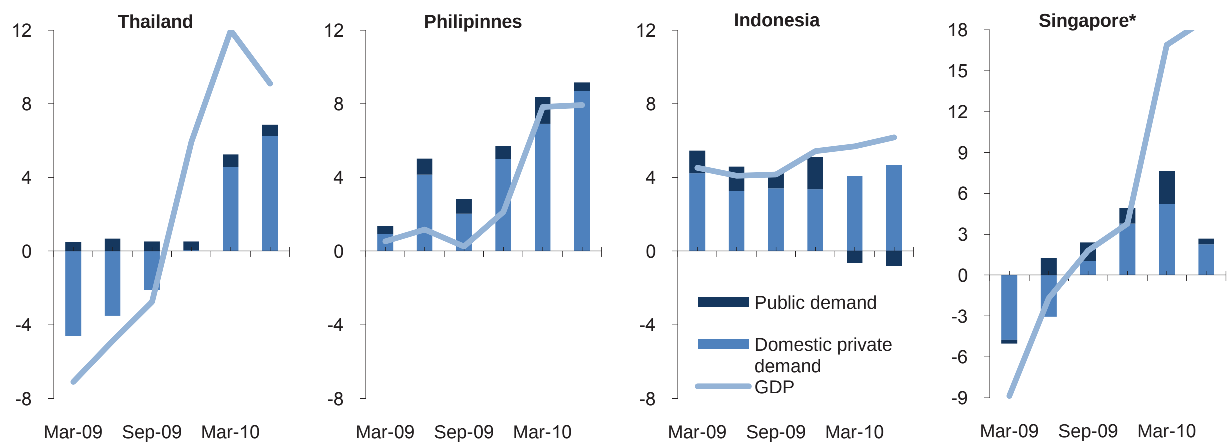
Source: World Bank.

In turn, these rebounds supported commodity demand, most notably in China and India. Crude oil prices oil traded in an unusually narrow range relative to the past half-decade, between about USD 75 and USD 85 per barrel. Demand particularly from India helped give crude palm oil prices a stronger trajectory in 2010, and some metals prices (Figure 1.2). In contrast, more broadly-based inflation has been limited, with the large scale of spare manufacturing capacity globally and the weakness in many labor markets, subduing inflationary pressures. Highly unusual weather patterns did affect food supply and prices in various parts of the world, particularly for wheat.

The rebounds in growth internationally have been mutually reinforcing and increasingly driven by domestic demand. Monetary and fiscal stimulus worked to stabilize economies and start the recovery process, with the direct impact from public spending and lower cost of funds continuing into 2010. This had ongoing indirect effects, by supporting businesses' confidence in their sales such that they were willing to replenish depleted inventories, drawing in exports from their trade partners, and so creating a virtuous circle, lifting consumers' confidence and firms' willingness to invest globally. In the process, private domestic demand became the key driver of growth in many economies (Figure 1.3).

Figure 1.3. Private domestic demand has reemerged as the source of growth across the region

Percentage point contributions to quarter-on-quarter growth, sa. Private domestic demand is private consumption plus gross fixed capital formation, and does not include inventories, which are largely driven by movements in external demand for these economies



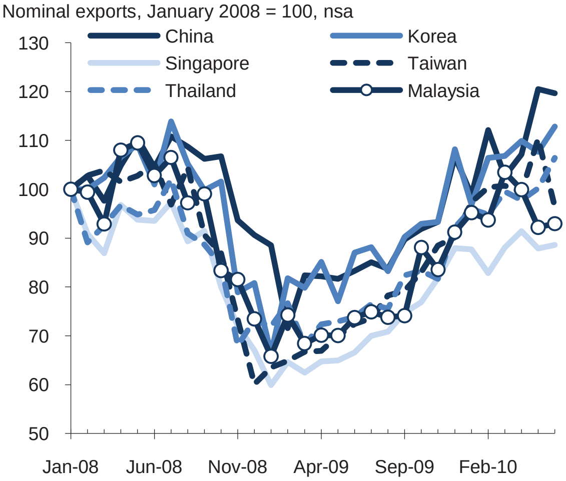
* Note different scale for Singapore. Source: CEIC, Haver and World Bank staff calculations.

The global economy's recovery has nevertheless remained tentative and incomplete. By mid-2010 trade flows generally remained below pre-crisis levels (the important exception being many commodities), as did overall output and especially industrial production in the developed world (Figure 1.3). By mid-year, the growth momentum had slipped too. Overall rates of growth in demand, trade and activity slowed, and confidence and order books weakened. Fiscal policy shifted from stimulus to consolidation under the weight of mounting public debt, especially in southern Europe; the slow recovery in employment spooked American households; and, policy makers in major emerging markets including China and Brazil, tightened policy as they became concerned about activity running ahead of capacity. This slowing was immediately evident across Asia's electronics production networks, with export demand and industrial activity stabilizing in early 2010 and then declining by mid-year (Figure 1.4).

Global financial markets generally reflected developments in their respective real economies. They have trended higher at least in most emerging economies, while experiencing periods of heightened volatility. In April and May this reflected concerns about sovereign solvency in the southern Eurozone, whereas in August it was increasing uncertainty about the strength of the global recovery (Figure 1.5). While both incidents led to a weakening in markets globally and a return of investments to financial assets perceived as 'lower risk', the contagion from the most affected markets to emerging markets was limited and transitory. Indeed, emerging market asset prices markedly outperformed those in developed economies, especially after accounting for the general weakening of the US Dollar. Much of this differential in performance was driven by—and in turn attracted—significant capital flows to higher-yielding assets in emerging economies, especially to those economies with more open capital accounts. The gradual renormalization of the stance of monetary policy in the better-performing emerging markets further accelerated these flows, even as policy makers in these markets examined various mechanisms to limit them.

Figure 1.4. Several major electronics producers saw weakening export growth

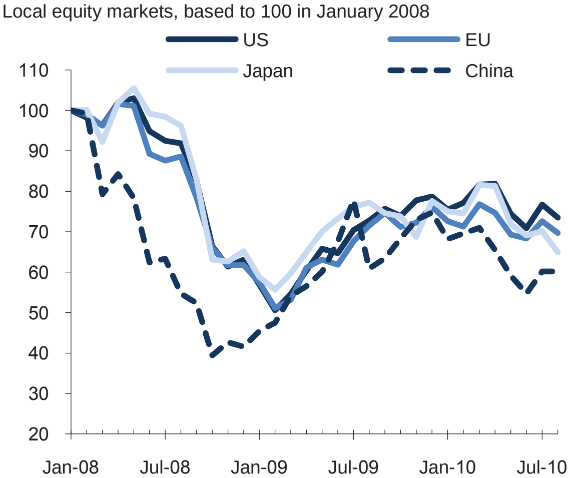
Nominal exports, January 2008 = 100, nsa



Source: CEIC and World Bank staff calculations.

Figure 1.5. Following a recent strengthening, equity markets also showed signs of weakness

Local equity markets, based to 100 in January 2008



Source: CEIC and World Bank staff calculations.

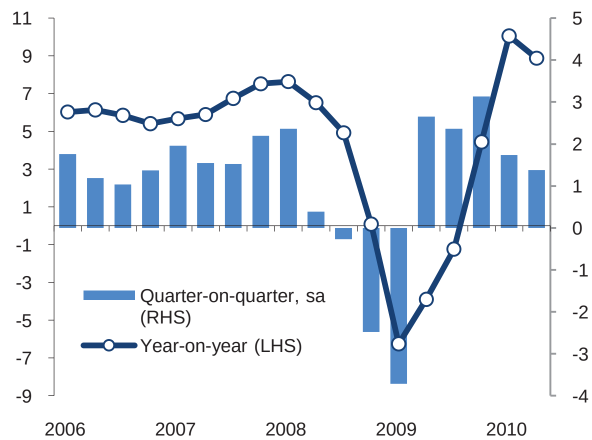
THE PACE OF GROWTH STARTED TO MODERATE IN MALAYSIA

In early 2010 Malaysia's economy completed its rebound from the sharp downturn of a year earlier, and moved to more sustainable, moderating growth rates in the second quarter. The economy expanded by 8.9 percent in Q2 from a year earlier (10.1 percent in the year to Q1), stronger than analysts had generally expected. These high growth rates in part reflect the depth and speed of the downturn a year earlier. Growth quarter-to-quarter, a much better guide of momentum during such volatile times (Box 1), slowed to 5.6 percent in Q2 (adjusted for regular seasonal patterns and annualized - saar) from 7.1 percent in Q1 and a peak of 13.1 percent in Q4 2009. Growth in Q2 is above the past decade's 4.6 percent average and is a little above many private sector economists' estimates of Malaysia's long-term potential growth rate given current investment patterns and policy settings.

The global recession and rebound has taken Malaysia's economy through a sharp and deep V-shaped pattern between mid 2008 and mid 2010. By Q2 2010, activity had recovered to be 4.7 percent above its pre-crisis peak two years earlier. Had the downturn not occurred and new investment and growth in the labor force continued at pre-crisis rates, activity by mid 2010 may have been as much as 8 percent higher. But private investment over these years was weaker than usual while the labor force shrank particularly in manufacturing, suggesting that the economy's potential output grew below trend. Indeed, capacity utilization had generally returned to pre-crisis averages (near 85 percent) according to various measures. The re-engagement of capacity has been particularly pronounced in the domestically-focused and fiscal stimulus-supported construction sector and its suppliers, among some commodity producers and more capital- or technology-intensive manufacturers. Meanwhile, low-skill labor-intensive manufacturers have not seen the same level of reengagement and report ongoing difficulties refilling order books, and the return to 'normal' activity was only achieved mid-year among some domestically-focused service sectors.

Figure 1.6. Growth moderates to more sustainable rates in the first quarters of 2010

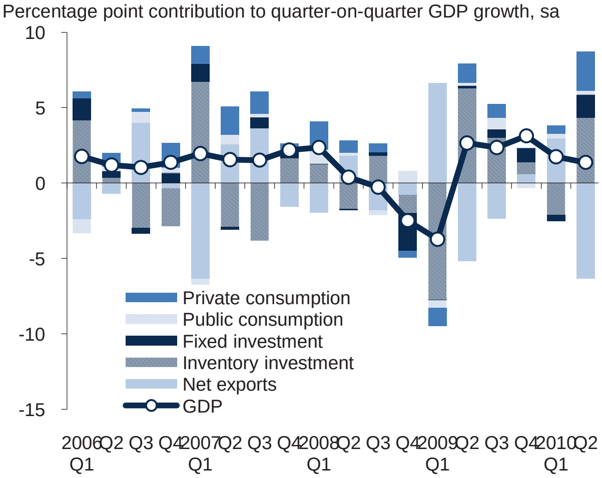
Aggregate GDP growth, year-on-year and quarter-on-quarter, sa



Source: CEIC, Haver and World Bank staff calculations.

Figure 1.7. The strength of private domestic demand was most notable

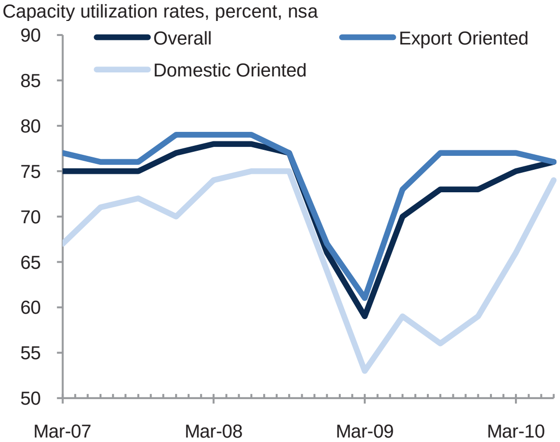
Percentage point contribution to quarter-on-quarter GDP growth, sa



Source: Haver and World Bank staff calculations.

Figure 1.8. Capacity use returned to typical levels for both domestically-oriented and export sectors

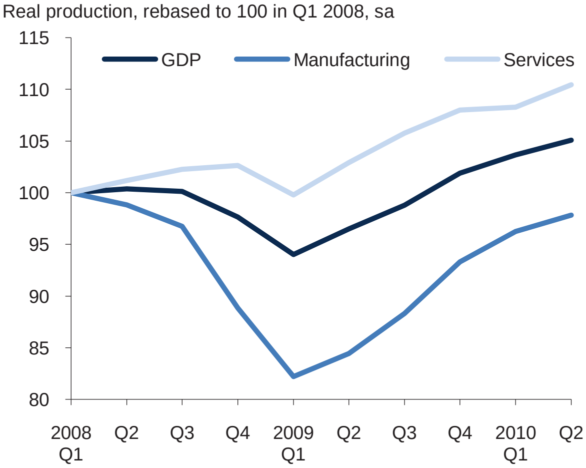
Capacity utilization rates, percent, nsa



Source: CEIC.

Figure 1.9. ...although output is only a little ahead of mid-2008 peaks, largely due to domestic demand

Real production, rebased to 100 in Q1 2008, sa



Source: Haver and World Bank staff calculations.

BOX 1. HOW ADJUSTED QUARTERLY DATA PROVIDES MORE TIMELY INSIGHTS INTO THE STATE OF THE ECONOMY

Macroeconomic time series, such as output or price indices, tend to move with a trend-cycle component, a seasonal component and an irregular component. The trend-cycle component incorporates the long- and medium-term movements of the series—for GDP, it includes both the average growth rate and business cycle fluctuations. The seasonal component includes the within-year fluctuations that reoccur in a similar way in the same month or quarter from year to year—for example, regular holiday periods reducing industrial activity. The irregular component is what remains after the seasonal and trend-cycle components are removed—reflecting for example data collection sample issues or one-off events. Identifying trend-cyclical movements (e.g., where the economy is in the business cycle) in quarter-on-quarter or month-on-month growth rates in non-seasonally adjusted data can be difficult. Seasonal adjustment aids this task by removing the seasonal component from economic time series data, leaving the trend-cyclical components and the random variation in the data.

Focusing on year-on-year growth can mislead, as it contains much old information

The simplest approach to accounting for seasonality is to examine year-on-year growth rates. Year-on-year (yoy) growth accounts for regular seasonality by comparing the level in a particular period of one year (eg, the September quarter, when Malaysia's manufactured exports generally peak) with the same period in the previous year. This smoothes out some of the quarter-to-quarter volatility.

But yoy growth rates can also hide turning points in the underlying series. This is apparent in recent aggregate GDP series (Figure 1.6). The yoy growth rates suggest that Malaysia's economy continued to contract through to Q3 2009, although less quickly than at the start of the year. This apparent contraction is due to the significant falls in output in late 2008 and the start of 2009, during the peak in global economic turmoil, remaining in the yoy growth calculation. In contrast, the seasonally adjusted qoq growth rate show the economy was growing at above trend rates from Q2 2009 to the end of that year. The yoy growth rates only showed this rebound in Q1 2010, by which time the rebound was completing and the economy was return to more normal growth rates.

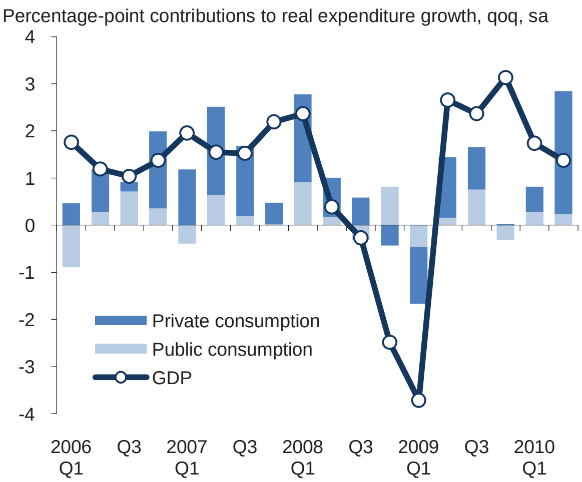
…quarterly growth, adjusted for regular fluctuations, gives much more timely insight

The Department of Statistics Malaysia does not currently publish seasonally adjusted estimates of many macroeconomic series. Some private statistical compilers, such as Haver, do make this adjustment, and it is fairly straightforward for most users to make a simple estimate. The simplest approach is to regress a dummy for each regular period on the original series. Other, more sophisticated approaches relax allow the seasonal patterns to change over time. One freely available and commonly used approach is the X12-ARIMA package. Another is the TRAMO-SEATS method. The Demetra platform, available from Eurostat, operationalizes both. Adjusting Malaysian data for seasonality has the additional complication of accounting for Muslim holidays. These follow a lunar calendar, which advances about 11 days each year relative to the Gregorian calendar. For quarterly data, the impact of Ramadan on seasonal patterns does not appear to be significant, particularly if seasonal factors are allowed to slowly adjust, for example through the X12-ARIMA technique. The impact can be larger in monthly data, and can be accounted for by regressing the seasonally adjusted series on dummy variables for the relevant holidays.

Private Domestic Demand Became Key Growth Driver

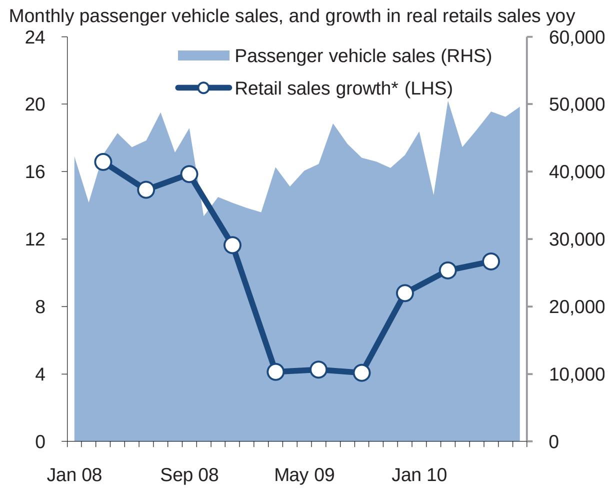
The drivers of growth shifted markedly from the turn of 2010 to mid-year. The domestic private sector took a stronger role, and the fillip from the global rebound ended. Malaysia's consumers and private investors both accelerated spending in Q2, contributing 14.2 percentage points of the economy's 8.9 percent growth year-on-year (Figure 1.10). Private (largely household) consumption rose at an annualized rate of almost 22 percent from Q1 to Q2, sa. Improvements in employment prospects, increases in disposable incomes among workers in commodity producing industries, and growth in consumer lending all supported consumers' confidence and actual spending. This translated into higher demand for various consumer services and imported consumer items, and a recovery in passenger car sales but not in motor cycle sales (Figure 1.11).

Figure 1.10. Private consumption contributed more to the economy's growth in H1 2010



Source: CEIC and World Bank staff calculations

Figure 1.11. … and demand for major purchases and services was resurgent



* Retail sales value deflated by CPI.
Source: CEIC and World Bank staff calculations.

Private investment accelerated, contributing an increasing share of aggregate growth. As capacity constraints emerged with the recovery in activity, and as financing became more accessible, both domestic and offshore investors lifted their spending. Gross fixed investment jumped by 7.5 percent from Q1 to Q2 (over 33 percent annualized). And while the final stages of the government's stimulus packages and development plans contributed, anecdotal reports suggest that private investment led this resurgence, and is now larger than public fixed investment. Foreign direct investment (FDI) funded part of this recovery, with net inwards FDI rising to almost MYR 6 billion (USD 1.8 billion), the highest levels since Q2 2008, following the very weak inflows recorded in 2009 through the financial crisis (UNCTAD reports that net inflows totaled USD 1.4 billion in 2009, about one-fifth of 2008's inflows). The plurality of approved new fixed investments in H1 2010 were in the E&E production sector (RM 3.3 billion), with much of the remainder in the other manufacturing industries. The largest share of the foreign investments inflows came from Singapore (RM 2.9 billion), followed by Japan and Switzerland (RM 0.7 billion and RM 0.5 billion respectively).

Inventory Restocking Continued Contributing to Growth…

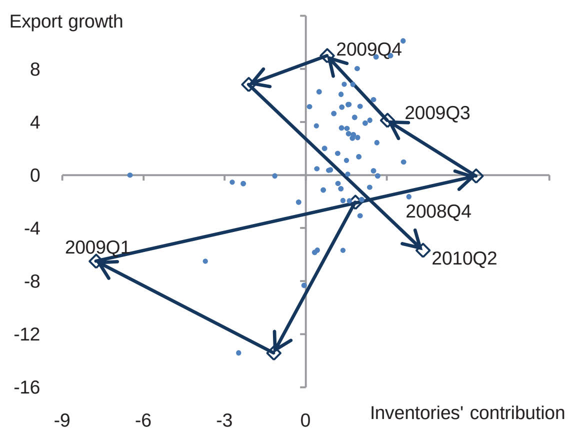
Investment in restocked inventories continued to contribute significantly across H1 2010, although not at the pace of late 2009 (see April 2010 *Malaysia Economic Monitor*). 6.3 percentage points of the economy's 8.9 percent growth in the year to Q2 was from inventory investment[1] (Figure 1.13). This inventory accumulation appears to be mainly in intermediate goods, inputs for manufacturing production for Q3 and Q4, and the strength in intermediate imports in Q2 especially (e.g., imports of primary industrial supplies rose by 50 percent between June 2009 and June 2010). This inventory restocking appeared to be near completion by mid-year, according to partial data (e.g., firm confidence surveys and intermediate import data). But even after the restocking since H2 2009, the value of inventories in Q2 2010 was still RM 40 billion lower than at the start of 2008.

… While Public Sector Demand Renormalized

While resurgent private demand dominated, the public sector did continue to contribute to Malaysia's demand growth in H1. Overall spending by the government on real goods and services fell compared with a year earlier in both Q1 and Q2, although these partly reflected the effects of the government's stimulus spending in early 2009.[2] After accounting for historical disbursement patterns, spending actually rose strongly in both quarters, by 6.5 percent compared with H1 2009 or seven to eight percent on a seasonally adjusted basis. This growth was largely due to development spending under the Ninth Malaysia Plan and the second stimulus package.

Figure 1.13. After the large declines in inventories in 2009, restocking is happening with unusual volatility

Export growth, quarter-on-quarter , and inventories' percentage point contribution to aggregate GDP growth quarter-on-quarter*, sa



Source: Haver and World Bank staff calculations.

[1] 'Inventories' in Malaysia's national accounts include the difference between the total spending estimates of GDP and the estimate of total production. Analysts suggest that this 'statistical discrepancy' has been stable over recent quarters, or at least is not an important driving factor of the large movements reported for inventories.

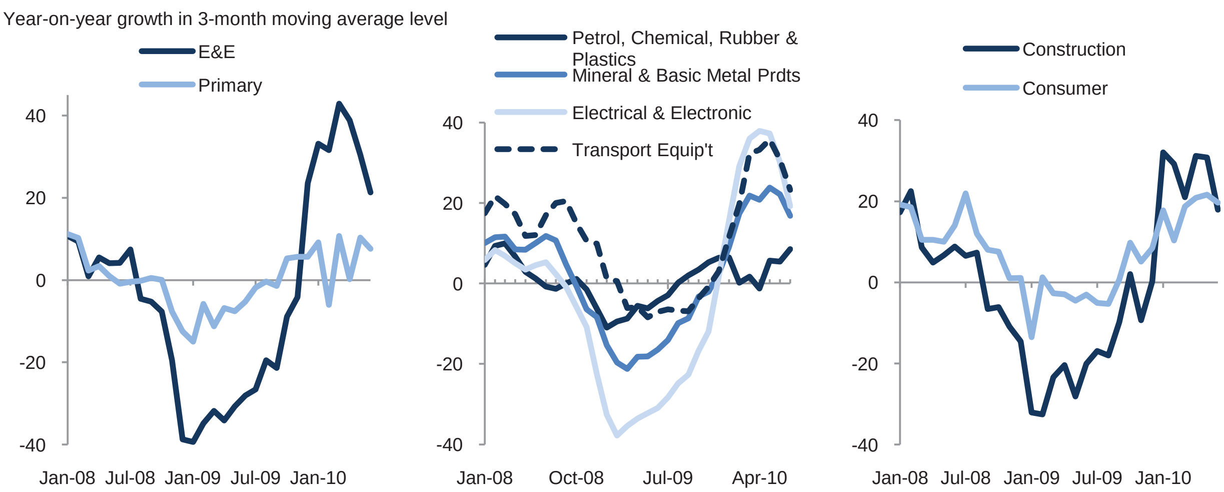
[2] From a GDP perspective, government purchases of goods and services, in contrast to transfers to other sectors of the economy, are key.

Growth Momentum Shifted from Manufacturing to Services

Activity has shifted more to domestically-focused sectors. Just as the growth in demand shifted from external and public sources to the private domestic economy, output growth shifted from externally-oriented manufacturing, as well as construction, to domestically-oriented services, which with the exceptions of tourism and some financial services are generally not traded across borders. Overall by mid-2010 externally-oriented industries had not recovered their pre-crisis output levels, despite the sharp rebound of late 2009 and early 2010, and output had stabilized or even retreated somewhat by July 2010. Meanwhile domestically-oriented industries' output passed their pre-crisis peaks late in Q1 and continued to expand into the second half of the year.

Manufacturing output continued to expand in the first half of 2010, but at a slower pace. Seasonally adjusted, growth was at 24.6 percent in Q4 2009, 13.3 percent in Q1 2010 and 6.8 percent in Q2 saar. By Q2 2010 activity overall was near pre-crisis peaks. But different industries experienced different degrees of recovery. E&E recorded a strong rebound up to Q1 2010 from the sharp drops a year earlier, but the recovery remained incomplete and output in July 2010 was still 15 percent lower than its pre-crisis. In contrast, transport equipment and of industries producing construction materials (e.g., iron & steel, or non-metallic mineral products such as cement) had recovered strongly by Q1, but was weakening into mid-year, despite the ongoing strength in motor vehicle sales and construction. More labor-intensive manufacturing, such as textiles and apparel, continued to perform sluggishly, which appears to be related to diminishing demand and cost competitiveness issues in the face of the appreciating ringgit.

Figure 1.14. Industrial production recovered most strongly in E&E and construction, sectors that suffered the deepest downturn; domestically-focused sectors showed more solid growth



Source: CEIC, Haver and World Bank staff calculations.

The commodity-dependent segment of Malaysia's economy, never as affected by the downturn, also recorded little change in production through the recovery in overall activity and commodity prices. Agricultural output was sustained with increased crop areas despite the declining trend on fresh fruit bunch yields for palm oil due to dry weather in Q2 2010. Oil production declined to 637,175 barrels per day by August due to aging facilities and lags between new investment and production. Meanwhile consumer product industries continued to prosper into mid-year, following a shallower downturn in these sectors in 2009 compared with Malaysia's externally-oriented industries. For example, the August data shows higher production for food, beverages, and transport equipment.

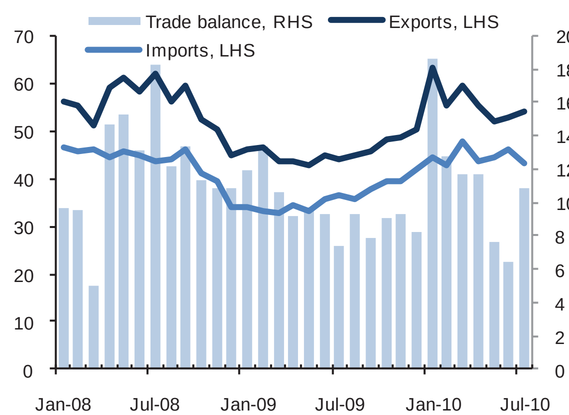
Exports Weakened Against Continued Import Strength

Malaysia's trade flows completed their recovery to pre-crisis levels by Q1 2010. Subsequent developments were driven by two contradictory processes, with imports rose slightly further while exports unwound some of their earlier rebound. The overall effect was for net exports overall to subtract from GDP growth in Q2, and for the nominal trade surplus to contract to the smallest level in several years in July (slightly above USD 2 billion). Monthly data suggest these trends stabilized into Q3, with exports rising slightly from June to July while imports fell almost seven percent on a seasonally adjusted basis (Figure 1.15).

Imports were lifted largely on the back of improving investment. By far the largest element was the recovery in 'floating' investment, in the form of restocked inventories of intermediate goods. For example, imports of intermediate primary industrial supplies rose by 20 percent in the year to July. These are likely to largely be for export reprocessing industries. Meanwhile the recovery in private 'fixed' investment also drew in a significant increase in 'capital' imports. Much of this is likely to be for developing manufacturing capacity in response to the recovery in activity, and some of may also be various electronic consumer items classified as 'capital' supplier resurgent consumer demand. Consumer goods imports are a minor part of Malaysia's overall import basket at less than 4 percent of total imports, and had stabilized by July (Figure 1.16).

Figure 1.15. The trade balance weakened on the back of weakening export demand…

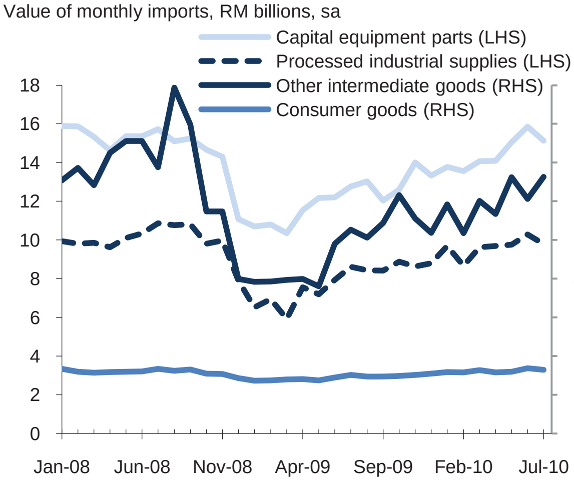
Index level, January 2008 = 100, sa



Source: Haver and World Bank staff calculations.

Figure 1.16. … coupled with continued strength in import demand

Value of monthly imports, RM billions, sa

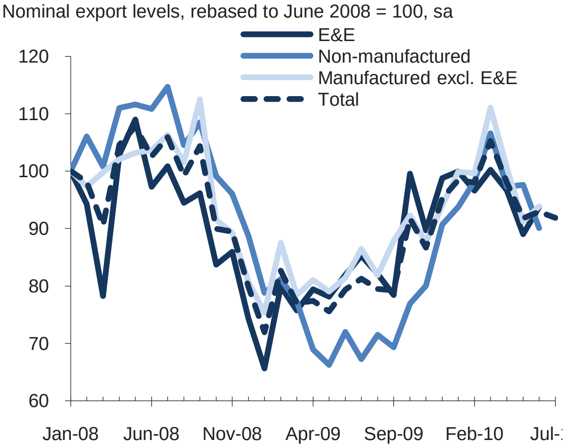


Sources: CEIC and World Bank staff calculations.

In contrast, exports unwound some of their earlier rebound from mid-year. Export volumes fell five percent from Q1 to Q2, a fall-off that started at the end of Q1 according to values data. (Figure 1.17) Exports of most items and to most destinations fell, with electronics and electrical equipment (E&E) such as consumer electronics particularly affected. Analysts attribute this slowdown to weaker demand for microchips and office machinery, as, for example, US back-to-school sales were weaker than expected and Intel lowered its projected sales for the remainder of 2010. Demand was flat or weaker across most export destinations, with the notable exception of the EU, in line with the robustness of activity there (Figure 1.18). The recovery in energy prices supported the value of these export through early 2010, although this affect waned as international prices stabilized mid-year and export volumes have been weaker.

Figure 1.17. Exports weakened into mid-2010 for most items…

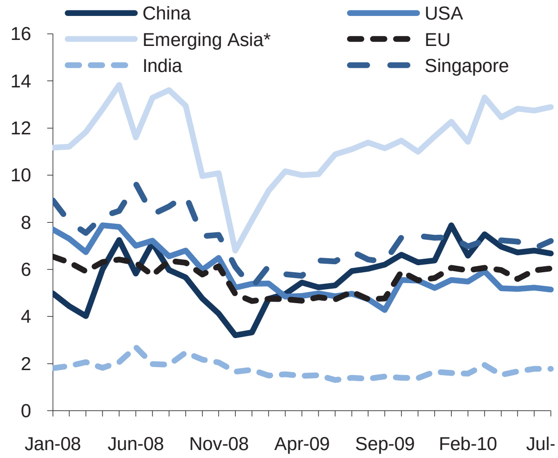
Nominal export levels, rebased to June 2008 = 100, sa



Source: Haver and World Bank staff calculations.

Figure 1.18. … and to most destinations

Nominal export levels, rebased to June 2008 = 100, sa



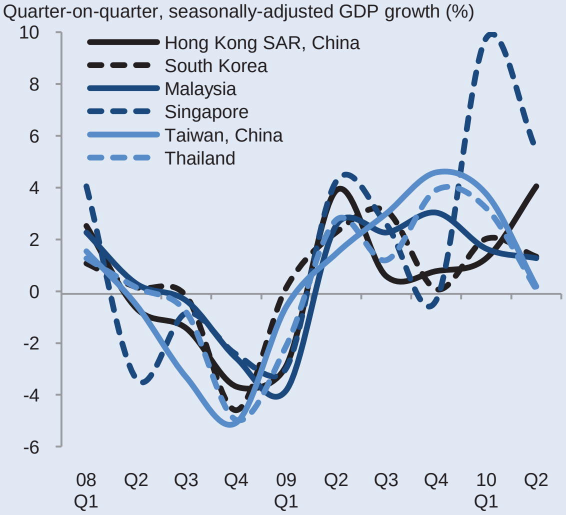
Source: CEIC and World Bank staff calculations.

BOX 2. MALAYSIA'S ECONOMIC PERFORMANCE FROM A REGIONAL PERSPECTIVE

After their recovery in growth from mid-2009, the growth momentum in crisis-affected East Asian economies has slowed. Except in Hong Kong SAR (China), sequential growth decelerated in Q2 2010 (Figure 1.19). Fading policy stimulus and normalizing stock adjustment mainly accounted for this but exports also fell in Malaysia, Taiwan (China), and Thailand. After quarters of unusually robust expansion during the recovery, the deceleration in growth simply reflects a return to historical levels, with growth in the second quarter converging to the mean growth during 2002-07.

Figure 1.19. Crisis-affected economies sustained growth since mid-2009 but decelerated recently

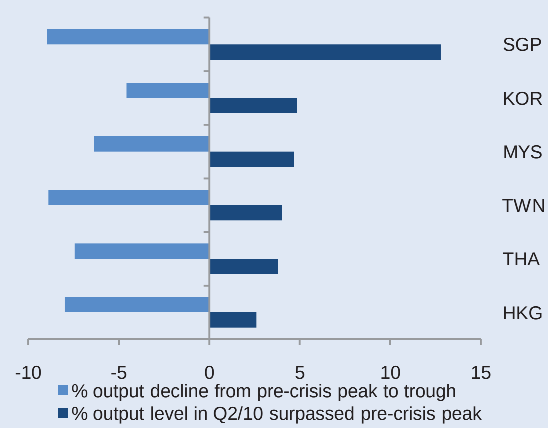
Quarter-on-quarter, seasonally-adjusted GDP growth (%)



Source: Haver and World Bank staff calculations.

Figure 1.20. Current output levels (sa) have all surpassed corresponding pre-crisis levels…

Percent change



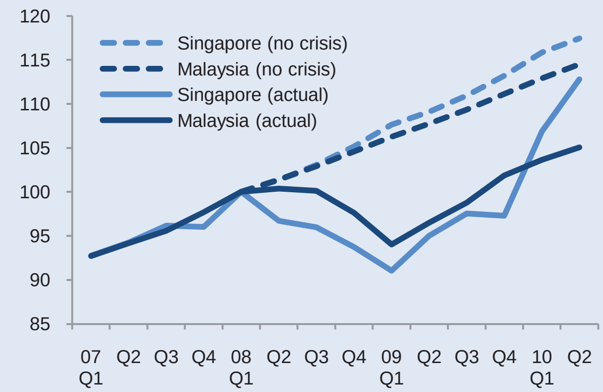
Note: HKG=Hong Kong SAR (China), KOR= South Korea, MYS=Malaysia, SGP=Singapore, TWN=Taiwan (China), and THA=Thailand.
Source: CEIC and World Bank staff calculations.

Current output levels have surpassed their pre-crisis peaks but remain well below counterfactual levels without the crisis. At troughs, output losses compared to respective pre-crisis peaks ranged between 4.6 percent in Korea to nine percent in Singapore (Figure 1.20). The levels in Q2 2010 have exceeded the pre-crisis peaks by nearly five percent for most economies, with the most affected Singapore advanced the furthest at about 13 percent as it enjoyed speedier growth in H1 2010. Despite strong rebound, current levels are still below levels which would have been seen had quarterly growth been sustained at the 2002-07 mean.[a] For example, Malaysia's GDP level in Q2 2010 is about 8.2 percent below this hypothetical "no-crisis" level (Figure 1.21), mainly underpinned by a 20-percent gap in exports and 12 percent in fixed investment. The six-economy average is slightly lower at 7.1 percent.

Growth in H1 2010 reflected a transition from public to private sources of growth. With the normalization of growth and the need for fiscal consolidation in some countries, fiscal injections generally eased relative to H2 2009. Private-sector growth drivers were diverse. Domestic demand was dominant in Malaysia, Korea and Singapore especially inventories but also private consumption in Malaysia and Korea. Hong Kong SAR (China), Taiwan (China) and Thailand benefitted more from external demand but fixed investment also edged up to maintain export-oriented production capacity.

Figure 1.21. …but remain well below the output levels that would have been without the crisis

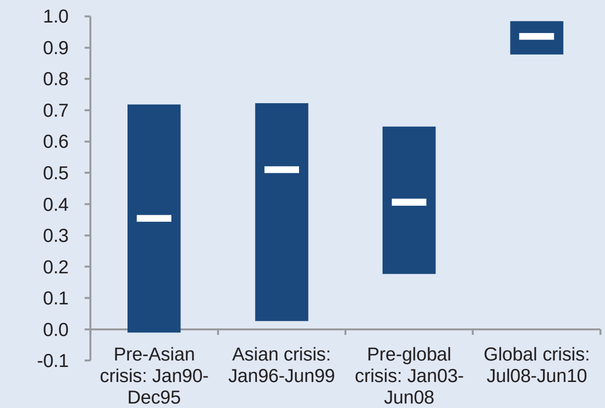
The actual and simulated GDP levels (sa) based on "no-crisis" assumption. Q1 2008=100



Source: Haver and World Bank staff calculations.

Figure 1.22. Export performance has become very closely associated during the crisis

Range of pairwise correlations of YoY goods exports growth across the six economies. Dashes inside the bars show means.

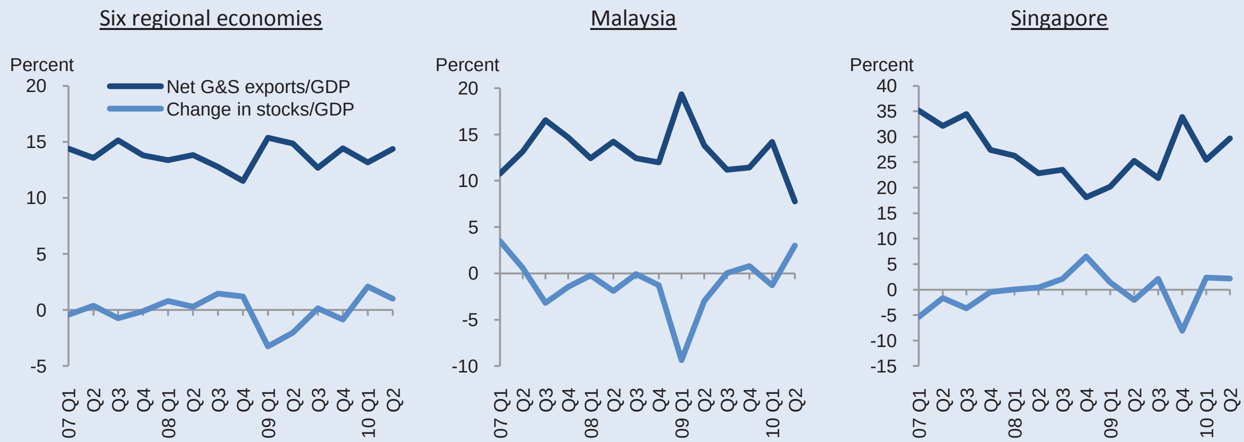


Source: Haver and World Bank staff calculations

The relatively synchronized growth patterns are partly explained by markedly correlated export performance during the crisis. Excluding Singapore, the extent that the other five economies have recovered so far is broadly similar. This is largely because their export cycles are very similar, with the range of pairwise correlations in export outturns across countries rising markedly in recent years (Figure 1.22). More integrated regional production networks are one factor tightening export patterns relative to the 1990s. But these economies' export baskets and destinations are still dissimilar so much higher correlations also reflect the fact that the crisis affected a very broad range of items and markets.[b]

The level of quarterly inventory adjustment is still larger than the pre-crisis period but has become more modest. The average absolute change in stocks as a share of GDP across the six economies softened to 4.5 percent in H1 2010 from 5.7 percent in H1 2009, but still more volatile than 1.4 percent during 2002-07. Changes in stocks essentially mirror net real exports of goods and services (Figure 1.23). Except in Thailand, exports and imports tended to move concurrently and closely[c] so export orders mainly shape how imports and inventory reacted. Net external demand is also determined by mismatches between views on export outlook (and associated intermediate imports) and actual outcomes. Renewed concerns over G3 economies suggest net external demand may continue to be rather volatile, and the contribution of inventory adjustment to growth difficult to predict.

Figure 1.23. Inventory adjustment is still rather volatile although more modest relative to early 2009



Source: CEIC and World Bank staff calculations.

Finally, the rebound in this crisis was more forceful than in the Asian or Dot.com crises. Table 1.1 displays the depth of the declines and the speed that economies rebounded in these three episodes. In general, this crisis witnessed a more powerful, and speedier, rebound than the previous two crises. This is partly because of the external source of the shock in this case with domestic firm and financial sector balance sheets more profoundly affected during the Asian crisis, propagating and prolonging the downturn. “Recovery” has on average exceeded “Decline” by around four percent compared to less than three percent in the preceding two crises.

Table 1.1. The recovery has been more powerful in this crisis than the previous episodes

	Asian crisis 1997/98		Dot.com crisis 2001		Global crisis 2008/09	
	Decline	Recovery	Decline	Recovery	Decline	Recovery
Hong Kong SAR, China	-10.0	9.9	-0.9	3.9	-8.2	6.9
Korea	-8.4	10.8	..	..	-4.6	6.0
Malaysia	-11.5	8.9	-1.2	4.7	-6.5	9.9
Singapore	-5.0	8.3	-5.7	6.8	-9.3	16.6
Taiwan, China	..	..	-4.2	6.8	-9.1	13.2
Thailand	-17.9	8.5	..	..	-7.6	11.5

Note: “Decline” measures the accumulative sequential, seasonally-adjusted decline in GDP when the economy contracted for at least two consecutive quarters, while “recovery” is the accumulative growth in the four quarters after the recessions ended. “..” indicates no recessions in corresponding economies and crises.
Source: Haver and World Bank staff calculations.

[a] For example, Malaysian sequential growth in Q1 2009 is assumed to be 1.5 percent, which is the mean Q1 growth during 2002-07, as opposed to the actual of -3.7 percent. The pre-crisis growth was rather stable so using medians rather means does not materially change the estimates.

[b] For example, telecommunication equipment is only important in Hong Kong SAR (China) and Korea, and auto vehicles in Thailand and Korea. Close to half of Hong Kong SAR (China)'s exports are destined to China, while this is below ten percent in Malaysia, Singapore, and Thailand.

[c] Contemporaneous cross-correlation coefficients of quarterly, seasonally-adjusted changes in real exports and imports of goods and services ranged between 0.82-0.96 at time t=0 during Q1 2000-Q2 2010 in the remaining five economies. Thailand's figure is 0.55 at time t=0.

INFLATION HAS RISEN GRADUALLY, BUT REMAINS BENIGN

Malaysia's consumer price inflation rose modestly through the first half of 2010. By August the headline inflation had risen to 2.1 percent year-on-year (yoy) from around 1.3 percent in Q1, and monthly inflation rates show a similar rising pattern (Figure 1.24). Most other countries experienced a similar pattern, with varying reasons (Figure 1.25). The adjustment of some regulated prices towards the economic cost of those goods explains most of the rise in Malaysia's headline inflation, especially since June.

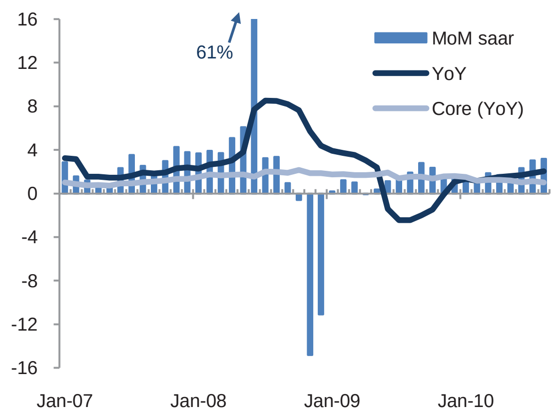
Food prices led the rise in consumers' cost of living. Food and non-alcoholic beverage inflation increased from 1.4 to 3.1 percent from Q1 to August (yoy) (Figure 1.26). Fresh meat prices drove much of this increase, rising by 4.4 percent in the year to August, and the government responded in August by issuing licenses to import chicken to supplement domestic supply. Sugar is one of the most significantly subsidized food items, particularly in light of the rise in global prices this year. This subsidy adjustment lifted its price by 14.3 percent in August, and this affected other confectionary prices too. Meanwhile weather-related increases in global grains prices had little impact on Malaysian food prices by Q3. While bakery goods prices rose by 3.0 percent in August, only 2.5 percent of the average Malaysian household's spending is on grains other than rice, and government involvement in the wholesale market is likely to limit the impact from the disruptions to global supply.

Meanwhile, reform of non-food subsidies has had limited impact on inflation. Non-food prices rose 1.5 percent in the year to August, only a little above their 1.2 percent pace in the year to March. Household gas prices rose by 5.8 percent in August, the largest movement in over four years, while transportation fuel prices rose by 2.7 percent. These moderate increases contrast previous period of major subsidy adjustment. In mid-2008, transportation fuel prices rose by 40 percent in just two months, while the last adjustment in gas prices, in March 2006, was 22.8 percent. The very small size of the adjustments in July suggests that these are unlikely to become focal points for generalized price resetting.

Other indicators suggest the underlying inflation momentum remains benign. Core inflation, which abstracts from movements in regulated and volatile prices, has been stable and mild at near one percent year-on-year since the start of the year. Services inflation actually slowed, to 1.6 percent in August from around 1.7 percent in Q2. Meanwhile the appreciating exchange rate also seems to be reducing inflationary pressures, with for example clothing & footwear prices, highly tradable, falling at an accelerating pace mid-year.

Figure 1.24. Volatile factors have lifted consumer price inflation

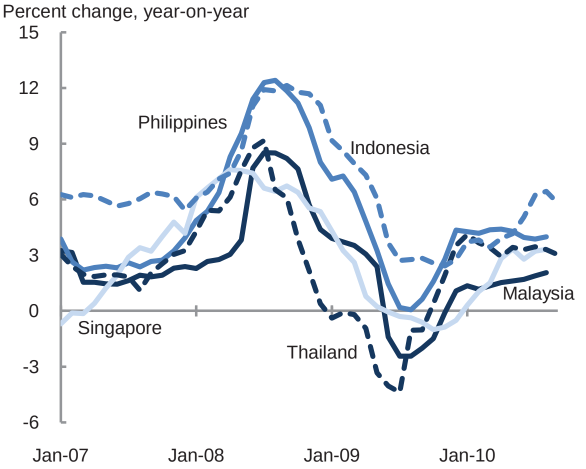
Percentage change, year-on-year and month-on-month



Source: CEIC, CIMB and World Bank staff calculations.

Figure 1.25. Inflation rose as in the rest of the region, but remains comparatively subdued

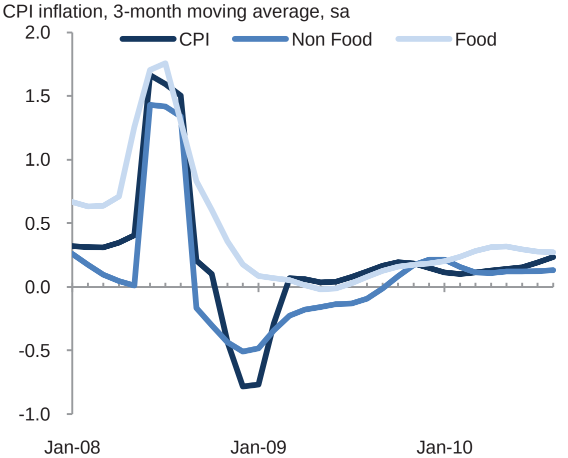
Percent change, year-on-year



Source: CEIC and World Bank staff calculations.

Figure 1.26. Food prices drove the limited rise in CPI inflation

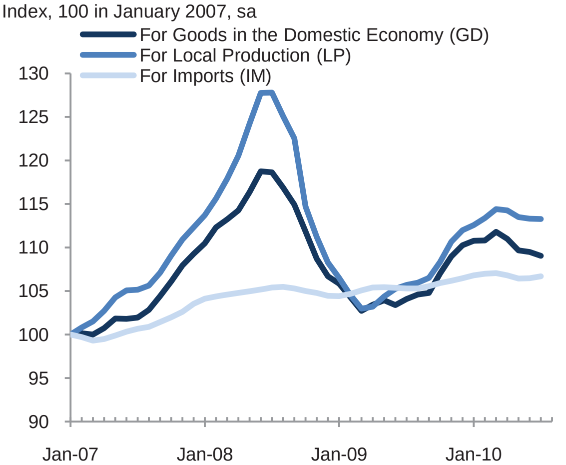
CPI inflation, 3-month moving average, sa



Source: CEIC and World Bank staff calculations.

Figure 1.27. The recovery in global commodity prices lifted producer prices

Index, 100 in January 2007, sa



Source: CEIC and World Bank staff calculations.

Upstream prices pressures have become pronounced since early 2010 (Figure 1.27). This mostly reflected the recovery in the global prices of the energy products and other commodities Malaysia produces and exports. The overall producer price index rose by 4.8 percent in the year to August, although there were signs of some moderation in price pressure in the monthly data mid-year. These movements stabilized in July. Imported intermediate goods prices accelerated to a 1.4 percent increase in the year to July, reflecting resilient global commodity prices dominating the disinflationary impact of the Ringgit's appreciation.

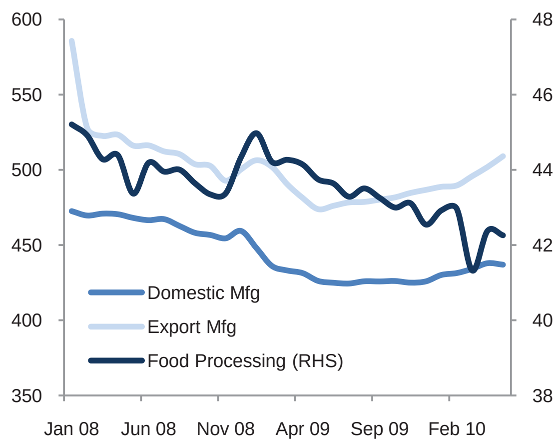
LABOR MARKET CONDITIONS IMPROVED

Employment more than recovered from the crisis by mid 2010, while unemployment returned to normal levels. Employment rose by 140,000 in Q2 compared with a year earlier. The recovery in employment was most marked in manufacturing, reflecting the recovery in industrial production (Figure 1.28). The recovery also appeared to be sustained, with monthly retrenchment declining by 82 percent in the first half of 2010 compared to the same period in 2009. Both local and nonresident workers benefited from this. Meanwhile the number of vacancies remains at high levels.

Anecdotes suggest the recovery in employment is likely to have benefited Malaysian citizens ahead of migrant workers. The unemployment rate fell to 3.4 percent in Q2, compared with 3.6 percent at the peak of the crisis. The participation rate fell slightly, to 62.8 percent, from 63.4 percent, reflecting in part non-resident workers dropping out of the labor market while remaining out of the larger population data. But much of the growth in employment appears to have been informal, with the number of own-account workers rising significantly in Q2.[3]

Figure 1.28. Employment in export manufacturing has recovered some of the crisis-related losses

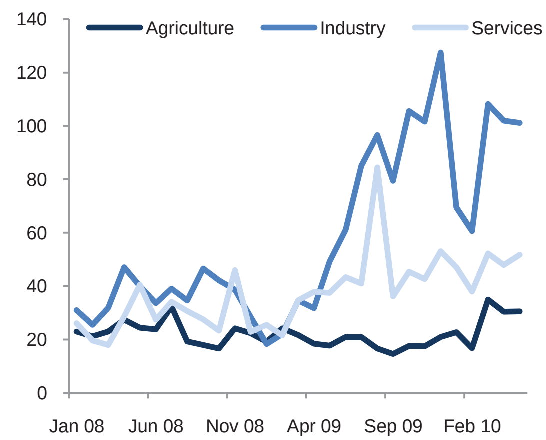
Workers by sector, '000s



Source: CEIC and World Bank staff calculations.

Figure 1.29. Vacancies rose most sharply in sectors that shed the most jobs in the downturn

Number of vacancies, by sector, '000s



Source: CEIC and World Bank staff calculations.

The recovery in employment appears to have become broadly based. Job vacancies rose strongly for all sectors, to be well above pre-crisis levels in manufacturing and construction, and slightly or at pre-crisis levels in agriculture and service (Figure 1.29). Shifts in employment from manufacturing to services also appear to have been reversed, with overall manufacturing employment approaching pre-crisis levels by mid-year. The share of those employed in manufacturing increased to 17.4 percent in Q2 compared to 16.6 percent a year earlier. Overall, this is still below pre-crisis levels, but the absolute number of employed persons in the manufacturing sector is already slightly above the corresponding number in Q2 2008. There does, however, appear to be some rebalancing in employment. Lower-skill

[3] The detailed data required to assess where and in which sectors this shift to less informal employment occurred, and whether it represents a longer-term shift in the labor market induced by the downturn are not available. Various circumstantial indicators suggest it particularly affects manufacturing workers.

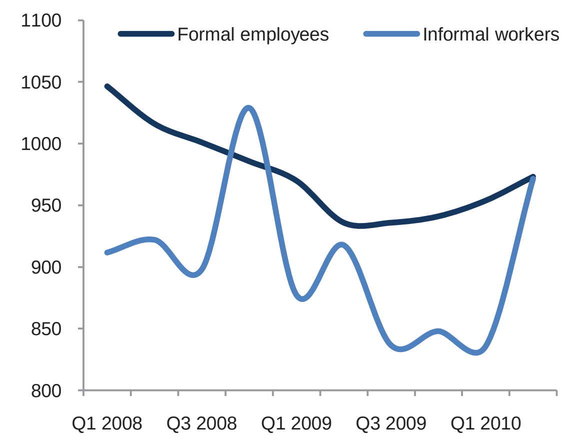
and more cost-focused sectors continued to lose jobs into mid-2010. Meanwhile E&E employment continued to rebound sharply in H1.

But the new jobs may also be lower quality than the jobs that have been lost. The number of own-account workers and unpaid family member rose significantly in the year to mid-2010, at the same time as formal employment was recovering (Figure 1.30). These sorts of employment arrangements tend to offer lower wages, poorer conditions, fewer non-wage benefits, and greater uncertainty over future income. Often unemployed workers turn to this sort of work after losing better-quality formal sector jobs and being unable to find new ones, and when they lack alternative income sources such as formal social protection mechanisms (see Chapter 3). The growth in informal employment may also reflect firms' uncertain outlook translating into an unwillingness to commit to formally rehiring workers.

Those who have held down a job are enjoying robust incomes (Figure 1.31). Real wages in the (formal) manufacturing sector remained at fairly high levels compared to the pre-crisis period. And this is consistent with the persistently high level of vacancies, suggesting shortages of skilled labor and some mismatching between the skills needed and those possessed across the labor force. It is also supported by the manufacturing firms reporting continued difficulties in finding staff with the right experience.

Figure 1.30. Informal employment rebounded sharply in 2010

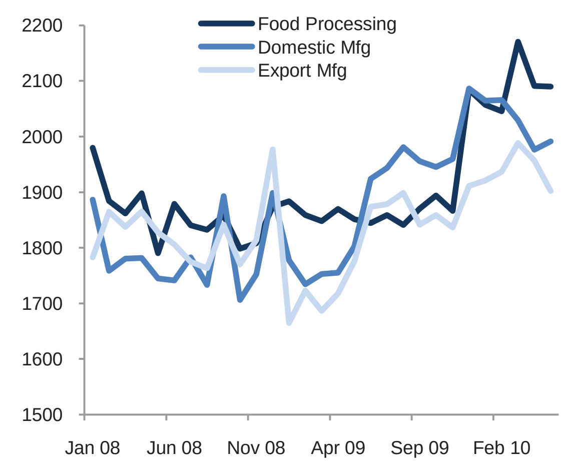
Number of workers by employment classification, '000s



Source: CEIC and World Bank staff calculations.

Figure 1.31. Real wages have recovered from the trough of the crisis

Wages deflated by the CPI, Ringgit per month



Source: CEIC and World Bank staff calculations.

BANKING AND FINANCIAL CONDITIONS REMAINED SOLID

Malaysia's banking system and capital markets performed positively year over year, primarily because of stronger private sector borrowing. Gross financing to the private sector through the banking system and the capital market rose to RM 61 billion in August 2010. The increase was mainly due to higher loan disbursements and issuances of equity. Net financing to the private sector expanded by 11.3 percent year-on-year, personal and household term loans continued to rise although at a slowing rate mid-year. Despite an emergent rebound, lending to the 'real' economy remains below pre-crisis levels, particularly in the manufacturing, real estate, and construction sectors. In contrast, and in line with relatively stronger activity indicators, lending to the service sectors like health and finance rose.

Meanwhile liquidity in the banking system remains healthy and the appetite for financing is sustainable, with loan-to-deposit and financing-to-deposit ratios rising in 2010.

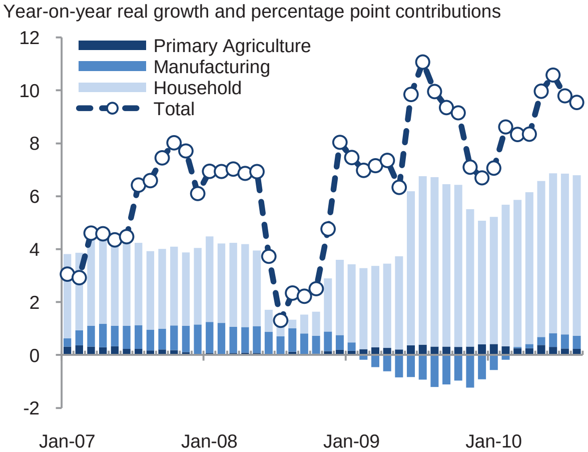
The public sector raised more (net) funds through the capital market. Overall public sector financing through issuance of debt has increased strongly, as may be expected given the larger budget deficits required to fund the government's stimulus. The high share of funds raised by the public sector in 2009 was unusual, but in 2010 there appears to have been a return to pre-crisis patterns. The recovery in lending and public sector tapping of capital markets has lifted general liquidity. Growth in broad money (M3) accelerated each month in 2010, with the exception of March to April, and by August, M1 growth had risen to 13.9 percent year-on-year, and M2 and M3 growth was at 8.2 percent (yoy). While the increase in broad money primarily reflected higher government spending, it was also supported by higher credit extension by the banking system as well as foreign inflows.

Lending Recovered, Particularly to Households

Financing has increased since the start of the year throughout the banking system—conventional and Islamic. The recovery in lending has been driven more by household demand than the industrial sector (Figure 1.32). Loan applications, approvals and disbursements all rose, with most of the funds going to purchases of residential and non-residential properties and of passenger cars. This lifted the value of loans outstanding to households by 13.2 percent to RM 471 billion as at end-August 2010 (August 2009: RM 416 billion). Lending to households remains the biggest portion of banking system lending, with a ratio of 55.5 percent as at August 2010. Personal consumption lending and credit card debt have also grown strongly, both by over 13 percent in the year to August (Figure 1.33).

Figure 1.32. Household lending has driven the rise in loans, with some pick-up in manufacturing loans too

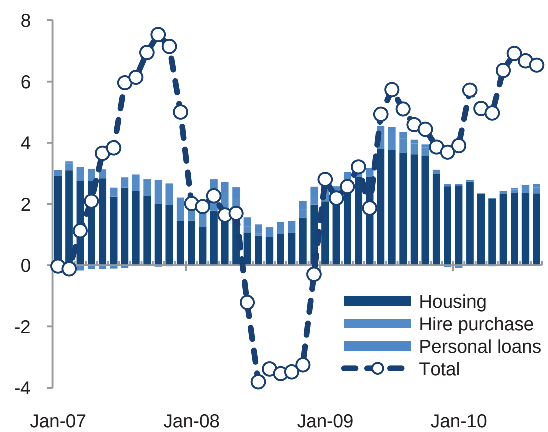
Year-on-year real growth and percentage point contributions



Source: BNM, CEIC and World Bank staff calculations.

Figure 1.33.Most new loans continued to be for house purchases

Year-on-year real growth and percentage point contributions



Source: BNM, CEIC and World Bank staff calculations.

Meanwhile lending to the industrial and manufacturing sector rebounded from the sharp decline of 2008-09. Private investment for the import of machinery for industry grew 39.0 percent year-on-year in April 2010 compared to -32.0 percent yoy for April 2009. In July these growth rates were moderating, across the board, with month-on-month drops in loan approvals and disbursement. Lending to SMEs has rebounded from 2009, with an increase in the number of applications, approvals, and disbursements

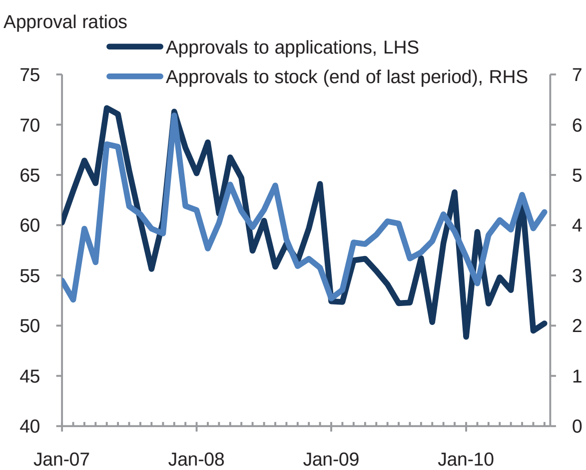
(SMEs make up 99.2 percent of establishments according to the Malaysian Census of Establishments and Enterprises 2005). Reflecting the 2009 fall in lending, fewer loans are outstanding.

This growth in lending occurred against rising lending rates (Figure 1.44). Commercial banks' average base lending rates were raised higher to 6.3 percent by mid-July (6.0 percent in June). The average lending rate (ALR) drifted upward to 5.05 percent as at end-June (5.0 percent in May and 4.9 percent in April). This upwards movement contrasts with the gradual drift downwards through the second half of 2009. Deposit rates also increased, though more gradually: the average quoted fixed deposit rates between 1 and 12 months ranged from 2.48 percent to 2.82 percent, compared with 2.47 percent to 2.81 percent in May. Movements in deposit and lending rates have generally anticipated or coincided with movement in the policy interest rate, although the scale of movement has been smaller (BNM raised the policy rate by 75 basis points (discussed below).

Banks Are in Even Sturdier Health

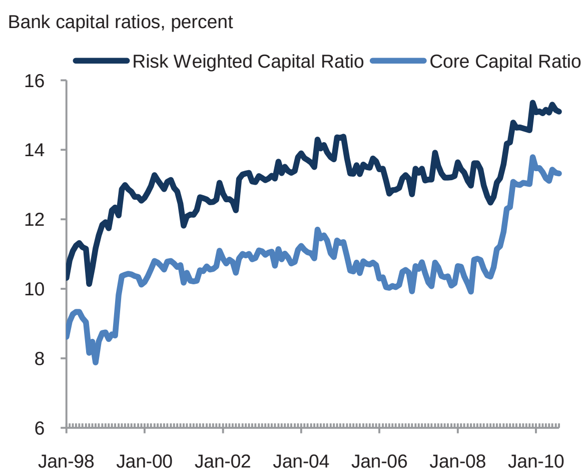
The health of the banking sector has surpassed pre-crisis levels. Malaysian banks hold adequate liquidity. Customer deposits rank as the single largest source of funds for banking institutions, accounting for more than 65 percent of liabilities and 73 percent of total funding. It is interesting that net NPLs during and after the crisis are at lower rates than pre-crisis, despite the increase in disbursements. Loan loss coverage remained above 90 percent. This may reflect two factors: (i) the nature of this downturn, which was focused on externally-focused multinational producers, with limited linkages upstream to the local SME sector that relies on bank financing, and (ii) the effectiveness of the 'guarantee fund' in the government's 2009 and 2010 stimulus packages, which focused on supporting financing to SMEs and ensuring their ongoing viability. The banking system's capitalization remained strong, with the risk-weighted capital ratio and core capital ratio at 15.3 percent and 13.4 percent respectively in August (Figure 1.35).

Figure 1.34. The recovery in lending is tentative, with banks remaining cautious in approving loans



Source: BNM, CEIC and World Bank staff calculations.

Figure 1.35. Core capital ratios have risen



Source: BNM, CEIC and World Bank staff calculations.

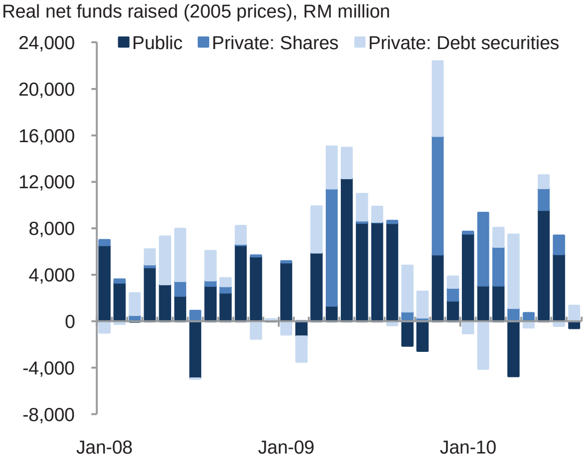
Islamic banks appear to be enjoying even stronger health (see also Box 3).[4] Average profitability in 2008-2009 was higher than pre-crisis levels in 2007, suggesting that Islamic banks fared better than conventional commercial banks in Malaysia through this period. Credit and asset growth continued to trend upwards for Islamic banks even in the midst of the crisis – over three times the rate of growth of the conventional banks between 2007 and 2009. This dynamic may reflect the nature and lending principles of Islamic banks.

Financial Markets and the Ringgit Continued to Strengthen

Malaysia's financial asset prices, particularly the exchange rate, continued to strengthen, despite the volatility in global markets. By August the capitalization of the stock market had risen by 28 percent from a year earlier, with financial and the largest listed companies showing the strongest increases. However, Malaysia's markets remain less volatile than its neighbors – just as Malaysia's capital markets fell less sharply during the downturn, the increase in the main index is smaller than that experienced by Malaysia's neighbors. The strength in all of the region's equity markets has been partly due to offshore portfolio investments. In Malaysia, these inflows, while contributing to the rise in the market, have been relatively smaller vis-à-vis other regional markets, for example, Indonesia. Meanwhile in the bond market, government bond yields have been stable overall. The yield curve has flattened, as the increase in the central bank's policy interest rate have raised shorter-tenor yields, and the improvement in global and local liquidity creates demand and lowers yields at the longer end. (Figure 1.36 and Figure 1.37) The government's commitment to reducing the deficit (discussed below) may also be supporting this trend.

Figure 1.36. The private sector is raising more funds than in 2009

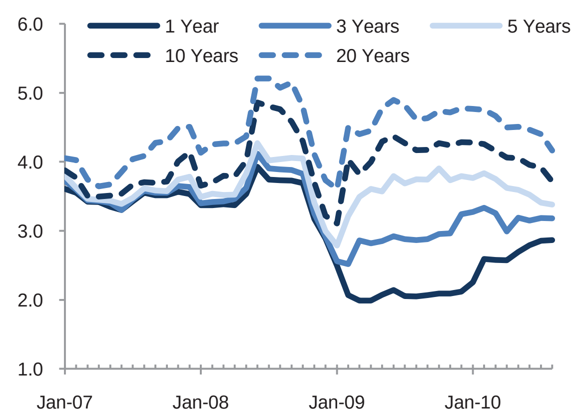
Real net funds raised (2005 prices), RM million



Source: BNM and CEIC.

Figure 1.37. Yields on government bonds have been stable overall, with the yield curve flattening

Nominal yields on government securities, percent



Source: CEIC and World Bank staff calculations.

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[4] As Islamic banking is an asset-based system, prevailing return rates are not comparable with interest rates in the conventional banking system.

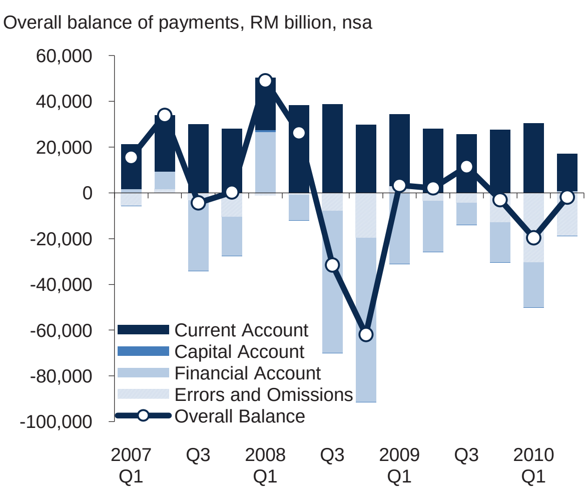
CAPITAL INFLOWS IMPROVED

Renewed capital inflows closed the balance of payments deficit in Q2. A small deficit of RM 1.9 billion was recorded in the quarter, compared with ten times this amount in Q1. Inwards investment was resurgent, although outwards direct investment expanded too. On balance, this took the financial account to (a small) surplus for the first time since the onset of the global financial crisis in mid-2008. In this respect too Malaysia followed a pattern similar to that found elsewhere in the region, where capital in search of both short-term and longer-term yield has flowed into economies' capital markets, lifting asset prices. In Malaysia's case these inflows appear to have been more moderate and with a longer-term horizon than has been the case for some of its neighbors.

The narrower current account surplus mainly reflected the strength in imports and weakening exports. Malaysia's large goods surplus narrowed to RM 30.8 billion in Q2 2010. The net income deficit widened to RM 8.6 billion on lower income receipts on Malaysia's offshore investment and higher income payments to offshore investors in Malaysia. Current transfers, incorporating foreign workers' remittances, expanded to RM 11.1 billion in H1 2010, compared with RM 8 billion in H1 2009.

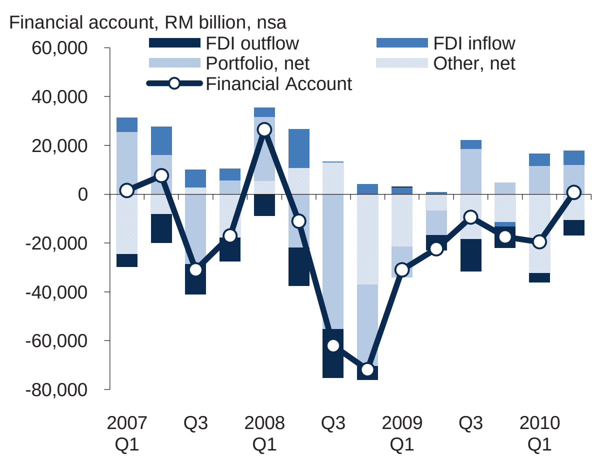
Rising net portfolio flows were invested largely into government securities, supporting yields against the increased issuance. Net portfolio inflows totaled RM 11.8 billion, a little above Q1, despite the rise in instability in global financial markets in Q2 and the withdrawal of capital from emerging markets elsewhere. The Government's conventional and *sukuk* bond sales attracted a large share of these investments. Increased corporate bond issuance, and the local equity markets, also absorbed much of these inflows.

Figure 1.38. The balance of payments recorded a small deficit in H1 2010



Source: CEIC

Figure 1.39. Direct and portfolio investment inflows returned in Q2



Source: CEIC

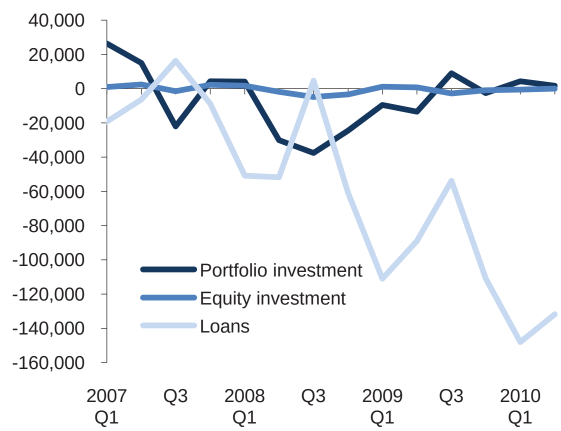
Longer-term investments in Malaysia's economy, in the form of inwards FDI, rose too. Malaysia recorded a net inflow of FDI of RM 11 billion for H1 2010, where this amount takes into account the repayments of inter-company loans. Most investment went to E&E manufacturing, and to petroleum-related industries. The domestically-focused finance & insurance, and trade industries were also FDI destinations. Malaysian business continued to make sizable direct investments offshore, although these flows also remain below pre-crisis levels. Net RM 10 billion of investments were made in H1, largely in the finance & insurance, business services and telecommunications subsectors, and also by Petronas. Net direct investment in H1 was slightly positive, although Malaysian firms' stock of offshore investment remains larger than FDI into Malaysia (See April 2010 *Malaysia Economic Monitor*).[5]

'Other' capital flows continued to accelerate out of Malaysia (Figure 1.40). Other investment recorded a lower net outflow of RM 43.1 billion in H1 2010 due to smaller outflows of the non-bank private sector, particularly the extension of trade credits. These flows are fairly large and volatile as they are driven mainly by the financing requirements and business decisions of the non-bank private sector. RM 43 billion was transferred out of Malaysia via this route in H1 2010 (RM 28 billion in H1 2009), although outflows by the private sector were the smallest in a year in Q2.

The international reserves of Bank Negara Malaysia amounted to RM 310.8 billion or USD 100.7 billion as at end-September 2010. This level of reserves has taken into account the quarterly adjustment for foreign exchange revaluation loss, following the strengthening of the ringgit against most major currencies during Q3. This level of reserves is sufficient to finance 8.5 months of retained imports and is 4.3 times the short-term external debt (Figure 1.41).

Figure 1.40. The 'other' outflows are largely loans, cycled through Labuan in part for tax reasons

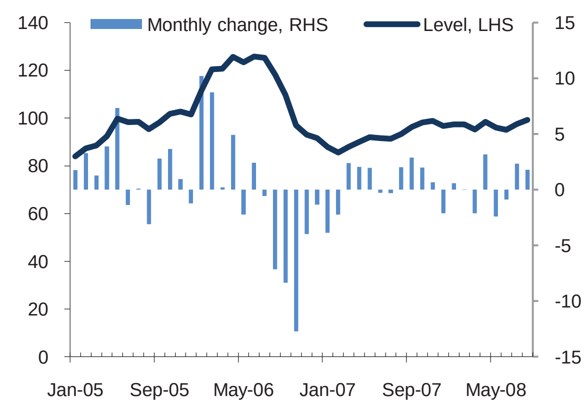
Net fund flows, RM billion, nsa



Source: CEIC.

Figure 1.41. With overall external flows near balance since late 2009, reserves have stabilized

Gross international reserves, USD



Source: CEIC.

[5] Note that these statistics exclude retained earnings.

BOX 3. ISLAMIC FINANCE IN MALAYSIA

Malaysia has been a key contributor to the emergence of a robust and dynamic global Islamic financial system over the past decade. Global *Shariah*-compliant assets are conservatively estimated to total US$ 1 trillion. Although this is about one percent of the total global financial system, the industry has achieved steady long-term growth of 10 to 15 percent each year since 1990. The number of Islamic banking licenses has grown to meet the demand. The consensus is that these growth rates will continue: Islamic Banks (IBs) could account for up to half of total deposits in countries with large Muslim populations within the next decade. Analogous to the development of Islamic banking, Islamic capital markets are also expanding rapidly, and more countries, developed and developing, are issuing *sukuks (Shariah*-compliant bonds). And some experts predict that Islamic Finance (IF) may grow even more rapidly given its approach to managing risks in fund-raising and project-financing.

Islamic finance encompasses a comprehensive range of services. It covers all major financial products and markets, including banking, *takaful* (insurance), and money and capital market products. This system operates in parallel and not in competition with traditional finance—as an integrated component of a larger composite financial system. It requires an underlying legal, regulatory and financial infrastructure, supporting the *Shariah* principles such as the prohibition of interest. The *Shariah* concept of *riba* (interest) in financial transactions covers all forms of interest and is not limited to usury or excessive interest. Other prohibitions under *Shariah* include *gharar* (uncertainty or asymmetrical information), *maysir* (gambling and speculation), hoarding, and trading in prohibited commodities (e.g., pork and alcohol).

Islamic Finance has Developed Rapidly in Malaysia

Malaysia's Islamic financial services have also quickly expanded to become an important component of the overall financial infrastructure. By the end of 2009 about 19 percent of banking assets were *Shariah*-compliant. A 2009 survey ranked Malaysia third internationally in terms of the size of banking assets and number of IBs, at US$ 86 billion and 53 banks respectively. Almost all *sukuk* issuances in the East Asia region and more than 50 percent of all *sukuk* issuances in the world were in Malaysia in the first half of 2010 (BNM 2010).

Malaysia's IBs stack up against their conventional peers (Table 1.2). In the past half-decade, IBs have been growing faster than conventional banks (CBs) in terms of the number of institutions, size of branch network, and deposit base (partly reflecting their smaller initial scale). IBs compare well based on their capital adequacy, liquidity as well as profitability, although there is a different structuring of assets in IF. Also, Malaysia's IBs are reporting slightly higher levels of NPLs (one percentage point) than CBs. This may reflect their very different allocation relative to their conventional peers (Table 1.2). IBs in Malaysia do more business with consumers but to a relatively smaller scale in the public or trade sectors. They are particularly involved in the real estate and construction sector, as is often the case among IBs globally.

Table 1.2. Islamic Finance has emerged to be an important provider of financial services in Malaysia

Indicators (2009, provisional)	Islamic Banks	Commercial Banks
Number of institutions	17	22
Office network	2,087	1,999
Deposits (RM million)	3,061.1	13,912.3
Capital		
Risk-adjusted Capital Ratio	14.7	13.8
Equity to Risk-Weighted Assets	11.9	10.7
Liquidity		
Cumulative mismatch (RM billion, < 1 month)	20.2	16.7
Buffer as a percent of Deposits (< 1 month)	30.9	122.8
Profitability		
Return on Average Assets	1.3	1.2
Return on Average Equity	13.9	14.3
Efficiency		
Profit per employee (RM thousand)	138.5	148.6

Source: Bank Negara Malaysia, *Financial Stability Report 2009*

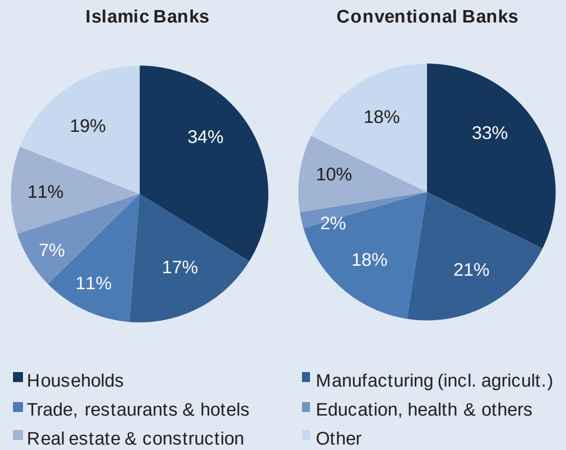
Malaysia's IF sector leads the East Asia and the Pacific (EAP) region. Khazanah Nasional's (the investment holding arm of the Government of Malaysia) inaugural issue of a Singapore dollar *sukuk* of SGD 1.5 billion (USD 1.1 billion) in early September 2010 has been heralded as "a bit of international Islamic capital market history" (The Edge Weekly, 2010). It earned a number of firsts: the first SGD *sukuk* to be issued out of the Malaysia International Islamic Financial Centre (MIFC) initiative; the largest and longest-termed *sukuk* issuance in Singapore; the largest SGD issuance by a foreign issuer in Singapore; and Khazanah's single largest *sukuk* issuance so far. The accomplishment solidifies Malaysia's position in the industry, and is likely to encourage the liquidity and deepening of regional Islamic capital markets.

Islamic Finance in Malaysia has Proved Robust Through the Crisis

The financial crisis had a larger negative impact on CBs than IBs. The resilience of IF institutions, whether a subsidiary of a CB or a stand-alone IB, reflects the characteristics of IF—having an asset-backed transaction system, maintaining higher capital adequacy ratios, being less leveraged, investing in traditionally less-risky sectors, and holding less credit risk. The storm was weathered overall better by IBs based on average profitability, credit growth, and asset growth. IBs experienced less of a decline in profitability through the crisis, even as it affected their primary market of consumer financing and the real estate and construction sectors in the 'real economy'. IBs continued to grow their balance sheets strongly through the crisis – credit and assets grew more than three times as fast as CBs between 2007 and 2009 (Hasan and Dridi, 2010). This growth appears to have been internally generated, as it was not accompanied by a dramatic increase in the number of banks. As the lagged effects of the crisis are still emerging, the drivers of this dynamic are unclear, and they may have longer-term implications for the relative health and vitality of the sector.

Figure 1.42. More of Islamic bank financing are to the household, construction and social sectors

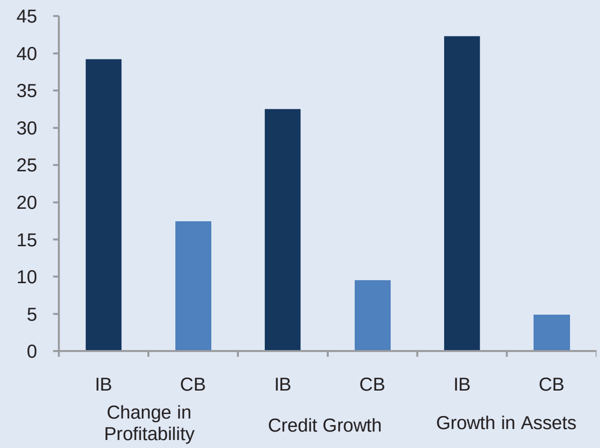
Financing disbursed by sector, August 2010



Source: BNM and World Bank staff calculations.

Figure 1.43. Islamic Banks' strong growth continued through the crisis

Percentage change from 2007 to 2009.



Source: Hassan and Dridi (2010) and World Bank staff calculations.

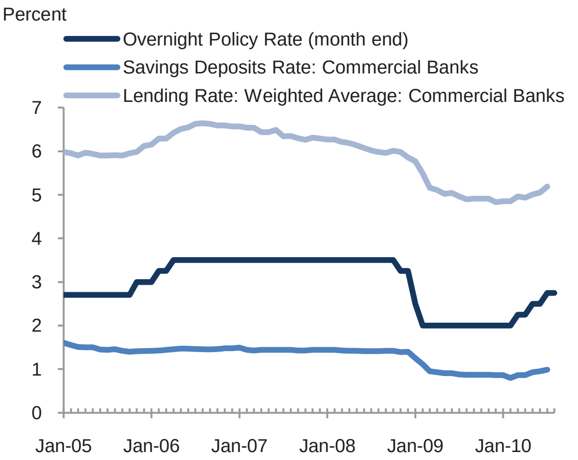
There are several factors that might explain why IBs fared better than CBs during the crisis. IBs' stronger profitability may reflect their smaller investment portfolios and lower leverage. Their exposure to the real estate and construction sectors did not seem to have a significant impact on profitability, possibly reflecting the strength in construction activity following the Government's stimulus spending. IBs' investment portfolios differ from CBs by having zero exposure to toxic assets, derivatives, and conventional financial institution securities. Finally, IBs' profitability correlates directly to their size (i.e., the larger, more diversified and stronger the reputation, the better the performance).

MONETARY AND FISCAL POLICIES ARE NORMALIZING

Bank Negara Malaysia (BNM) withdrew much of the monetary stimulus in the first half of the year. This earned it the reputation of being among the most anticipatory in the region. It raised its policy interest rate by 75 basis points between March and July 2010 and held it at 2.75 percent through to October. At the same time, a marked if relatively smooth appreciation of the ringgit against the USD limited inflationary pressures. In September BNM described its stance as accommodative and appropriate given the benign inflation environment and uncertainties in the external outlook, a view echoed by most financial market participants and analysts. Against this moderate tightening, actual financing flows have accelerated (discussed above).

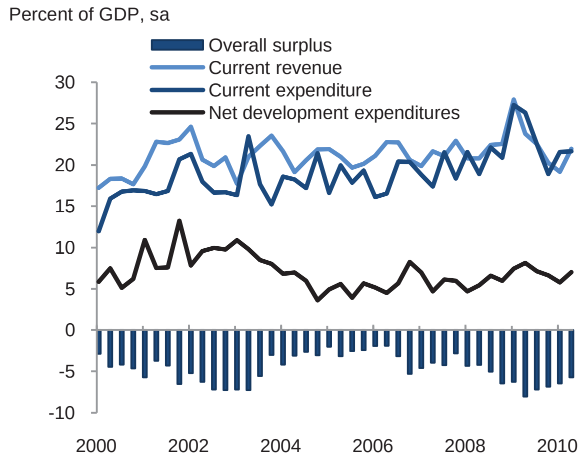
BNM continued its gradual liberalization of the exchange rate regime. Three significant regulatory changes were made in August, designed to reduce the transaction costs associated with organizing trade. These reforms were intended to support trading of the Ringgit for reasons related to real transactions. Moves to allow offshore trading in particular appear likely to remain off the policy agenda for some time, and an open position offshore continues to be prohibited.

Figure 1.44. The policy interest rate is at more normal levels, but only partially translating into market rates



Source: CEIC.

Figure 1.45. Fiscal policy is also normalizing, as the stimulus completes and revenues recover



Source: CEIC and World Bank staff calculations.

The first reform allows Malaysia residents to use Ringgit to settle trade with non-residents. It is particularly focused on facilitating trade-flows. Previously only foreign currencies could be used, and the receipts had to be repatriated into Ringgit within six months. In particular this reform is focused on entrenching trade ties with China (13 percent of Malaysia's exports went directly to China in the first seven months of 2010, a growing share), by allowing traders to transact directly from Yuan to Ringgit rather than working through third currencies. These transactions are also facilitated by the Ringgit being the first emerging market currency allowed to trade on China's official Interbank Foreign Exchange Market, and by the RM 40 billion currency swap agreement entered in February 2009. This reform does not allow non-residents to use Ringgit through non-Malaysian banking groups.

The second reform improves flexibility in the management of integrated transnational corporations operating in Malaysia. It allows them to borrow any account in foreign currency from non-bank related companies in other countries. Previously unlimited borrowing was only allowed from parent companies with borrowing from non-parents limited to RM 100 million. Analysts describe this reform as being particularly important for Malaysian corporations with offshore operations, from which Malaysian-domiciled entities can now borrow, and so it may facilitate a return of some of the substantial offshore direct investment by Malaysian corporations.

The third reform is a practical response by the authorities to the volatility in trade flows since mid-2008. It allows firms to hedge current account (mostly trade-related) foreign currency needs on an anticipatory basis. Previously the maximum hedge amount was restricted to the previous 12 months' flows. Given the collapse in trade flows in early 2009, this was acting as a significant limit on hedging practices. Market analysts, pointing out that the earlier collapse in trade meant that significant unfilled demand for hedging had built up with the recovery in trade in early 2010, believe this reform could add some short-term demand for the Ringgit in Q3 2010.

Fiscal policy has also started to normalize. The 2010 Budget projects a deficit of 5.6 percent of GDP, compared with the realized deficit of 7.0 percent (in line with earlier projections) and 2008's deficit of 4.8 percent. The overall balance in the first half of 2010 was RM 17.3 billion, or 4.7 percent of H1 GDP (spending in the first half tends to be somewhat smaller than the second half, reducing the first half deficit). The final stages of the Ninth Malaysia Plan and the second stimulus package absorb much of the additional spending, with gross development spending totaling RM 19.4 billion in H1 2010, a third more than in 2008 but 4.4 percent lower than the stimulus-affected first half of 2009. Education and transportation received most of the development spending. The more substantial increase in spending went to operating spending, particularly subsidies, reflecting the recovery in global commodity and particularly energy prices. By Q2 subsidies overall were consuming 10.9 percent of total central government spending, up 1.2 percentage points compared with H1 2009; energy subsidies alone consumed 5.4 percent of total government outlays by Q2 2010.

In light of this loss of fiscal space, the government took a well-signaled first step to systematically reforming subsidies. On 15 July, energy prices, including gasoline and household gas, and sugar prices were raised incrementally towards market levels. Prices of RON95 and RON97 grades of petrol were increased by RM 0.05 per liter to RM 1.85 and RM 2.10 per liter respectively; diesel prices were held at RM 1.75 per liter. The price of liquefied petroleum gas (LPG) was raised by RM 0.10 to RM 1.90 per kilogram, lifting the price of a standard 10 kg cylinder of cooking gas from RM 17.50 to RM 18.50. Sugar prices increased more significantly, by RM 0.25 to RM 1.85 per kilogram. Poor growing weather and strong demand growth from developing economies have lifted global sugar prices to record highs. The government also announced plans to adjust regulated fuel prices monthly, as a step towards indexation, although with global oil prices relatively stable and the Ringgit's slow appreciation, by October there had been no further adjustments. The government projects that the July round of subsidy reform alone will save RM 0.75 billion over the remainder of 2010.

2. ECONOMIC OUTLOOK

Following the weakening in growth momentum in the first half of 2010, economic activity is expected to decelerate further. Given the low base in 2009, growth of 7.4 percent is expected for 2010, before falling to 4.8 percent in 2011. Domestic demand is expected to continue to drive growth in the near-term. The strength of the global demand, both from the G3 and China, remains a key source of uncertainty. In addition, domestic sentiment is sensitive to reform progress relative to expectations.

Achieving Malaysia's Vision 2020 objective of high-income status requires average growth of 6 percent during the 10th Malaysia Plan period. This would be a marked improvement on the 4.4 percent achieved over 2006-2010 during the 9th Malaysia Plan. However, the challenge is not only to boost the level of growth but also to ensure that the process of growth is inclusive and sustainable. The policies and projects of the Economic Transformation Program (ETP) are at the core of meeting this challenge through greater, and higher quality, investment and growth in productivity.

The main risks to medium-term growth remain reform implementation risks and progress on fiscal consolidation. The Government is taking steps to address both areas, but both upside and downside risks remain. Until solid reform implementation is seen there is unlikely to be a groundswell of positive sentiment of foreign investors towards Malaysia. In addition to the sustainability of public finances, the quality of public service delivery will be a crucial determinant of the success of the Government's plans.

THE UNEVEN PATH TO ECONOMIC RECOVERY

The recovery in global growth in 2010 has been steady, albeit unspectacular and uneven. As policy stimuli are withdrawn, this trend is expected to continue. Growth in high income economies is expected to be lower over the medium term than before the crisis. Recent data releases and leading indicators point to the fragility of the US recovery. The weakness in labor markets (and residential property sector) is unlikely to turn around in the near-term. Consumer confidence has dipped in recent months (Figure 2.1). However, the impact of its debt crisis on Eurozone growth as a whole has been relatively muted. Leading indicators point to a leveling off in the recovery across the G3 economies (Figure 2.2).

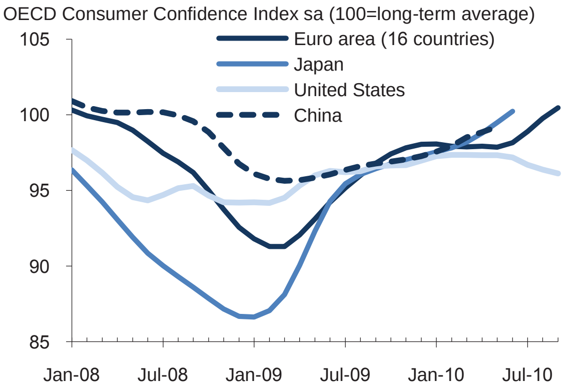
Sustained, albeit moderating, growth in China provides an increasing source of external demand for Malaysia. China became Malaysia's largest export destination in 2010. The extent to which this provides important export diversification benefits depends on how much Malaysia's exports to China are for domestic demand in China (whether they are final or intermediate goods exports) or destined for final demand in the G3. Although recent data suggests that earlier fears of a sizeable slowdown in China are not materializing, leading indicators have moderated, after their much earlier rise relative to the G3. Growth in China is projected to decelerate in H2 2010 (mainly relating to fixed investments) but set to remain at 9.5 percent for the full year and 8.5 percent in 2011. This compares with growth for developing East Asia excluding China projected at 6.7 percent in 2010 and 5.1 percent in 2011.

Overall, the pace of recovery in world trade volumes is due to decline. This follows the earlier strength shown in the first half of 2010. The IMF's October World Economic Outlook (IMF, 2010) projection for world trade volume growth in 2010 is 11.4 percent, up 2.4 percentage points from the

July WEO projection. This growth offsets the 11 percent contraction seen in 2009. Growth in 2011 is forecast at 7 percent although the headwinds seen from the G3 pose a downside risk to this projection.

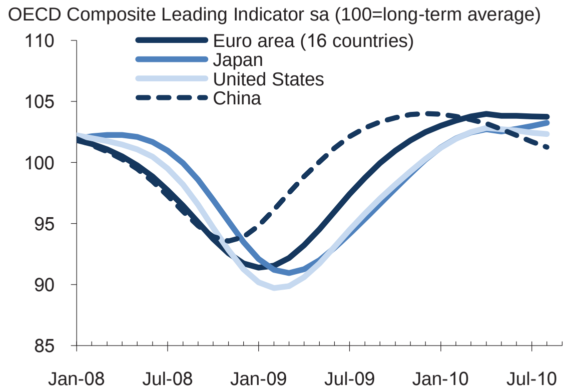
Commodity prices are expected to remain buoyant in 2010 before stabilizing in 2011. The impact of recent weather catastrophes on wheat prices are expected to support food prices, although a generalized rise in prices is not expected. Oil prices are expected to remain relatively stable due to the continued growth in China along with some tightening of supply factors. Given the firmness in commodity prices and the stronger than expected recovery in the first half of 2010, the WEO projection for inflation rates in advanced economies in 2010 is 1.4 percent, up from 0.1 percent in 2009.

Figure 2.1. US consumer confidence weakening



Note: Amplitude-adjusted standardized index.
Source: OECD.

Figure 2.2. Recovery in leading indicators flattens out



Note: Amplitude-adjusted index.
Source: OECD.

International capital flows to developing economies are projected to recover through 2010. Private capital flows to the East Asia and Pacific region fell from 6.5 percent of GDP in 2007 to 2.2 percent in 2009. In the first nine months of 2010 inflows to the region exceeded the level seen in the comparable period in 2007. With Asian growth prospects remaining considerably more favorable than in the G3, and interest rates ahead of the tightening curve, capital inflows may show further upside potential going forward. On the back of this, regional exchange rates are set to see continued strength.[6]

MALAYSIAN GROWTH SET TO MODERATE FURTHER

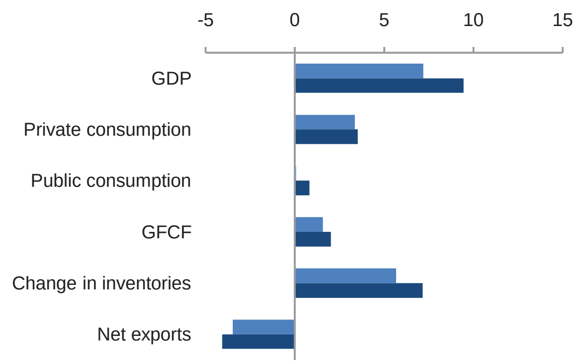
Recovery Exceeded Expectations

Growth in the first half of 2010 strongly outperformed the forecasts made in the April 2010 *Malaysia Economic Monitor* (Figure 2.3). The strength of domestic demand was the primary driver, up 16.3 percent year-on-year in H1 versus the forecast of 12.9 percent growth. This strength was seen across private and public consumption, along with investment. Although export growth was higher than expected, the strength of imports led to a greater negative contribution of net external demand.

[6] For further discussion of the regional capital flows and their implications see the World Bank's October 2010 East Asia and Pacific Economic Update (World Bank, 2010e).

Figure 2.3. Strong growth in H1 2010 relative to projections in April 2010 …

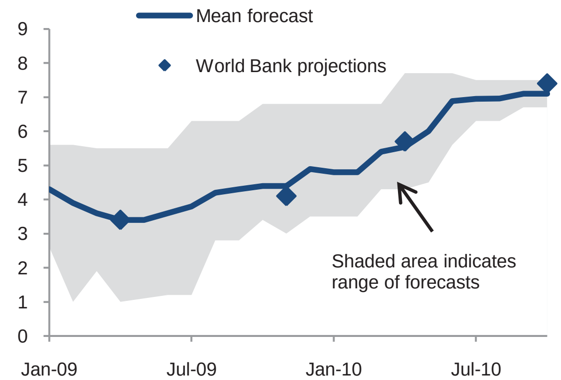
Contributions to year-on-year real GDP growth rates, percentage points



Source: CEIC and World Bank staff projections.
Note: MEM is *Malaysia Economic Monitor*.

Figure 2.4. …and full-year growth forecasts upgraded

GDP growth year-on-year, percentage points



Source: Consensus Economics and World Bank.

Figure 2.5. Leading indicators point to a moderation in economic momentum

Growth month-on-month (3 month moving average sa), percent

Note: Seasonal adjustment of Malaysia Leading Index using TRAMO-SEATS package.
Source: CEIC and World Bank staff calculations.

As a result, expectations for growth in 2010 as a whole have been upgraded (Figure 2.4). Even if quarterly GDP growth (seasonally adjusted) in H2 is zero percent, the full-year growth for 2010 would be around seven percent. Indeed, the mean October 2010 Consensus forecast for 2010 growth is 7.1 percent, with a minimum of 6.7 percent and maximum of 7.5 percent. The variance in the forecasts has declined over the year as quarterly growth outcomes have been revealed. The mean forecast for 2011 has remained relatively stable over the year and in October was 5.0 percent.

Indicators point to a moderation of the pace of growth in the second half of 2010 and 2011. Leading indicators of activity have trended downwards in recent months (Figure 2.5). The contraction in the Department of Statistics composite leading indicator of activity has been relatively broad-based across its components, including, for example, base money growth, major trading partner trade, and the ratio of price to unit labor costs in manufacturing. This moderation reflects both the unwinding of base level effects and also the uncertainty over external demand, as seen in the decline in the growth of new IT orders from the US.

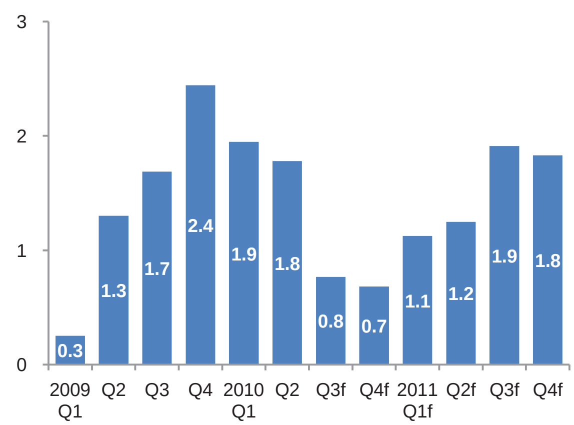
Near-Term Growth Expected to Soften

Economic activity in the second half of 2010 will decelerate. Quarterly growth rates are set to slow down in H2 before rising moderately in early 2011 (Figure 2.6). This reflects less supportive base-period effects, inventory cycle normalization, and waning policy stimulus. But the magnitude of the growth slowdown is still highly uncertain. Malaysia's exposure to external drivers of growth, such as policy-induced moderation in China and renewed concerns over the prospects of advanced economies, along with uncertainty over the impact of the current reform program complicate near-term forecasting. There is therefore the possibility that sequential quarterly growth could turn into a small negative number in the third and/or fourth quarter of 2010 if external demand is weaker than expected.

The baseline projection is for growth in 2010 of 7.4 percent (Figure 2.7), the highest level since 2000. After the 1.7 percent contraction in 2009, this would lead to an output level in 2010 around six percent above 2008's level. For 2011 as a whole GDP growth of 4.8 percent is expected, due to base effects and the prospect of weaker global economic conditions dampening domestic confidence.

Figure 2.6. Quarterly growth set to moderate

Actual and forecast GDP growth, qoq sa, percent



Source: CEIC and World Bank staff projections.

Figure 2.7. …after a robust growth recovery in 2010

Actual and forecast GDP growth, yoy, percent

Source: CEIC and World Bank staff projections.

Domestic demand is expected to continue to drive growth in H2 (Figure 2.8). There is expected to be a continuation of the transition from public to private sources of growth in H2, in line with the withdrawal of the fiscal stimulus packages and moves towards fiscal consolidation. This transition is in line with the Government's objectives under its reform plans. However, there is the potential for upside in the contribution of the public sector to growth due to rising fiscal disbursements towards the year-end rise or large-scale capital expenditures on remaining projects under the 9th Malaysia Plan or new projects under the 10th Malaysia Plan.[7]

[7] For example, the operating and development expenditure allocation under the 2011 budget includes RM 22 billion for projects carried forward from the 9th Malaysia Plan and RM 12.4 billion for new projects under the 10th Malaysia Plan.

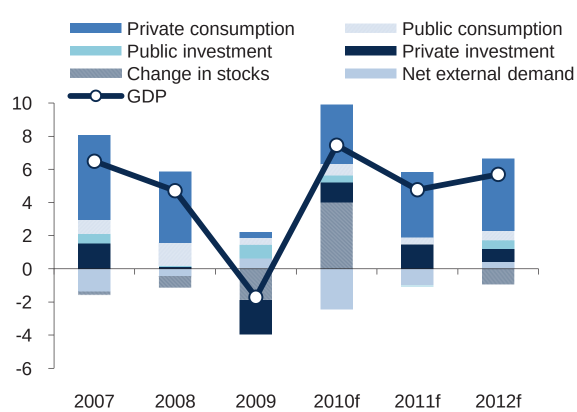
Private consumption is set to contribute to over half of GDP growth in the next few quarters. This is a similar pattern to the pre-crisis years.[8] Some of the leading indicators of consumption are broadly supportive, for example the improvements in the stock market, recovery in rubber prices, return of consumer sentiment index almost to its pre-crisis levels according to the MIER survey and the fall in the number of retrenched workers.[9] However, the momentum of some such indicators has dropped off recently.

The upswing in private investment is expected to broaden from the construction sector. High frequency indicators suggest capacity utilization is rising and suggest further growth of private investment in H2, albeit at a slower pace. On the downside, investments may be postponed until export orders firm up and business loans also dropped in July 2010 on a month-on-month, seasonally adjusted term for the first time since May 2009. In addition, given Malaysia's openness, and the ability of multinational corporations to relocate their production, pressures on investment may be dampened by global spare capacity. On the other hand, as discussed below, private investment is expected to be supported by projects under the National Key Economic Areas (NKEAs).

Public investment should remain relatively strong during the remainder of 2010, although will be a relatively minor contributor to overall growth. The short-term outlook for public fixed investment depends on the pace of disbursement of funds allocated under the second fiscal stimulus package over 2009-10 and the ninth Malaysia Plan that ends in 2010. As of August 2010, less than 70 percent of total allocations for the stimulus package had been spent so sequential growth of public investment in Q4 could pick up, although some funds may be carried over into 2011. Public investment in 2011 is expected to fall slightly, following the cut in development spending outlined in the budget (see discussion below).

Figure 2.8. Private sector to drive future growth

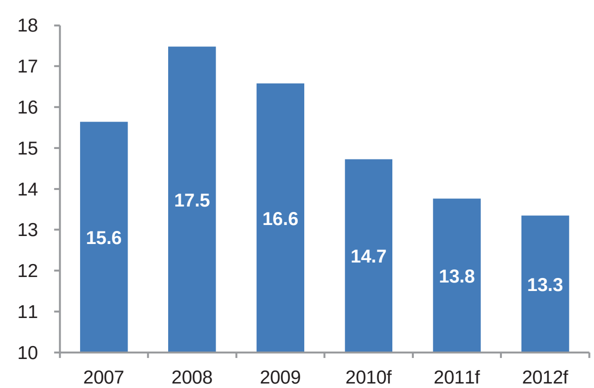
Actual and forecast contributions to GDP growth, yoy, percent



Source: CEIC and World Bank staff projections.

Figure 2.9. Current account surplus to decline but will remain high

Current account surplus, percent of GDP



Source: CEIC and World Bank staff projections.

[8] During 2003-2008, private consumption contributed around 70 percent of GDP growth on average. This dropped to only 21 percent in 2009.

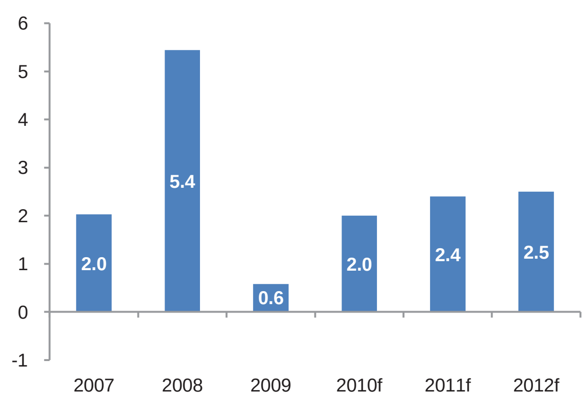
[9] These four variables have historically led private consumption in Malaysia with the cross-correlation coefficient of at least 0.5 and a lead time of at least one quarter.

The role of inventory adjustment is expected to diminish. In H1 2010, inventory adjustment made a sizeable contribution to growth (with the massive restocking in Q2 offsetting some destocking in Q1). But as this began to normalize, relatively small stock building is expected in the second half of 2010. Indeed, only by end-2011 will the accumulated restocking since the start of 2010 match the destocking seen in 2009.

Net external demand will remain a drag on growth through H2 2010. Modern supply chains and the changing composition of intermediate and final goods exports leads to a difficulty in untangling the implications for net external demand of the growth outlook for China and G3. However, overall it is expected that the growth of imports will generally continue to outpace that of exports in the next few quarters. However, in 2011, the negative contribution of net external demand to growth is projected to decline as the external environment improves, boosting exports, and restocking of domestic inventories completes, curtailing import growth.

Figure 2.10. Inflation to rise gradually

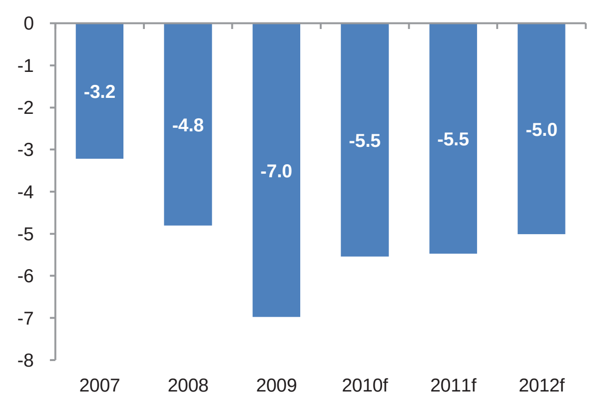
CPI inflation, yoy, percent



Source: CEIC and World Bank staff projections.

Figure 2.11. Fiscal consolidation is expected

Federal government balance, percent of GDP



Source: CEIC and World Bank staff projections.

Although declining relative to GDP, the current account surplus is projected to remain sizeable (Figure 2.9). In nominal terms the faster pace of growth of imports to exports will, given initial levels, lead to a goods trade balance which is broadly unchanged in 2010 and 2011. It will remain down between RM 15 billion to RM 20 billion on the RM 171 billion surplus in 2008. Similar patterns are expected for the overall goods balance with a slight improvement in the nominal current account, but a decline relative to GDP. On the financing-side, FDI and portfolio inflows are set to recover over the next two-three years, although, this will continue to depend crucially on the credibility of the government's policy reform efforts and the progress booked under the NKEA project initiatives. The continuation of capital inflows is likely to maintain pressures for nominal appreciation of the Ringgit.

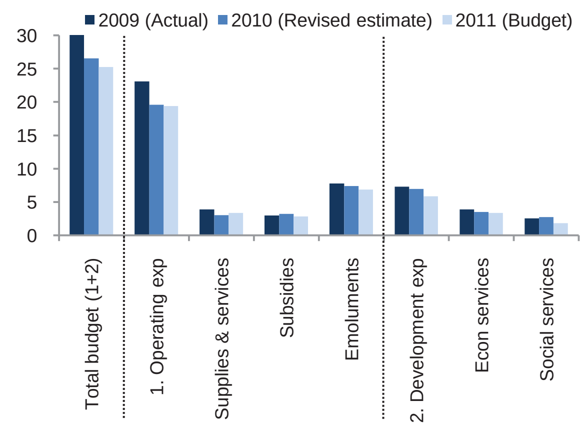
Inflation is set to rise but remain low. As mentioned in Chapter 1, the underlying inflation momentum is relatively benign. Although private consumption is expected to remain strong in H2 and 2011, demand-pull inflation is seen as unlikely. The strength of the Ringgit also helps to curb imported inflation. The outlook for inflation depends mainly on the speed and magnitude of further subsidy cuts and global commodity prices. The introduction of GST is unlikely to have a major impact given it will replace existing sales tax. Producer price inflation, which tends to be closely linked with oil prices, is not expected to rise sharply given the weaker global outlook. However, increased investment and construction may feed into some rise in PPI inflation.

Monetary Policy Outlook Stable, Fiscal Consolidation Efforts Ongoing

The fiscal deficit target of 5.6 percent in 2010 is likely within reach. Expenditure restraint and improved revenues, combined with nominal GDP growth, are projected to limit the deficit to 5.5 percent of GDP in 2010 (Figure 2.11). Revenue collection is expected to be buoyant on the back of stronger business activity and supportive oil prices. Continuing the trend of the first half, nominal operational expenditures may contract by three percent in 2010. The 2011 Budget projects a strengthening in revenues and a shrinking of development expenditure offsetting rises in operating expenditure (especially for supplies and services) (Figure 2.12). The revenue-operating spending gap, which has become smaller over time, is likely to reach one of the record lows in 2011. As a result the deficit-to-GDP ratio is projected to be comparable to 2010. The financing position remains solid. This reflects strong domestic, and rising foreign investor, demand for government securities along with sizeable potential proceeds from divestments of government-linked companies (GLCs).

Figure 2.12. Budget spending in 2011 to decline

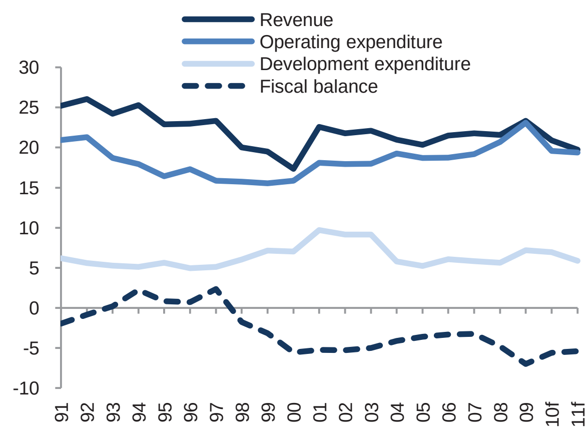
Percent of GDP



Source: Ministry of Finance Economic Report 2010/11.

Figure 2.13. Fiscal consolidation advances slowly

Percent of GDP



Source: CEIC, Ministry of Finance Economic Report 2010/11, and World Bank staff calculations.

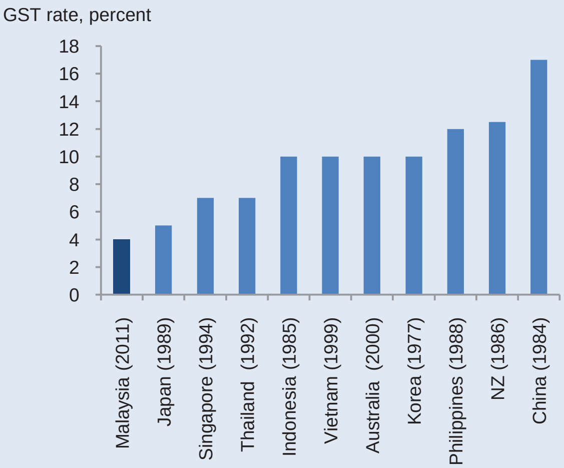
Bolder fiscal consolidation efforts are required to bring down the deficit. The projected decline in the deficit is largely due the recovery in nominal GDP. The overall deficits in 2010 and 2011 are expected to remain well above 2008 nominal level. The Government has signaled its commitment to fiscal consolidation through subsidy cuts on food and energy items but these imply limited savings (about 0.5 percent of operating expenditures in 2009). The implementation of goods and services tax (GST) has been postponed, but the service tax rate is due to increase from 5 to 6 percent from 2011 onwards. While the immediate impact is limited given the revenue-neutral design, the medium-term impact could be sizeable (see Box 4). Further expansion of the tax base is required to reduce dependence on oil revenues, which are estimated to be as high as 40 percent of total expenditures (IMF, 2010).

No further changes in the monetary policy stance are expected in 2010. Rates are projected to rise moderately in 2011 as inflation recovers. A stronger tightening in monetary policy is unlikely unless inflation picks up more quickly than the baseline projection. This could be due to larger-than-expected subsidy cuts on fuel and staple food items and/or a sharp rise in imported inflation due to global food or energy prices which then feeds through into inflation expectations and more general price pressures.

BOX 4. INTRODUCING A GST IN MALAYSIA

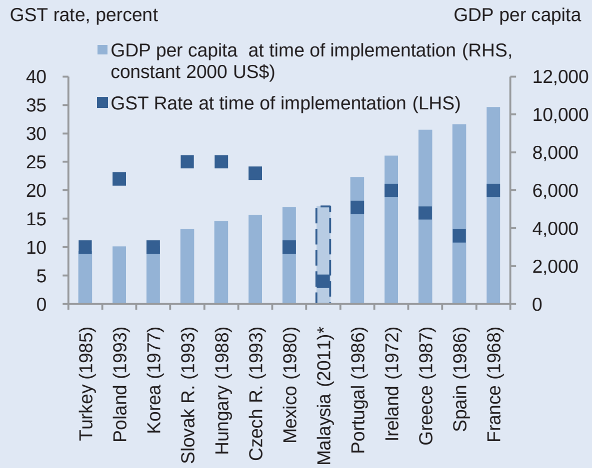
Broad-based taxes on domestic consumption have been widely adopted in recent decades. In 1989 49 countries had a Goods and Services Tax (GST), also commonly known as a value-added tax (VAT). By 2007 this had risen to 143 countries, with revenues accounting for about a fifth of total tax receipts on average (Norregaard and Khan, 2007, and OECD, 2008). Malaysia has announced plans to adopt a GST. At 4 percent, its rate will be lower than the 5 percent service and 5 or 10 percent sales tax it will replace. It will also be much lower than both existing GST rates in the region (Figure 2.14) and relative to introductory rates in countries with similar levels of GDP per capita at the time of adoption (Figure 2.15).

Figure 2.14. Current GST rates in Asia-Pacific, 2010



Source: KPMG (2010). Note: The date on which a GST was/will be introduced is in parenthesis next to each country label.

Figure 2.15. GDP per capita at GST introduction,



Source: OECD (2008) and World Bank.
Notes: Selected sample of economies. GDP per capita data for Malaysia is from 2009. The date on which a GST was introduced is in parenthesis next to each country label. * GST rate expected to be introduced in 2011 in Malaysia.

Rationale for GSTs

Typically GSTs are adopted on revenue and efficiency grounds. The dismantling of trade barriers and increasing capital mobility have eroded traditional revenue bases, which tax authorities have sought to compensate for by mobilizing taxes on domestic consumption. Proponents also argue that the GST does not distort production choices like sales or turnover taxes (Ebrill et. al., 2001). By being levied throughout the production chain on all sales by registered firms, with full refunds on taxes paid on input purchases, the final incidence of the tax is on domestic consumption. Exports are zero-rated and receive a refund of tax on their inputs. When implemented properly the GST avoids cascading effects associated with a traditional sales tax, where the tax element embedded in the final price of goods is much higher than the tax rate levied by the government. A GST can also serve as a catalyst for modernizing tax administration, in particular, by introducing methods for self-assessment and stimulating a culture for record keeping that can then be extended to other taxes. Moreover, even if there is evasion, for instance by informal retailers, there will still be revenue collected at the wholesale or manufacturing level unlike the sales tax, where such informality causes all tax revenues to be lost.

In Malaysia's case, the primary rationale for introducing the GST are to modernize the tax system and improve the efficiency of indirect taxes. GST can also enhance fiscal sustainability, by broadening the tax base and reducing dependence on oil-related revenues. Oil revenues contributed nearly 40 percent of total revenues in 2009 (9.3 percent of GDP). However, declining oil reserves and volatility in oil prices mean that these are neither a stable nor sustainable revenue source. The government is also heavily dependent on income taxes. But the corporate tax base has been eroded by complex and inefficient tax incentives and tax holidays resulting in large revenue losses (World Bank, 2010a).

Expected impacts from the introduction of a GST

The GST yield varies depending on rates, coverage, compliance and the ease of collection.[a] However, studies indicate that GST adoption is associated with a long run increase in the overall revenue-to-GDP ratio of 4.5 percent on average (Keen and Lockwood, 2007). Based on these estimates, an initial tax revenue-to-GDP ratio of 16 percent, as in Malaysia in 2009, would imply a 0.7 (or 0.045 times 16) percentage point of GDP increase in tax revenues over the long run, which is not insubstantial.

The impact of a GST on inflation cannot be considered in isolation from other factors such as the taxes it is replacing, its coverage, the country's wage setting mechanisms, monetary policy stance and so on. Other countries that have adopted a GST have typically not seen an increase in inflation at the time of introduction or in the year immediately following and that is likely to be true for Malaysia as well. It is expected that the overall impact will be temporary, with inflation increasing during the period of introduction and falling back thereafter and with insignificant knock-on effects on wage demands.

Typically GSTs tend to have multiple rates to address equity concerns, with "essential" goods such as basic food zero-rated[b] under GSTs and services such as health, housing, public transport and education treated as GST exempt, as is also planned in Malaysia. Studies carried out by the Ministry of Finance showed the Malaysian GST model is indeed a progressive one and not expected to burden the poor households. Counterbalancing this, multiple rates often lead to misclassifications and can create large compliance and administrative burdens as well as revenue erosion. Meanwhile, exemptions for certain sectors may lead to distortions and incentives for evasion, adding to the administrative burden.

Given such administrative and compliance issues, it may be desirable to err on the side of simplicity in designing the GST. This would amount to a single GST rate,[c] with few zero rates, for example for some basic necessities, and even fewer exemptions, and a high threshold allowing tax authorities to focus on larger traders. Equity concerns should be addressed through the GST system design, but also through other taxes and spending policies. In order to support self-assessment, taxpayers need to be provided with effective education, training and services, backed by automated invoicing and timely enforcement, including verification through audits to minimize misreporting, fraudulent schemes, etc. (Owens, 2005).

Notes:
[a] As an illustration, GST accounts for 10 percent of total tax revenues (2.5 percent of GDP) in Japan which has a 5 percent GST rate, and over 26 percent of revenues (9 percent of GDP) in Hungary where the rate is 25 percent.
[b] Credit is given for taxes paid on inputs in contrast to GST exemption when the rate of tax applied to output sales is zero but the seller is not given any refund for taxes paid on inputs.
[c] Since 1995, 70 percent of countries that have adopted a GST had a single rate (Keen, 2005)..

Near-Term Risks Remain Substantial

As in the previous *Malaysia Economic Monitor*, the strength of the recovery in global demand remains a key source of uncertainty. While a double-dip recession is viewed as not impossible but unlikely, the length of the recovery in external demand from the G3 remains a major uncertainty. This reflects the continued labor market weaknesses, for example in the US, and need for fiscal consolidation amongst many of the highly indebted high-income economies. China could also pose a source of downside risks if withdrawal of policy stimuli leads to a sharper than expected downturn in the growth of investment and private consumption. A further risk to external demand arises from the impact of any further real appreciation, due to continued capital inflows, on export competitiveness. Weaker-than-expected export earnings affect not only the external demand component of GDP directly but also tend to have a lagged effect on consumer spending through employment conditions and wage growth.

Domestic sentiment is sensitive to reform progress relative to expectations. The reform agenda has led to generally cautious optimism but, with expectations raised, failure to deliver could lead to a fall in sentiment. This could have spillovers to the real economy through domestic investment and consumption. Foreign sentiment, which has been bolstered by strong monetary and exchange rate policy management, could also be disrupted. While market contacts suggest that expectations are low for some investors, such as in portfolio flows, it would have greater impact on longer-term investors, particularly for foreign direct investment for example. Any political uncertainty in the lead-up to elections could also affect domestic and foreign investor sentiment.

Risks to near-term fiscal consolidation progress are most likely to relate to expenditure restraint. For example, reform of subsidies and transfers are, as in other countries across the region and internationally, a technically and politically complex issue. Stagnation of reforms in this area could weaken the adjustment of expenditures. On the revenue-side, a softening in commodity prices would also limit progress in reducing the fiscal deficit. As in other countries, there is also the opposite risk of too early withdrawal of the fiscal stimulus, particularly given the potential weakness in external demand. In terms of monetary policy, a strengthening in global commodity prices, could lead to a surprise on the upside for imported inflation, for example, via food prices or oil. But, given underlying weak upward price pressures, such a scenario would most likely be of limited impact for overall inflation.

MEDIUM-TERM OUTLOOK HINGES ON REFORM IMPLEMENTATION

Reaching High-Income Status through Inclusive and Sustainable Growth

Malaysia's Vision 2020 is to achieve high-income status through inclusive and sustainable growth. GNI per capita was USD 6,760 in 2009 compared with the high income target range of USD 15,000 to USD 20,000. According to the 10th Malaysia Plan achieving the goal of high-income status by 2020 will require, among other things, average growth of 6 percent over the plan period of 2011-2015. Such growth rates require a marked improvement on the 4.4 percent achieved from 2006-2010 during the 9th Malaysia Plan, but are less than the rates seen in the early 1990s.

One challenge is not only to boost the level of growth but also to ensure that the process of growth is inclusive. Inclusive growth policies enable the benefits of growth to be shared across all communities. But the challenge will be to achieve this objective while enhancing the growth potential of the economy, as distributional objectives are more easily accomplished when the aggregate pie is expanding.

Examples of policies that serve these dual objectives are education and health policies, which build the human capital base of the economy. Chapter 3 in this Monitor focuses on the concept of inclusive growth, Malaysia's performance to date across a range of related metrics and the policy adjustment that are being, and might be, considered to further promote this objective.

A second challenge is to achieve sustainable growth. This means that the wealth of current generations grows in a way that does not come at the expense of future generations. This involves, for example, moving towards appropriate cost-based pricing of environmental resources to improve the efficiency of usage of fuels and water (see Box 5 at the end of this Chapter for a discussion of energy efficiency issues in Malaysia). It also includes putting in place appropriate incentives to promote "green" innovation and conservation of biodiversity.[10]

Meeting the Challenge: Thinking Big and Thinking Small about the Enabling Environment

Four interrelated government programs have been developed to meet the Vision 2020 challenge. The first, 1Malaysia, focused on building support for a "People First, Performance Now" concept and was introduced in April 2009. The second, the Government Transformation Program (GTP), was announced in early 2010 and aims to improve the efficiency of delivery of government services in 6 National Key Results Areas (NKRAs). The NKRAs are reducing crime, fighting corruption, improving student outcomes, raising living standards of low-income households, improving rural basic infrastructure and improving urban public transport.

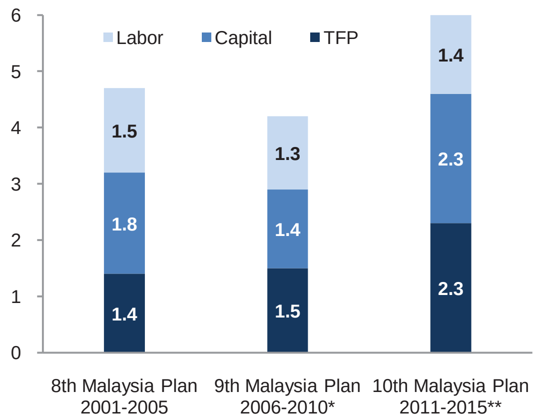
A third pillar is the 10th Malaysia Plan (10MP) covering the period of 2011-2015. The 10MP incorporates macroeconomic and socio-economic targets and development expenditure allocations within a framework of "10 Big Ideas". In particular it targets a revival of private investment, improvement in productivity and rationalization of the role of the government. Accordingly, relative to the outcomes for the 9th Malaysia Plan, the 10MP average growth target of 6 percent includes considerably stronger contributions from capital growth and total factor productivity (Figure 2.16). The plan also foresees a continued shift towards services within the economy (Figure 2.17), with a notable rise in growth in transportation, storage and communication, for example. However, manufacturing is also expected to grow strongly, by around 5.7 percent per year relative to 1.3 percent over 2006-2010.

The final pillar is the Economic Transformation Programme (ETP), which was launched October 2010. The ETP report incorporates both policies and projects, thinking "big" in terms of the macro-enabling environment and cross-cutting issues and thinking "small" about the micro-enabling environment and specific projects. The National Economic Advisory Council's first report on the New Economic Model (NEM), delivered in April 2010 (see also the April 2010 *Malaysia Economic Monitor*), focused on cross-cutting issues. Grouped under 8 Strategic Reform Initiatives, it set out policy options to improve the enabling environment for the investment and productivity improvements needed to reach the macro targets of the 10MP and the Vision 2020 objectives. The ETP combines these policies with the project focus of the National Key Economic Areas (NKEAs), which were discussed in an Open House in the second half of September.

[10] Sustainable growth will be the theme of the April 2011 Malaysia Economic Monitor.

Figure 2.16. 10MP targets TFP and investment growth

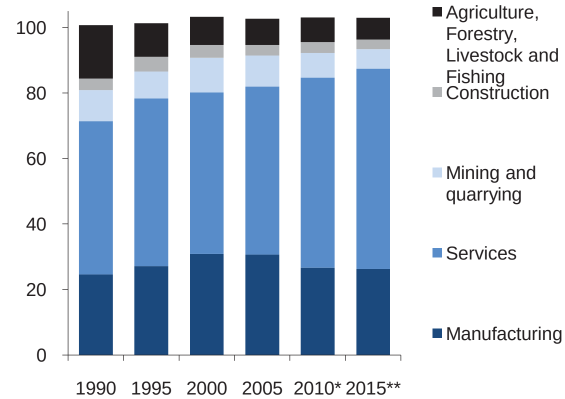
Contributions to average annual GDP growth, percentage points



Note: * estimate, ** target.
Source: Economic Planning Unit (10MP report).

Figure 2.17. Further expansion of services projected

Share of real GDP at purchasers' prices, percent



Note: * estimate, ** target. Total does not sum to 100 as deduction of financial intermediation services indirectly measured and addition of import duties not shown.
Source: CEIC and World Bank staff projections.

The NKEA initiative represents a bottom-up consultative approach to identifying investment opportunities in support of Malaysia's high-income objective. The intensive NKEA consultations and "labs" that took place quantified the potential gross national income benefits of projects in different economic areas. This decentralized process involved experts from the private sector, GLCs and public sector. A total of 12 NKEAs were identified including 11 economic sectors — oil, gas and energy, financial services, palm oil, wholesale and retail trade, tourism, E&E, business services, education, communications content and infrastructure, healthcare, agriculture — and one geographic sector — the greater Kuala Lumpur conurbation. Improving the infrastructure of KL, for example, through the proposed metro project, would not only help promote activity and agglomeration economies but in improving the livability of the city could also improve its attractiveness for high skilled labor, both within Malaysia and internationally. Similarly, building up the transport infrastructure in the corridor between KL and Singapore will play an important role in determining the success of the private investment and growth targets for the Iskandar development region in Johor (see Box 6 at the end of this Chapter).

The NKEA projects identified require substantial fixed investment. Within the NKEAs 131 entry point projects (EPPs) were identified, i.e. projects which can be implemented relatively quickly and with sizeable estimated impact on gross national income. A further 60 business opportunities for future investment projects were also highlighted. The investment required over 2011-2020 for the EPPs is estimated to be USD 444 billion, of which an estimated 8 percent is from the non-GLC public sector, 32 percent from the GLCs and 60 percent from the private sector. Just over a quarter of the overall figure is planned to come through in the form of foreign investment.

The success of the NKEA approach in generating economy-wide growth will critically hinge on the simultaneous implementation of policies addressing the cross-cutting obstacles identified in the NEM. Although the NKEA process has shown a high level of consultation and focus on implementation, there are some concerns over whether the targeted benefits will be delivered when adopting a holistic perspective taking into account the impact on the overall economy. Without the appropriate improvements in the macro-enabling environment, the substantial private (i.e. non-GLC), and foreign, investments required to deliver the EPPs and develop the future business opportunities may be less likely than anticipated to be forthcoming. The NEM policies will also determine the multiplier effects of the projects which were used to calculate their GNI impact, and ultimately select the NKEAs. Furthermore, the robustness of the quantitative GNI assessment of the projects, and the job creation figures of 3.3 million jobs by 2020, may be subject to resource reallocation effects of projects. For example, implementing a number of large infrastructure projects may contribute to rising construction or labor costs, impacting the returns on other NKEA projects and private sector investments more generally. In addition, some of the projects may lead to creative destruction, which, while increasing productivity, can lead to offsetting falls in output and employment.

Reform Implementation Key Risk to Medium-Term Outlook

The risks to medium-term growth remain focused on those set out in the April 2010 *Malaysia Economic Monitor*, namely implementation risks and progress on fiscal consolidation. The baseline medium-term projections presented here price in a gradual implementation of the structural reform agenda. This is one reason why the average GDP growth projection of 5.4 percent over 2011-2015 compares with 6 percent in the 10MP. Another reason is that even with complete implementation of the reforms, Malaysia is aiming at a moving target of improving productivity and moving up the value chain. For example, other countries in the region, such as China, are also making significant advances in many of the NKEAs identified for Malaysia.

Risks to the implementation of the necessary reforms and projects remain sizable. A first risk relates to the policy coordination required between the policies and the projects, between the 8 SRIs of the NEM, the projects of the 12 NKEAs, the 6 National Key Result Areas of the GTP and the 10 Big Ideas of the 10th Malaysia Plan. The 2011 Budget is also accompanied by the creation of new institutions focusing on different policy aspects of the Government's reform objectives, including the Special Innovation Unit, the Talent Corporation, and the National Wage Consultation Council. The multi-dimensionality of the reform agenda and, by extension, the complexity of the coordination required across ministries and agencies will require extra vigilance so as not to reduce the effectiveness of the reform efforts. Second, the constituencies for different reform plans may not overlap. For example, the benefits of infrastructure projects under the NKEAs are easier to focus upon than the more dispersed economic advantages of reforms to cross-cutting policies, such as for example the competition law.

Reaping the full benefits of the projects requires the policy reforms to improve the enabling environment for the investments. The procurement process for public-financed projects will also play an important role in determining whether the net benefits identified in the NKEA process are realized. Key Performance Indicators (KPIs) can help to mitigate some of these implementation risks, providing they provide holistic measures of what it is being targeted else they may act as a straightjacket and distort incentives in harmful ways. This is particularly important in areas such as innovation, which as highlighted in Box 10 in the April 2010 *Malaysia Economic Monitor*, should be facilitated rather than orchestrated.

Risks associated with reform implementation are also on the upside. For example, the multipliers used in the NKEA calculations may not fully capture the virtuous circle of policy reform and project development. Similarly, facilitating the private sector to discover their own niches of activity which may or may not fully overlap with the NKEAs, could yield greater growth benefits than expected.

In terms of assessing these risks, market perceptions over the reform process appear to be improving. Various market participants surveyed in the preparation for this report suggest that the skepticism of international investors to the reform process in Malaysia is related to the performance of previous plans relative to target and past policy reversals. Nevertheless there appears to be a general consensus that reform communication has improved. Other steps viewed positively include the coordination of foreign exchange policy changes with China and the improved dialogue with Singapore. Other news adding to the improvement in sentiment includes Malaysia's movement up to rank 10th in the World Competitive Year Book in 2010, from 18th in 2009. Nevertheless, until solid implementation of reforms is seen there is unlikely to be a groundswell of positive sentiment of foreign investors towards Malaysia. Other key indicators of the perceptions of implementation risk are the volumes of foreign investment inflows and skilled labor. Of particular interest will be the response of Malaysia's sizeable diaspora to the reform agenda, just as the return of skilled Indian migrants from the US was taken as a signal of the growth potential of India's IT services sector.

Moving to the second set of risks, the fiscal risks to the outlook are two-fold – the sustainability of public finances and public service delivery. As detailed in the April 2010 *Malaysia Economic Monitor*, the rise in fiscal deficits in 2008 and 2009, combined with the slower growth has put upward pressure on Malaysia's public debt ratios. The government has set out a plan for gradual fiscal consolidation in the 2011 budget, as discussed above, which motivates the focus on strategic initiatives aimed at delivering concrete results through well-targeted programs and projects. Nevertheless, revenues also remain heavily dependent upon the commodity sectors, increasing risks to the budget projections. Public sector (including GLC) involvement in the large-scale infrastructure projects of the NKEAs may also add to fiscal risks through potential cost overruns and any implicit or explicit financing guarantees. In addition, the usage of Public-Private Partnerships to finance these projects needs to ensure an appropriate pricing and sharing of risks.

The quality of public service delivery is a crucial determinant of the success of the Government's plans. Indeed strengthening public services delivery is one of the four strategic planks of the Government's 2011 budget, and, of course, the focus of the GTP. A risk however is that, despite policy changes, implementation does not always fully filter through to the front line. This relates to the importance of ensuring that there is clear coordination of the Government's different programs at the line ministry level. This in turn calls for the public expenditures under the various reform initiatives to be closely monitored and evaluated against outcomes. This will also help introduce feedback loops that allow for early corrections and interventions should the desired outcomes not be achieved.

BOX 5. PROMOTING ENVIRONMENTALLY SUSTAINABLE GROWTH: ENERGY EFFICIENCY IN MALAYSIA

Sustainable growth is one of the three pillars of Malaysia's Vision 2020. However, as for many countries, its trends in energy intensity and CO2 emissions are not yet in line with this aspiration.

Outlook for energy efficiency (EE) and energy security

The industry, transport, and commercial sectors are driving energy demand in Malaysia and hence offer the best opportunities for increasing energy efficiency. For example, In 2008, the industrial sector accounted for 43 percent of total final energy consumption, followed by the transport sector at 36 percent (NEB 2008). Similarly, the industry sector accounted for 46.6 percent of total electricity consumption, followed by the commercial and residential sectors at 32.3 percent and 20.7 percent respectively. Also, the importance of residential and commercial sectors is likely to increase due to rapid urbanization which is driving energy demand.

The fuel mix in the electricity generation and prospects for energy efficiency are primary determinants of the future CO2 intensity of production. The dominance of natural gas in the electricity generation is expected to be reduced and its share is likely to fall to 25 percent in 2030 from 63 percent in 2009. Under a business-as-usual scenario, this would lead to a strong growth in coal-fired generation of around five percent per year, rising from 30.4 percent of total generation in 2009 to 43 percent in 2030, according to New Energy Policy. Combined with the slow progress in improving EE in the transport sector, this would result in a further increase in CO2 intensity. However, an alternative scenario based on a strong policy support for EE would stabilize CO2 emissions by 2020.

In addition to the sustainability benefits, improving energy efficiency can promote energy security. Malaysia is a net exporter of oil and liquefied natural gas (LNG). But, rising demand for coal for power generation and oil for the transport and industry sectors will turn Malaysia into a net energy importer by 2019.[a] However, a continuation and intensification of improved measures to increase EE since 2008 could reduce energy intensity gradually over the next few decades (IEA 2009; ADB 2009).

Institutional and regulatory issues

A range of institutions are involved in the energy efficiency agenda in Malaysia. The Ministry of Energy, Green Technology and Water (MEGTW) formulates EE policy with the Economic Planning Unit (EPU) of the Prime Minister's Office. The EPU provides the general strategy and determines the level of implementation. The Energy Commission (EC) regulates the electricity and piped gas supply industry as safety regulator and provides advice on related EE and renewable energy issues. Pusat Teknologi Hijau Negara or the Malaysia Green Technology Corporation is an independent non-profit company set up to develop and coordinate energy research and act as a catalyst for linkages with universities, research institutions, industry, and domestic and international energy organizations.

The main barrier for further progress in improving energy efficiency is a fragmented body of EE laws and regulations which is unable to comprehensively cover all aspects of energy demand and supply and provide necessary incentives for investments in EE. EE is addressed in the National Energy Policy (1979) supported by various financial measures and activities. However, existing laws and regulations are focused on electricity supply and safety while many elements on the demand side remain unregulated or voluntary (APERC 2010a; EC 2010). The forthcoming Malaysia Energy Efficiency Master Plan aims to address barriers to the implementation of current EE initiatives

Recommended options for further improvement in energy efficiency in Malaysia

Moving forward with the energy efficiency agenda in Malaysia requires putting in place the policy framework, including the overall strategy and the EE master plan, and the supporting financial incentives and targeted investment programs. A high-level EE strategy defines the main objectives, guiding principles, and policies for improving EE. To be effective, this strategy requires political support and commitment across all levels of the Government. This overall strategy feeds into the EE Master Plan, identifying key laws and regulations relating to EE, helping to create a comprehensive framework for stimulating EE investments. The master plan should cover all major stakeholders, for example, the transport sector should be included. To be effective it should be supported by an institutional champion, such as a dedicated energy efficiency agency. In terms of content, the experience from several countries which succeeded in improving energy efficiency shows that mandatory regulations, such as industry EE targets, appliance standards, building codes, and fuel economy standards, are among the most cost effective policy measures to improve EE.

Financial incentives and mechanisms can play an important role in promoting EE. For example, decoupling utilities' profits from electricity sales can go a long way to improving their EE incentives. Financing mechanisms for EE projects include loans and partial loan guarantees through commercial banks or specialized agencies or revolving funds. Surcharges on electricity consumption by all consumers or third party financing of EE through electricity supply companies are other approaches.

Investment programs also have a role to play in promoting EE. These can be direct investments throughout the supply chain. This covers carbon capture utilization and storage technology for coal and gas power plants, investments to reduce transmission losses, and advanced metering infrastructure or "smart meters" – to mention just a few. . The recent progress in "smart metering" is particularly important in creating demand-side incentives by relating price more closely to cost of supply. Other investments can improve energy efficiency indirectly. For example, substantial reductions in energy usage can be derived from improvements in the efficiency of water supply and sanitation systems. The energy efficiency of transportation can be improved markedly through the development of mass transit facilities, land use planning, and intelligent traffic management, such as congestion taxes. Tighter vehicle efficiency standards, fuel price reforms, introduction of electric vehicles and behavioral changes to choose mass transits will also have great impacts on reducing the energy associated with the future growth in vehicle demand.

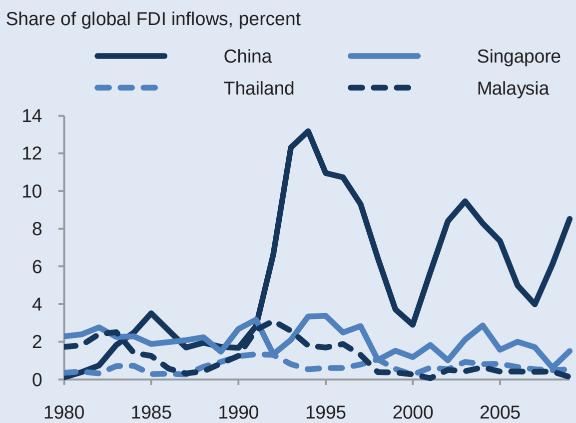
Notes:
[a] See, ADB 2009; IEA 2009; World Bank 2010b; EPU 2010b; EC 2010.
[b] See, for example, Deris 2006; Malaysian Insulation Manufacturing Group 2007; Ahmed 2008; Van Den Akker 2008; Lim 2009.
[c] See, for example, Kristensen 2010; EC 2010; Saidur 2009.

BOX 6. ISKANDAR MALAYSIA: ECONOMIC GEOGRAPHY AS A DRIVER OF INVESTMENT

Malaysia has witnessed a slowing in its relative share of global foreign direct inward investment (Figure 2.18). The lower production costs and larger domestic market of China has been a major reason but smaller and higher-cost locations such as Singapore seem also to have received larger inflows.

The Iskandar Malaysia project is part of the Government's effort to revive private investment. As one of the five development corridors to revive private investment following its drop after the 1997/98 crisis, the Iskandar project was launched in November 2006. At planned completion in 2025 the scheme will spread across 2,217 km^2 in the southern tip of Peninsular Malaysia in Johor state, three times larger than Singapore. The project focuses on six services sectors (financial services, logistics, education, creative industries, tourism, and healthcare) in addition to three manufacturing activities that have had strong presence in Johor (electrical and electronics, petrochemicals and oleochemicals, and food processing). The Government expects real regional output to increase by 8 percent per year through to 2025 with employment reaching a level over 1.3 times larger than in 2005.

Figure 2.18. Malaysia's share in global FDI inflows has been declining since 1992



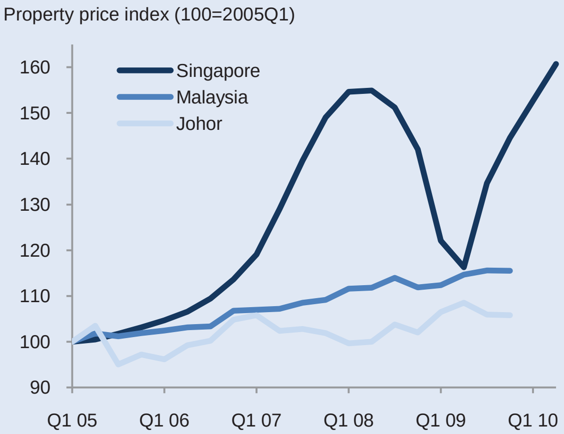
Source: UNCTAD and World Bank staff calculations.

Harnessing the forces of economic geography

The Iskandar Malaysia project aims to harness the new economic geography forces of agglomeration, concentration and specialization (see World Bank, 2009b for a discussion). Higher density of economic activity can generate the benefits of agglomeration economies. Strong infrastructure and proximity to Singapore will facilitate connectivity of firms and workers leading to concentrations of economic activity, yielding gains from scale and specialization

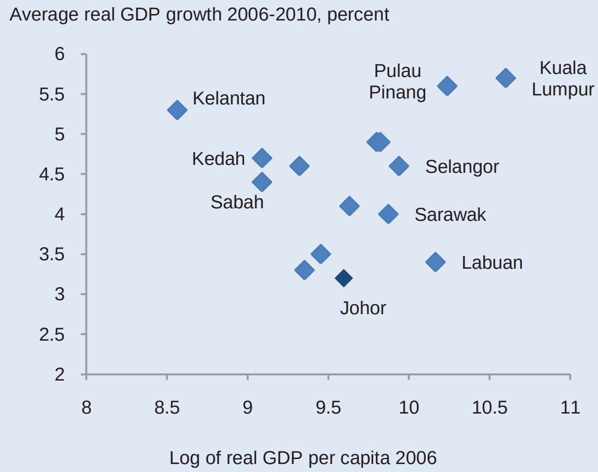
Synergies with Singapore motivate the Iskandar project and will be strengthened further. In China's recent coastal development, two mega cities--Hong Kong, SAR and Shanghai--are the cores, and have helped to spur investments in nearby Chinese cities. The Iskandar region could greatly benefit from similar ties with Singapore. Distances are being cut with enhanced public transportation services. Improved relationships between Malaysia and Singapore have been facilitated by the resolution of land

Figure 2.19. Unlike Johor, residential property prices in Singapore have risen sharply since early 2009



Source: CEIC and World Bank staff calculations.

Figure 2.20. Johor has experienced slower output growth relative to regions of Malaysia



Source: The Tenth Malaysia Plan and World Bank staff calculations.

ownership issue in May 2010 and eased border clearance system. Singapore also has a traditional interest in Johor as a production base with the comparative advantage of the region being its low cost of land (Figure 2.19). Shifting to higher value-added production activities and knowledge-based services sectors would help to move Malaysia up the value chain.

The success of Iskandar would energize Johor, one of the slowest growing regions in Malaysia in recent years (Figure 2.20). Employment in Johor has also expanded at a similar rate to output, implying sluggish labor productivity growth. In contrast, Palau Pinang, with similar job growth, saw much higher output growth. On the upside, the share of approved investment in Johor in total investment rose from ten percent during 2000-02 to 15.5 percent during 2007-09, reflecting Johor's rising attractiveness.

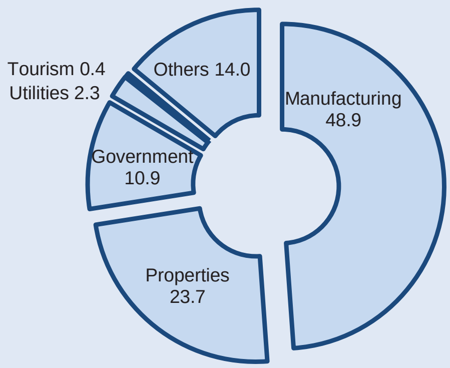
Committed investment into Iskandar has so far been sizeable but actualized investment remains below the target. As of July 2010, actualized cumulative investment amounted to RM 26 billion compared with the 2006-10 target of RM 47 billion. Manufacturing activities accounted for around half of this figure, with investment in a focused sector such as tourism relatively small (Figure 2.21). Total committed investment is much higher, at RM 63 billion. Around ten percent of this is public investment, with the contribution of the Government expected to be disproportionally high at the beginning given the need for physical infrastructure projects. The rest of the investment is equally split between domestic and foreign investors.

Enhancing the attractiveness of the Iskandar region

To move the Iskandar region forward, the two key challenges are enhancing the investment climate and city livability. The investment climate in Malaysia is less supportive than Singapore, e.g. in terms of government regulations for standardized SMEs, Singapore was ranked top across countries while Malaysia (effectively Kuala Lumpur) was 23rd out of 183 (World Bank, 2010c). Firms in KL spend more time to start a business, complete trade transactions, and pay taxes. But the particularly lagging areas

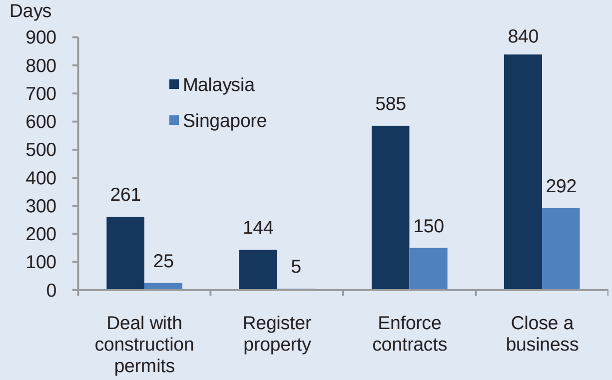
Figure 2.21. Investment in manufacturing activities is about half of actualized investment so far

Share of total actualized investment in Iskandar, percent



Source: Source: Iskandar Regional Development Authority

Figure 2.22. Certain regulatory issues are far more cumbersome in Malaysia than Singapore



Source: World Bank (2010c).

are dealing with construction permits, registering property, enforcing contracts, and closing a business (Figure 2.22). The corporate tax burden is also heavier.

When comparing the Iskandar region with Singapore, it is notable that Kuala Lumpur and its surrounding areas are already perceived as being a better place to do business than Johor. The World Bank's survey of Malaysian manufacturers in 2007 shows that Klang valley (covering KL, Selangor, and Melaka) is generally perceived as the most business-friendly region in the country.[a] Close to half of sample producers located in Johor shared this view, and estimated that moving their production base from Johor to Klang Valley would save up to 14 percent of production cost. This increased from ten percent in 2002, so the gap in investment climate actually widened.

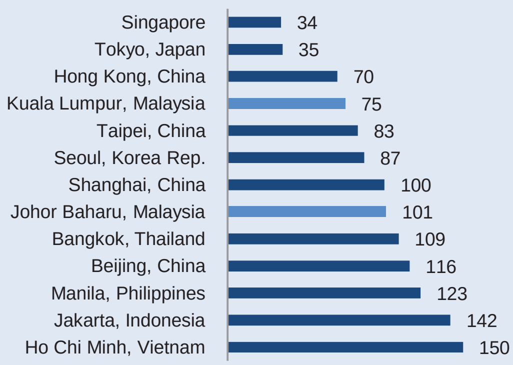
Johor needs to improve its business environment to become more competitive. Shortage of skilled workers, a key investment obstacle countrywide, is relatively severe in Johor. For example, it typically took six weeks to find professional staff (i.e. workers with university degree), one week longer than Klang Valley. This figure can go up to 17 weeks, and there is little change since 2002. Other areas of concern in Johor include power interruptions and security costs and losses. Addressing such constraints is key to attracting further private investment, especially as the fiscal incentives offered in Iskandar are matched by equally attractive packages in, for example, China, Indonesia, Singapore, and Thailand.[b]

City livability also needs to be enhanced. Johor Bahru trails behind Kuala Lumpur and Singapore on city livability (Figure 2.23). Singapore is Asia's best performer. While Johor performs well on education, with the second lowest secondary student/teacher ratio, health services could be strengthened. The number of population per one doctor is close to 1,600 or over three times higher than Kuala Lumpur (Figure 2.24) and has improved only marginally in recent years.

In terms of attracting workers, despite special privileges, personal income tax in Iskandar remains relatively high. Starting from 2010, individual income tax rates for Malaysian and foreign professional workers in selected activities in Iskandar are indefinitely fixed at 15 percent. However, the tax regime in

Figure 2.23. Kuala Lumpur is seen as more livable than Johor Bahru

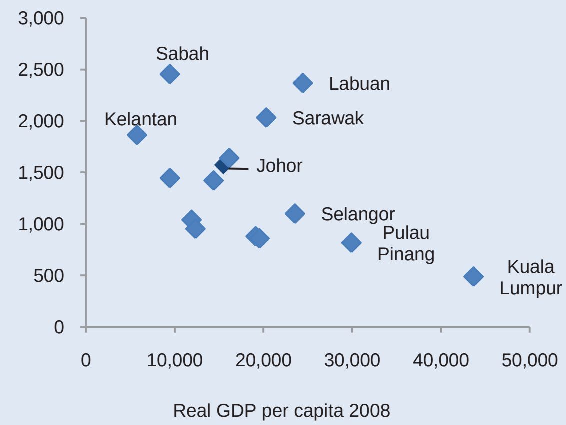
Mercer Quality of Living City Ranking



Note: Based on dimensions e.g. economic, environmental, safety, health, education and transportation.
Source: Mercer's Quality of Living 2007 Survey.

Figure 2.24. Doctors are more abundant in many other states with similar income level as Johor

Population per doctor, 2008



Source: CEIC, Tenth Malaysian Plan, and World Bank staff calculations.

Singapore is still more favorable. Excluding various tax reliefs that both countries offer, a worker who earns RM 240,000 per year would pay around a 7 percent tax rate in Singapore compared with 15 percent in Iskandar (and 26 percent elsewhere in Malaysia).

Recent reforms are addressing these challenges on business environment and city livability. For example, reducing crime is one of the six GTPs introduced in April 2009. Within the context of falling national crime rates, it is reported that the crime rate in Johor has fallen by 20 percent since April 2009. On business climate, the introductions of standard company ID numbers, e-tax refunds, one-stop centers, and new commercial courts are all help to reduce cost of doing business. The success of Iskandar Malaysia will be a showcase model for many other initiatives and a barometer for investor confidence in the success of the Government's reform agenda.

Notes:
[a] World Bank (2009c) covers 1,115 producers of various employment sizes and industries in every region of Malaysia in 2007, including 346 firms in Johor. In 2002, the sample sizes are 902 and 346 firms, respectively.
[b] For example, both Malaysia and Singapore offer a 10-year tax holiday, accelerated depreciation scheme, import duties exemptions, and tax deduction on R&D spending.

3. PROMOTING INCLUSIVE GROWTH

"Inclusiveness is the main prerequisite to ensure that every Malaysian can benefit from the prosperity resulting from the country's development." Excerpt from a speech by the Prime Minister of Malaysia (2010)

Inclusive growth has been a key objective of the Government of Malaysia since independence. Through sound macroeconomic policies, investment in infrastructure and human capital, and other measures, Malaysia has achieved high rates of growth over the last four decades. This economic expansion has gone hand-in-hand with the process of urbanization, a structural transformation of the economy towards manufacturing and services, and rapid poverty reduction. Government policies have also been successful in reducing disparities between urban and rural areas and among ethnic groups. Key to this has been the New Economic Policy (NEP), introduced in 1971, which sought to eradicate poverty and to restructure society to eliminate the identification of ethnicity from economic function.[11] The underlying principles of the NEP were carried on into successive vision documents, such as the National Development Policy (NDP), the National Vision Policy, and the National Mission.

Despite these successes, significant challenges remain. The level of inequality has remained largely unchanged in the last two decades. Poverty also remains a significant concern in the case of some groups and in some parts of the country, including Sabah, Sarawak, and some states on peninsular Malaysia. Moreover, many would argue that poverty is underestimated because non-citizens living in Malaysia are excluded from officially reported estimates.

In addition, new challenges are emerging as Malaysia prepares itself to join the league of high-income countries. To revive growth, Malaysia needs to boost its innovation capabilities and increase the knowledge-intensity of its economic activity, which may accentuate disparities across skill levels. Spatial disparities may also widen as geographical clustering leads to greater concentration of economic activity, which is likely to favor urban areas. The restructuring of the sources of growth, along with the need to expose the economy to greater competition, will increase the demand for social protection, not to mention heighten the expectations of a more educated generation of youth. In short, the road towards the high-income economy entails additional risk that some groups will be left behind. This argues for a clear and coherent strategy to make sure that the growth that ensues is also inclusive.

This Chapter addresses the challenge posed by the Prime Minister, namely how to align the goal of promoting inclusiveness within the overall objectives of the country's growth strategy. The Chapter is structured as follows. The first section reviews Malaysia's record on poverty reduction and inequality. While Malaysia has accomplished much in this respect, it may be able to do even better in promoting inclusive growth, in particular by addressing the remaining deep pockets of poverty and persistent inequalities across areas and population groups. Address the question what can be done to reduce poverty and inequality further, the three subsequent sections focus on the following three areas:

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[11] Economic Planning Unit (2010a, p.145).

- *Increasing economy-wide income-earning opportunities.* Malaysia's steady growth has benefitted many. However, there are those who are being excluded because the growth has not translated into steady employment or has not turned self-employment from a desperate last resort to an opportunity to become an independent and creative entrepreneur. This section will highlight policies that reduce the costs of and barriers to labor mobility, increase competitiveness in the labor market to push up wages, and reduce the rigidities in labor market regulations. Together, these measures would help to raise the level of employment, strengthen the labor market matching process, and reduce the degree of informality.

- *Promoting investment in human capital.* Many Malaysians cannot take advantage of income-earning opportunities because they lack the skills to do so. Some never got them in the first place, despite the massive investments that Malaysia has made in its education system. In the case of others, the skill needs of the Malaysian economy have changed more quickly than the educational and training opportunities that are available to them. This section will discuss policies that address these challenges by reducing disparities in the availability of quality basic education among states and between rural and urban areas, restructuring the vocational training system, and ensuring that the skills being produced match the needs of the market.

- *Providing social protection for the poor and vulnerable.* Some Malaysians will not be able to avail themselves of opportunities to increase their incomes or their human capital because of disability, old age, or other factors. Others may require temporary support because of factors beyond their control such as natural disasters or the financial crisis. This last section will discuss policy options to ensure that benefits get to the right people and provide sufficient protection to allow them to take the prudent risks needed to participate fully in today's global economy.

INCLUSIVE GROWTH IN MALAYSIA: SUCCESSES AND CHALLENGES

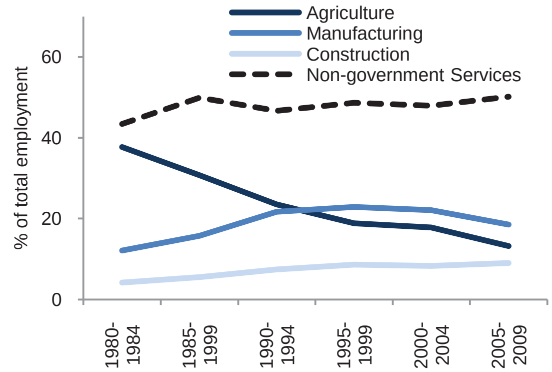
The Malaysian economy has grown at an impressive pace since 1971 when the New Economic Policy was launched. Growth has been accompanied by, and to some extent driven by, a shift in labor away from agriculture towards manufacturing and services sectors (Figure 3.1). Over the same period, there has been a steady process of urbanization in Malaysia. An estimated 68 percent of the population now (as of 2010) lives in urban areas (cities or towns with populations of more than 10,000), up from around 33 percent in 1970.

Large Reductions in Poverty, Improvements in Inequality

In 1970, the incidence of poverty in Malaysia exceeded 50 percent. This average masked even higher rates for some groups. For instance, poverty rates for rural smallholders exceeded 70 percent, and poverty among the Bumiputeras was around 65 percent (Henderson and Philips, 2002; Economic Planning Unit, 2004; Ahmad, 2005; and Nair, 2010).[12] Since then, poverty, especially extreme poverty, has declined dramatically. This is consistent with the government's goal to eradicate extreme poverty by

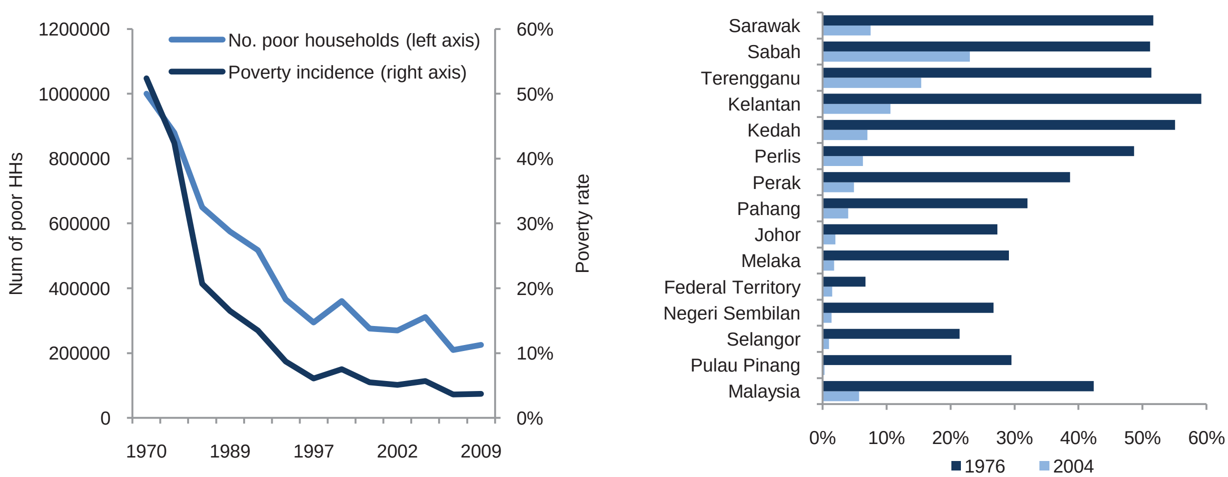
[12] The Bumiputera—translated as "sons of the land"—comprise the indigenous people of Malaysia and consist of the Malay population and various non-Malay indigenous communities.

Figure 3.1. Agricutural labour force have come down significantly since 1980



Source: ILO-Labor stat (2010).

Figure 3.2. The incidence of poverty in Malaysia has declined over time and across states



Source: Data from government reports cited in Nair (2010).

2010 as it accounted for 6.9 percent of households in 1984, compared to 0.7 percent in 2009. In 2009, only 3.8 percent of households were poor based on the national poverty line, around 229,000 households nationally (see Figure 3.2). Moreover, reductions in the incidence of poverty have gone hand-in-hand with reductions in the depth of poverty, from 2.69 in 1995 to 0.8 percent in 2009. With shallower poverty, the transfers or income gains required to lift households out of poverty are more modest than in the past.

In earlier periods, economic growth in Malaysia was associated with a steady reduction in inequality. This can be seen from the fall in the Gini coefficient, a widely used indicator of income inequality, from 0.51 in 1970 to 0.45 in 1990. This decline, which occurred in both urban and rural areas (see Figure 3.4), can be attributed to the rural and regional development policies adopted under the NEP, the development and enhancement of education and training programs, and the rapid expansion of labor-intensive manufacturing and services sectors (Ragayah, 2008).

BOX 7. ABSOLUTE VERSUS RELATIVE POVERTY IN MALAYSIA

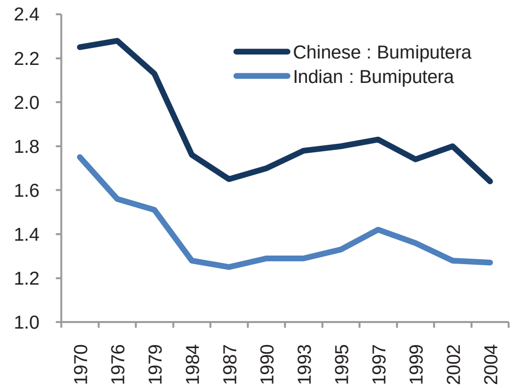
For much of the last four decades, the government's poverty reduction strategy has focused on eradicating absolute poverty—the concern was to ensure that all households had sufficient income to obtain the basic necessities of life, including both food and non-food items. Although the approach to assessing absolute poverty in Malaysia has evolved over time, the central premise is that household income is assessed with reference to a poverty line that reflects the cost of meeting basic nutrition needs as well as minimum costs for clothing, rent, fuel, transportation, and so forth. In the 1990s, the government also introduced the concept of hardcore poverty, defined as having an income less than a half of the poverty line.

An absolute poverty line provides a good basis for assessing progress in reducing poverty over time (provided the line is updated to account for price changes). Trends in absolute poverty are strongly linked to trends in average income, and, as has been seen above, Malaysia has managed to significantly reduce poverty over time. Indeed, in some states or territories, absolute poverty has nearly been eradicated. Yet, the concern with poverty has not faded away, and in 1991 the National Development Policy introduced the goal of reducing relative poverty, which was defined as having an income less than 40 percent of the median income. More recently, the New Economic Model has re-affirmed the government's focus on relative poverty, while also suggesting new thresholds for targeted assistance programs. Relative poverty is effectively a crude measure of inequality and is insensitive to the level of income—it can decrease even as average income falls or fall as average income increases. While this is seen as a limitation by some, relative poverty provides a simple measure of the number of households with "low" incomes and is a useful starting point for understanding the factors—such as unemployment, low compensation, or social exclusion—that explain their predicament.

The incidence of relative poverty in OECD countries is around 11 percent (using a cut-off at 50 percent of median income). However, reflecting differences in income inequality, the incidence of relative poverty varies significantly across countries, from around 5 percent in Sweden and Denmark to over 15 percent in Japan, the US, Turkey, and Mexico. In Malaysia, relative poverty (also using a cut-off of 50 percent of median income) stands at around 19 percent, slightly up from 15 years ago (UNDP Poverty Report, 2008). However, reflecting inequality across and within states and territories, there is substantial variation around this mean.

Between 1970 and 2004, the ratio of average incomes for Chinese and the Malay and non-Malay Bumiputeras has declined from nearly 2.3 to less than 1.7, and over the same period, differences in average income between Indians and Bumiputera also declined, from nearly 1.8 to just under 1.3 (Figure 3.3). The narrowing of these income gaps is likely to be the result, at least in part, of expanded educational opportunities for the Bumiputeras, and a disproportionately large shift of this group towards employment in government, manufacturing and service sectors. The incidence of poverty among Bumiputeras has also been declining more rapidly than for other ethnic groups over the last few decades, from 65 percent in 1970 to 5.2 percent in 2009.

Figure 3.3. Income differentials among ethnic groups have decreased



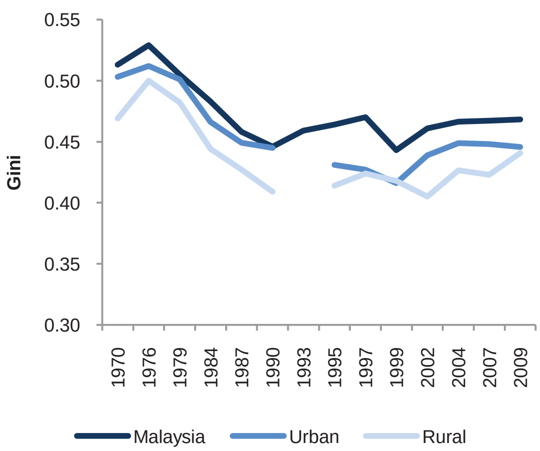
Source: Household income survey

In Spite of These Successes, Significant Challenges Remain

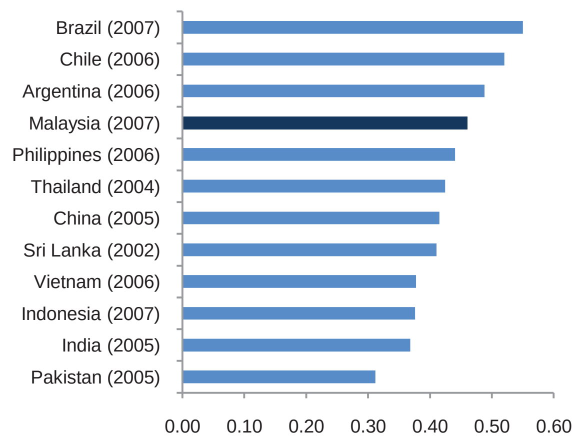
Inequality Has Persisted at High Levels

Since 1984, inequality has remained largely unchanged for the country as a whole, although inequality has decreased in rural areas. Currently (as of 2009), the bottom 40 percent of households account for only 14.3 percent of total income, while the top 20 percent account for nearly 50 percent. Also, despite the declines in inequality in the 1970s and 1980s (Figure 3.4), the Gini coefficient in Malaysia is one of the highest in Asia, not far off from levels observed in Latin America.

Figure 3.4. Inequality in Malaysia remains high over time and compared to other countries



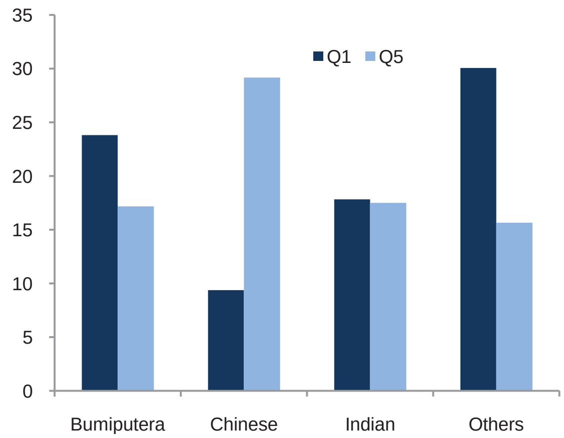
Source: Data from HIS, reported in Ragayah (2008).



Source: WDI and World Bank staff calculations.

There is still significant income inequality within the main ethnic groups, with Gini coefficients being around 0.44 for Bumiputeras, and slightly lower for Indian and Chinese households (Figure 3.5). Analysis shows that with a decline in the gap between average incomes of different groups, inequality in income within ethnic groups accounts for nearly 94 percent of total income inequality in Malaysia. Another way to understand the disparities between and within groups is by looking at the proportion of households in each group represented across the income distribution. Chinese households are bunched in the fifth and fourth quintiles, with fewer than 10 percent in the bottom 20 percent of the distribution. Indian households have a wider distribution, though they tend to be bunched in the second, third, and fourth quintiles. Bumiputera households are mostly bunched around the first, second, and third quintiles; however, the proportion of Bumiputera households in the fifth quintile is around 18 percent, similar to Indian households. About 30 percent of households classified in the others category, which is composed largely of other ethnic non-Bumiputera groups, are in the lowest quintile of the income distribution.

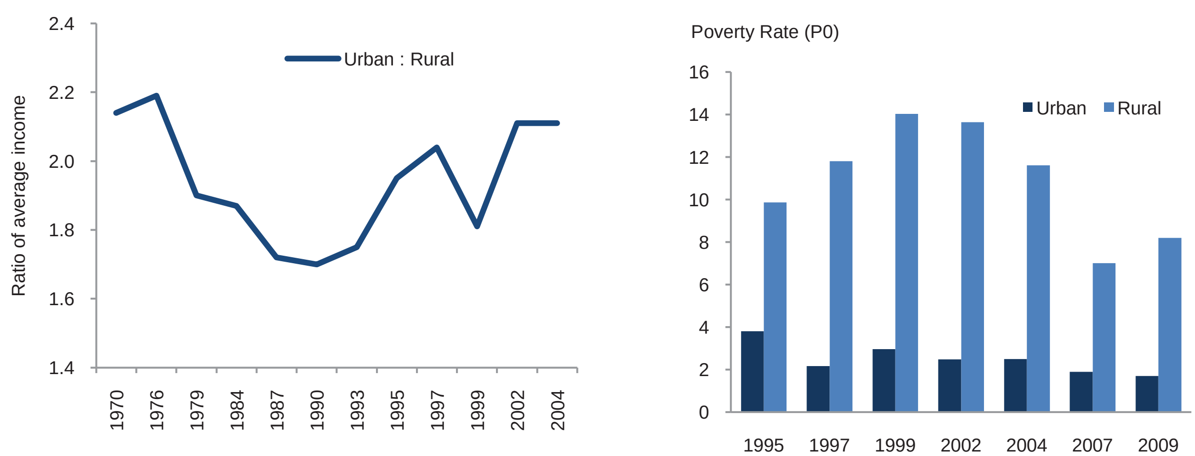
Figure 3.5. The concentration of Indian and Bumiputera households at the top of the income distribution is similar to the concentration at the bottom of the income distribution in 2009



Source: World Bank staff calculations using the Household Income Survey.

In the 1970s and 1980s, there was a narrowing of the income gap between urban and rural areas, but this gap has increased again in the last two decades, and a significant gap remains between urban and rural areas in the incidence of poverty. At least in part, this may be due to the ongoing process of urbanization, with young and employable individuals being more likely to leave rural areas than older workers. Nonetheless, despite these remaining differences in income and poverty, income differences between urban and rural areas account for only 11 percent of total inequality.

Figure 3.6. The poverty gap between urban and rural areas has widened



Source: World Bank staff calculations using Household Income Surveys.

These inequalities are troubling, not only because they are counter to Malaysians' sense of fairness and justice, but because, if other countries' experiences are any guide, they can present significant challenges for the sustainability of development (see Box 8).

BOX 8. WHY DOES EQUALITY MATTER FOR DEVELOPMENT?

The main reason why persistent inequality is a concern for both citizens and policymakers around the world is that egregious disparities violate a sense of fairness, particularly when the individuals affected can do little about them. Recent empirical research shows that the concern for equality is pervasive across cultures, religions, and philosophical traditions, and is thus a fundamental human concern.

Important as this intrinsic concern is, there is also an instrumental relationship between equality and development in two important dimensions. First, inequalities in power and wealth translate into unequal opportunities which, with imperfect markets, can lead to wasted productive potential and an inefficient allocation of resources. For example, if capital markets worked perfectly, one would not be concerned about the distribution of wealth since all those with a profitable investment opportunity would be able to finance it. However, if credit is rationed or if interest rates vary across borrowers in ways that are not linked to default risk, then the allocation of resources would not be efficient. Markets in other assets such as land and human capital are also far from perfect.

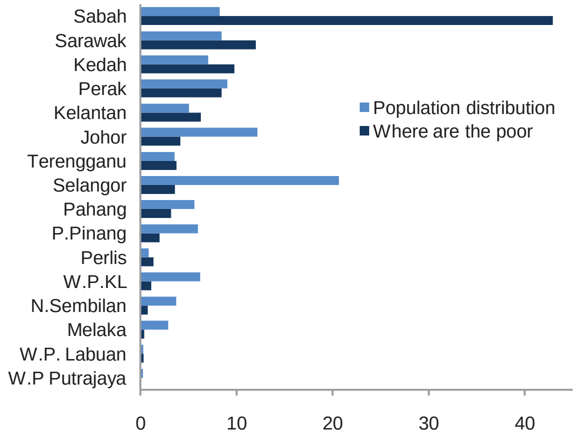
Second, persistent inequality can undermine the development of the sound economic and political institutions that are necessary to safeguard sustained growth. Researchers claim, for example, that the government-controlled marketing boards championed by the elite in power in several African countries led to price regulations that stymied agricultural performance. Examples of such rent-seeking abound in almost all countries.

Deep Pockets of Poverty Continue to Exist

If the objective is to fully eradicate poverty, then the deep pockets of poverty that are found in certain socioeconomic groups as well as in certain areas will need to be addressed. The states with the highest poverty rates are those where the poor have least access to services and employment opportunities.

Even though there have been substantial reductions in poverty in all states, significant differences in income and poverty remain. In 2009, 80 percent of poor households were located in five provinces (Kedah, Kelantan, Terengganu, Sabah, and Sarawak) (Figure 3.7). Thirty-one percent of all poor households live in rural Sabah and Labuan, even though only 3.6 percent of all households are located there. Conversely, urban peninsular Malaysia, home of about 60 percent of Malaysian households, accounts for only 16 percent of the poor. Again, however, there are large income disparities within states, and only about 14 percent of total inequality can be accounted for by differences in income among states.

Figure 3.7. Poverty has declined in all states but remains higher in some



Source: World Bank staff calculations using Household Income Surveys (2009).

All poverty estimates presented exclude foreign laborers. Not counting this segment of the population is likely to be underestimating how many people live in poverty in Malaysia because they are estimated to make up around 15 percent of the Malaysian workforce; and many of them earn low wages. Box 9 explains the evolution of foreign laborers in Malaysia.

BOX 9. FOREIGN MIGRANTS IN MALAYSIA

Malaysia has been and continues to be a major destination for migrants in Asia. International migrants, mainly from other Asian countries, are drawn to Malaysia for better job opportunities and higher wages. Even though labor migration to Malaysia includes many skilled workers, the great majority of labor migration is of low skilled workers. Currently about 1.8 million foreign workers are legally employed in Malaysia. Among these, 38 percent are in manufacturing and the rest are divided between construction, plantations, maids, agriculture and services (Figure 3.8). In terms of geographic location of foreign migrants, in 2003 (the latest data point available), it was estimated that about 78 percent of all foreign workers went to Peninsular Malaysia; the rest went to Sabah (13 percent) and Sarawak (9 percent).

Malaysia's experience with migrants goes back to its origins. During the period of industrialization the development strategy and, in consequence, economic activity was significantly focused on labor-intensive economic activities (such as the assembly-based electrical and electronics industry); as industry grew, so did labor shortages making the need for labor migrants more accentuated.

As the flows of migrants continued to increase, the government put in place a variety of labor regulations pertinent to migrant workers. These laws changed over time and in 1968 the Employment Restriction Act made labor migration into the country contingent on holding a work permit or labor contract. The policies outlined in the Act were meant to encourage more highly skilled labor to enter the country, while discouraging the influx of low-skilled labor. In spite of this, low-skilled migrants, particularly from Indonesia, continued to come into Malaysia through old routes. Given the limited sets of skills of most labor migrants, their sectoral mobility remained limited to primary sectors (such as

Figure 3.8. Foreign workers are mostly concentrated in low-skill sectors and come from Indonesia

(January-June 2010)

Source: Immigration Department, 2010

agriculture) and construction (Kaur, 2006).

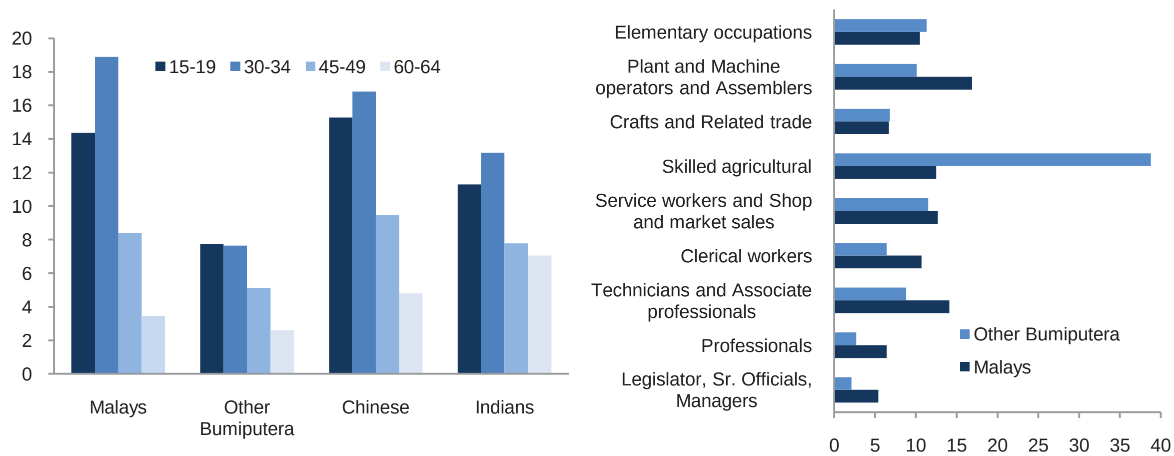
Several key regulatory changes in the country came about in the early 1970s under the New Economic Policy. During this period the Malaysian government put in place an industrialization plan as well as many large scale development projects. During this period the manufacturing industry registered significant impetus. In addition, the construction and plantation sectors also continued to develop, all of which amplified existing labor shortages.

To help remedy labor shortages, the government made modifications to the labor code. These modifications—such as legalized foreign labor recruitment and temporary contracts—allowed foreign workers to come legally into Malaysia to work. During the 1970s and 1980s the government kept a more or less tolerant approach to labor migration; however, this changed in the latter part of the 1980s when government began to regulate migration more stringently and made changes to the process. As part of the modifications, the government began to charge levies to companies who employed foreign laborers, where the magnitude of the levies varied according to several factors and has been revised upwards over time (Kaur, 2008). In the 10th Malaysia Plan, a multi-tiered levy mechanism was introduced. This new levy system will be implemented to encourage less use of low skill migrant laborers.

After the Asian Financial crisis in 1997/1998, the government put in place a more organized and regulated work-permit system, which had clearer enforcement rules and outlined penalties for those who did not abide. The system was mainly designed to control the number of low skilled workers that came into the country. In the case of skilled workers the system was designed as a work pass and was tied to an economic activity in most sectors (including self-employment); on the other hand, permits for low skilled workers were strictly limited to a job and specific sectors (Kanapathy, 2006). The government also entered into bilateral agreements with sending countries, through memoranda of understanding, to improve control of the flow of legal migrants. In parallel to these activities the government amended the labor code (namely the Employment Act) to protect local workers from being displaced by foreign workers. No employer could terminate the contract of a Malaysian and then hire a foreign worker; during down periods, when employers need to retrench workers, all foreign workers must be dismissed before a Malaysian is dismissed (Sreenevasan, 2006).

Also, even though the incidence of poverty among Bumiputeras has been declining steadily over the past decade (from 12.2 percent in 1995 to 5.3 percent in 2009), there is large variation within the group. Because of data constraints, most of the data used throughout this chapter aggregate all groups under the Bumiputera label, making it difficult to differentiate across groups, but it is nevertheless possible to draw some conclusions. Most poverty reduction has been achieved by some groups (namely the Malay) while the non-Malay ethnic groups classified under Bumiputera remain more heavily represented among the poor. According to the 2000 census, the younger generation of Malays (aged 15 to 34 years old) have higher post-secondary and tertiary educational attainment than any other group in the country, including non-Malay Bumiputera groups (Figure 3.9). The same disparity is evident in terms of occupation; non-Malay Bumiputeras are significantly less likely to work as legislators, senior officials, managers, or in the main professions (such as doctor, lawyer) than Malays. Both disparities have direct implications for income (Mohamad, 2005). As a result, inequality within the Bumiputera group has worsened in the last decades (Lee, 2000 and Haque, 2003).

Figure 3.8. A wide diversity exists within the Bumiputera group in terms of education levels and types of employment (2000)

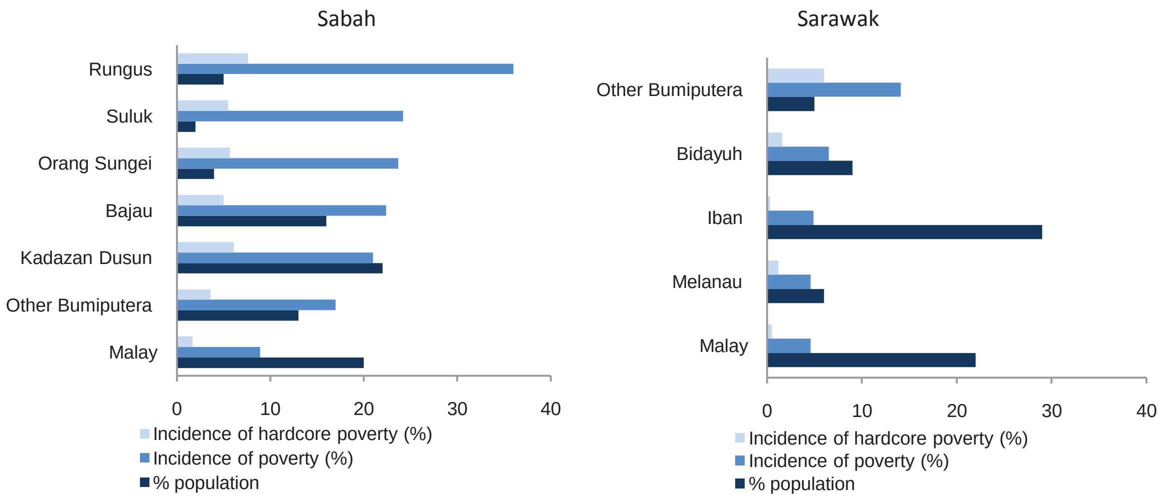


Source: Malaysia Census 2000.

Two recent reports by the EPU and UNDP in two of the poorest states in Malaysia (EPU/UNDP, 2010) have shown that indeed there are clear differences in economic status between the various ethnic groups within the Bumiputera group. For example, in Sarawak in 2007, the Melanau and Malay had a significantly lower poverty incidence (4.6 percent) than the other Bumiputera groups, which had 14 percent incidence. In the same year in Sabah, the non-Malay Bumiputera had a poverty incidence of 17 percent, while the Malay had nearly half that amount (Figure 3.10).

However, even in urban areas, poverty persists in slums, which are difficult to eradicate. How much human capital a person has and whether they are a migrant are two critical factors behind much urban poverty; for example, having a higher than average level of education significantly reduces the chance of being poor. Box 10 indicates that these areas are substantial.

Figure 3.9. Poverty incidence varies significantly among ethnic Bumiputera groups (2007)



Source: EPU and UNDP (2010) using Household Income Survey.

BOX 10. URBAN POVERTY REMAINS AN INTRACTABLE CHALLENGE

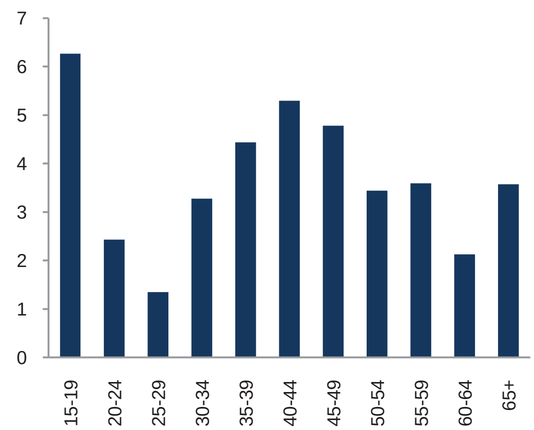
Urbanization is part of the economic development process and is a stated goal of the Malaysian government. Movement from rural to urban areas has been taking place in Malaysia for decades, and the rapid change is likely to be causing a geographical shift of the poor (Mok, Gan, and Sanyal, 2007). In the last five-year period, about 2.5 percent of households moved out of rural areas. One can posit whether this population shift, from rural to urban sectors, has contributed to decreases in overall poverty in Malaysia given that workers have access to new employment opportunities (and higher wages) in expanding non-agricultural sectors. Future analytical work can help determine whether this is true or not.

However, urban poverty has remained largely unchanged, with the incidence of poverty in urban areas remaining at around two percent over the last decade. Recent analysis of urban poverty in Malaysia has shown that the formerly rural households who have moved to urban areas tend to have low levels of education and tend to become employed in low-earning sectors where skill requirements are limited (Ragayah, 2008).

Pockets of poverty are also found in households headed by women. Male and female headed households have similar poverty incidence rates (four percent), but female headed households have higher probability to be poor. The proportion of poor male-headed households is larger than that of females; however, this seemingly disproportionate presence of male-headed households among the poor is due to the fact that only 15 percent of all households in the country are headed by females. Taking into account various demographic characteristics—namely household size, age of household head, number of income earners—evidence shows that female headed households indeed have a higher probability of being poor, relative to male-headed households. Recent poverty analysis focused on Sabah found that the incidence of poverty for female-headed households in that state was 22 percent, compared to seven percent for male-headed households (Economic Planning Unit and United Nations Development Programme , 2010).

Many of the poor are also concentrated among households headed by someone in their prime working years (30 to 59 years of age). In 2009, households headed by someone aged between 30 and 59 had a higher probability than others of being poor. Even when other demographic factors are taken into account, this result still holds. Figure 3.11 illustrates the density of poverty among this group. Further analysis has shown that, even though most of these people are working, many have earnings that are lower than the poverty line.

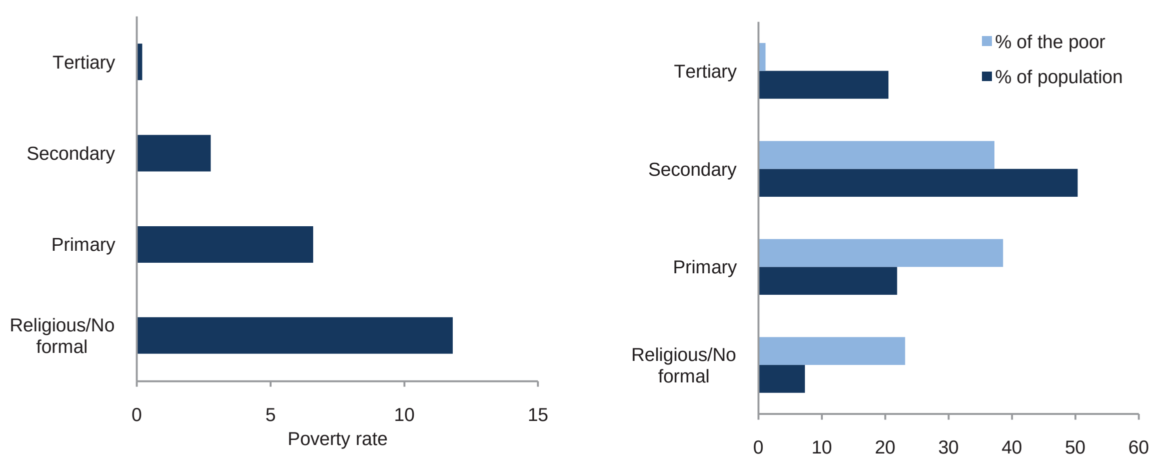
Figure 3.10. The poverty rate among the working age population is high (2009)



Source: World Bank staff calculations using Household Income Surveys.

Another important correlate of poverty is education. Households whose head has a non-formal education level have a 12 percent incidence rate, and these account for almost 10 percent of all households in the population. On the other hand, households headed by someone with a secondary level of education have only a 4 percent incidence rate of poverty, and they account for over 50 percent of all households (Figure 3.12).

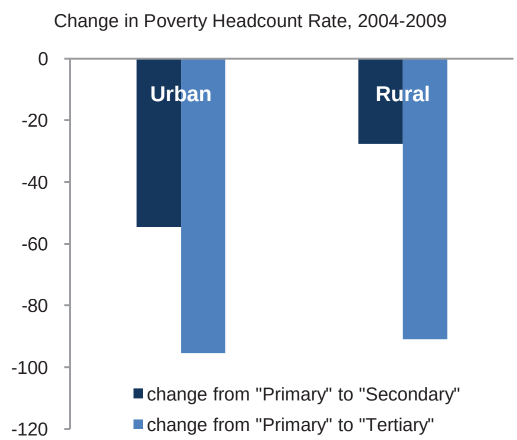
Figure 3.11. Poverty incidence is higher among those with a lower education level



Source: World Bank staff calculations using Household Income Surveys.

Eradicating these deep pockets of poverty may be costlier for Malaysia than it was in the past because most of these heads of household live in remote areas that are difficult to access. Figure 3.13 shows that, as the level of education of the household head changes from primary to secondary level, the probability of being poor declines by 54 and 28 percent in urban and rural areas respectively. The probability of a decrease in poverty is significantly higher—90 percent in urban areas—if the change in educational level is more drastic, from primary to tertiary. This indicates that education affects income differently in urban and rural settings.

Figure 3.12. Increasing educational attainment reduces the chance of being poor by less in rural than in urban areas



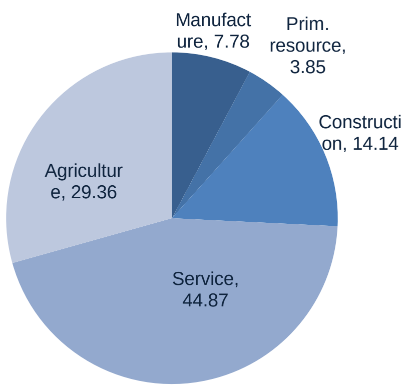
Source: World Bank staff calculations using Household Income Surveys.

Reaching the poor in rural areas where economic opportunities are scarce is a clear challenge. People working in primary sector activities like agriculture have a high poverty incidence, around 13 percent, compared with manufacturing or service workers. Despite increases in agricultural growth output and favorable commodity prices, average incomes in the primary sectors (such as agriculture, fisheries, and forestry) are lower than in other sectors. Unfortunately, many people, especially with low educational levels, remain unable to move into more productive sectors where wages are higher. Of all the poor, about 52 percent work in a primary-sector activity, even though only 15 percent of all household heads work in these sectors. The poor in Sabah, for example, are largely self-employed in low-productivity primary-related sectors, and, of those who are engaged in wage employment, most work in services and activities that pay low wages.

Informal workers are another segment of the Malaysian workforce with high poverty levels. Informal employment is defined as own-account work or working for a wage but with the employer making no contributions towards the worker's social security, pensions, and benefits (EPF, SOCSO, health benefits, and paid leave). About 35 percent of all household heads in 2009 were classified as informal workers. Most of these workers are employed in agricultural work (29 percent) and in service sector jobs (45 percent) (Figure 3.14). Among informal workers who are poor, more than half (59 percent) are employed in primary resource sectors (agriculture, forestry, and fishing); the rest are employed in low-skilled service jobs and in the construction sector (Figure 3.15).

Figure 3.13.Most informal workers are in the agricultural and service sectors

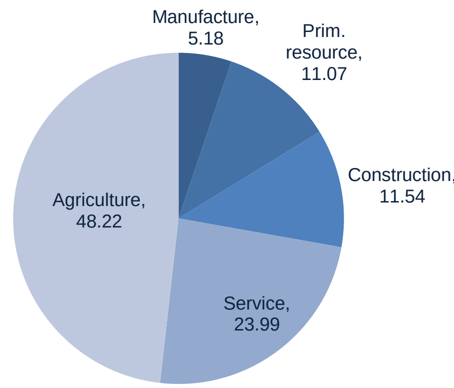
Percentage (2009, all households)



Source: World Bank staff calculations using Household Income Surveys.

Figure 3.14.Most informal workers who are also poor work in primary resource sectors

Percentage (2009, poor households)



Source: World Bank staff calculations using Household Income Surveys.

Informal employment is prevalent in both rural and urban areas. However, the types of activities that these workers perform depend on the strata they live. In rural areas, informal workers are typically employed in family-owned enterprises and on smaller farms or plantations. In urban areas, most informal employees are concentrated in the wholesale and retail trades, in hotels and restaurants, and in construction jobs. According to a pilot study of informality in Malaysia (Mohammad, 2004), about 57 percent of all informal employees in the sample (urban areas only) worked in a sole proprietorship; the rest of the informal employees worked in enterprises that had been established as partnerships and limited corporations.

Many Households Are Vulnerable to Shocks

The share of households clustered above the poverty line has declined between 2004 and 2007, but there has been no change—even a slight increase—between 2007 and 2009. This can be most likely attributed to the negative effects of the financial crisis. Clustering indicates that even small changes in income (or the poverty line) can result in significant changes in the poverty rate. For instance, a 10 percent increase in the poverty line (or a corresponding decline in incomes) would increase the poverty headcount from the 3.7 to 5 percent—an increase of 34 percentage points (Table 3.1). Hence, a substantial number of households are at risk of falling into poverty as a result of unemployment, loss of income, or other reasons.

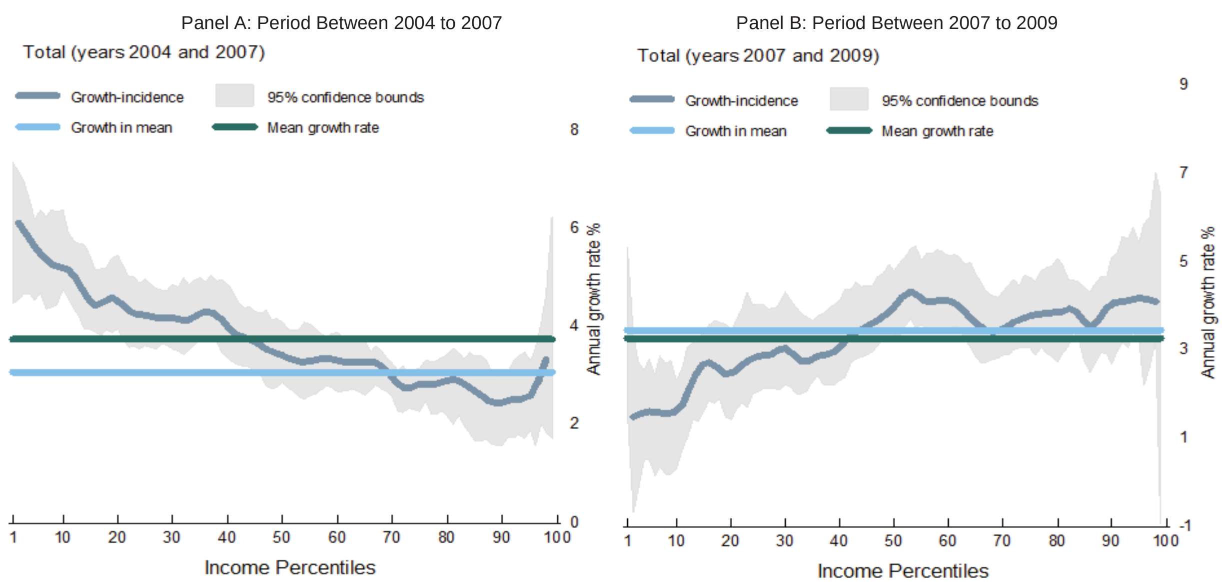
Table 3.1 Even small changes in income (or the poverty line) can result in significant changes in the poverty rate because of the clustering of households around the poverty line

	2004		2007		2009	
	Poverty Headcount Rate (P0)	Change from actual (%)	Poverty Headcount Rate (P0)	Change from actual (%)	Poverty Headcount Rate (P0)	Change from actual (%)
Actual	5.6	0.0	3.5	0.0	3.7	0.0
5%	6.2	11.0	4.1	16.4	4.3	15.7
10%	7.0	24.8	4.7	32.9	5.0	34.4
20%	8.6	54.7	6.1	74.4	6.4	70.7
-5%	4.8	-13.2	2.9	-16.1	3.2	-14.6
-10%	4.1	-25.7	2.4	-30.4	2.7	-27.0
-20%	2.9	-47.9	1.6	-54.5	1.8	-51.8

Source: World Bank staff calculations using Household Income Surveys.

In the last five years, the incomes of the poor in Malaysia have grown substantially, at an even faster rate than those of the wealthy. The growth incidence curves shown in Figure 3.16 (panels a and b) illustrates how the gains from growth in Malaysia were distributed by showing the incidence of growth experienced by each segment of the income distribution. Between 2004 and 2007, the pattern was downward sloping, which means that the poorer gained more than the wealthier. In fact, the mean growth rate for household income was around 4 percent per annum, and the growth rate of the bottom 40 percent was much higher. However, in the aftermath of the 2008 financial crisis, there was a slowdown in the growth of the incomes of the poor. This raises doubts whether the poor are able to weather macroeconomic shocks. Figure 3.15 (panel b) shows that, in the period between 2007 and 2009, the mean growth rate for household income was around three percent per annum, but the growth rate of the bottom 40 percent stayed below the mean, varying between one and three percent.

Figure 3.15. The incomes of the poor in Malaysia have grown faster than those of the wealthy



Source: World Bank staff calculations using Household Income Surveys.

RAISING ECONOMY-WIDE INCOME-EARNING OPPORTUNITIES

Despite Malaysia's stellar growth record over the past few decades, there is a widespread recognition that the dynamism of its economy has weakened following the Asian financial crisis. This is reflected both in a significant slowdown of economy-wide productivity growth and a lack of recovery in the private investment activity relative to GDP. As the previous section illustrated, while Malaysia has booked significant success in reducing poverty, inequality has remained persistently high. Some of the inequality in Malaysia, as in other countries, can be traced to various dimensions of unevenness in the growth process arising from imperfections in the enabling environment that constrain economic opportunities.

Future success in reducing inequality will require reviving the dynamism of the Malaysian economy and ensuring that all Malaysians have the opportunity to participate in the growth that ensues. This would require measures to improve the investment climate, promote innovation and incentivize investment, which subsequently can help reduce the scope for inequality (Thomas, 2007).[13] In this process there are at least three factors that need to be addressed to reduce inequality in Malaysia: (i) the costs of and barriers to internal labor mobility; (ii) barriers that prevent firms from entering the market and investing; and (iii) rigidities in the labor market.

This section will focus primarily on the important role that labor markets are expected to play in addressing Malaysia's inclusive growth challenges. The section starts off by presenting evidence of how key constraints to labor markets affect poverty and inequality. It then goes on to make a number of policy recommendations to strengthen the functioning of labor markets in support of the objective to raise economy-wide income-earning opportunities for all.

Key Challenges in the Functioning of Labor Markets

Internal rural to urban migration is one way in which workers respond to the wage disparity between rural and urban job markets (Ray, 1998). In Malaysia, income differentials between urban and rural areas and among states account for a significant share of income inequality. To narrow the gap, the Malaysian government has put in place policies that promote development in less developed areas and encourage the population to move from one geographic area to another. It has also put in place a variety of programs that give industry incentives to locate in less developed areas. Even though there has been measurable success in terms of poverty reduction in these areas, the availability of higher paying jobs remains significantly lower than in urban centers. Therefore, many laborers choose to emigrate in search of better labor opportunities but are often unable to afford the costs of transportation and living costs at their destination until they get a job.

A recent survey in Malaysia showed that, of all those who moved across administrative boundaries, half migrated within the state, one-third migrated to a different state, and a small percentage were international migrants. Figure 3.17 illustrates the movement of the population across administrative boundaries between 1995 and 2000. For example, over 20 percent of 25 to 29 year olds emigrated away from their place of origin, and that age cohort makes up 19.5 percent of all internal migrants.

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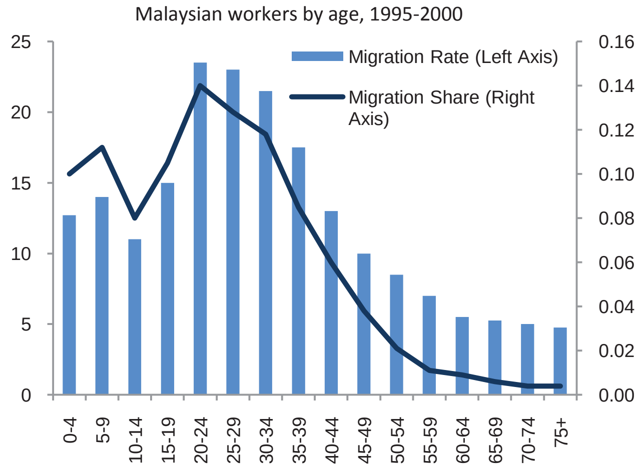
[13] The broader investment climate issues have been the focus of the April 2010 *Malaysia Economic Monitor—Growth through Innovation.*

Figure 3.16. Internal migration is a common strategy for increasing job opportunities



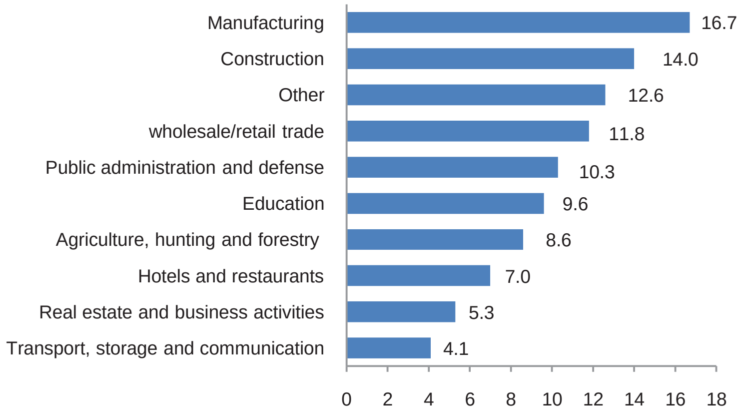
Source: Malaysia Census, 2005

Constraints to Internal Mobility of Labor

A recent report found that transportation costs from Sabah, Labuan, and Sarawak to Peninsular Malaysia are high and nearly prohibitive for most workers. These costs are lower for villagers from Terengganu, where migration to urban areas is one of the key strategies for exiting poverty (Qiaolun, 2006). The same report found that, in Sabah, workers carefully calculate the costs and risks of migrating before leaving their villages. The main factors that they consider are transportation costs, the risks and expenses of job hunting including the costs of housing and food during the migrant's first few days in the city, the level of potential wages, the urban versus rural cost of living, and the possibility of encountering unexpected difficulties. Even when cost is not a problem, potential migrants can face other policy constraints. For example, a clause in the migration policy (Clause 3, Article 9) requires the approval of the state before West Malaysians can move into or work in East Malaysia (namely Sabah and Sarawak) (Harding, 1996; and Sadiq, 2009).

The primary reason why Malaysians migrate is to access jobs that pay higher wages, and this was borne out in a recent study by the Department of Statistics (DOS, 2006). In other Asian countries, it has been estimated that labor migrants from rural areas earn three times the average income of a typical rural worker with an equal skill level. However, despite the prospect of earning higher wages, low-skilled internal migrants face other difficulties, including finding a suitable job and adequate housing. Low-skilled laborers have more of these kinds of problems than skilled laborers because there are more of these workers and, therefore, more competition for a limited number of decently remunerated low-skill jobs (Siwar and Kasim, 1997). As a result, many low skilled migrants—domestic and foreign—get segmented into informal sector work and low-paying jobs. Figure 3.18 shows that 60 percent of internal migrants work as manual laborers (in manufacturing, construction, and services), and only about 20 percent work in civil service jobs.

Figure 3.17. Most internal migrants work as manual laborers
By industry, 2007



Source: Labor Department presentation, using Labor Force Survey, 2007

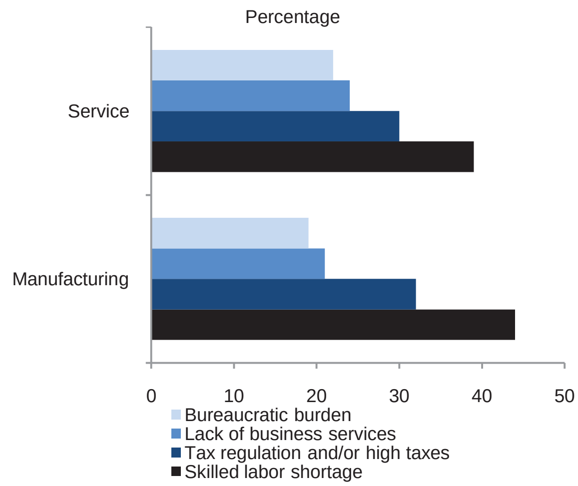
A recent study of internal migration has confirmed that internal migrants take jobs in the lowest remunerated occupational categories. As a result, the poverty incidence among these groups and inequality in urban areas both continue to rise (Ragayah, 2005). Other studies have confirmed that, among the urban poor, migrants (both internal and international) figure prominently. The study found that, other than having few skills and limited access to information, migrant groups also lack community cohesion and informal social support systems because they come from different places (historically, Malay migrants came from Kampongs and Indian migrants came from Estates) and have distinct ethnic backgrounds. Also, migrants often have limited knowledge of services available to them, including of low-cost housing options. Hence, many of them are forced to live as squatters or in temporary shelters.

Constraints to Labor Market Competition

In non-competitive labor markets, employers have more bargaining power than workers and are able to keep wages down. There is evidence that in Malaysia workers do not get a fair share of output. The main non-competitive aspects of Malaysian markets are the excessive bureaucratic red-tape, regulatory burdens, and tax-related costs, all of which dissuade investment, new firm creation, and firm operation (Figure 3.19). In 2007, the average number of days it took manufacturing firms to obtain licenses from the federal government was five days, with the estimated time being slightly lower from the state government. The percentage of both manufacturing and services firms that had to incur the additional costs involved in hiring consultants to deal with permits, licenses, and approvals was 14 percent and 9 percent respectively. It took manufacturing firms three days to clear their exports and four days to get import clearances.

According to the Doing Business Indicators produced by the International Finance Corporation, Malaysia ranked tenth among 24 countries in the region in terms of creating a business, thirteenth in terms of registering property, nineteenth in terms of dealing with construction permits, and fourteenth in terms of labor costs in 2008. Some of these estimates improved slightly These statistics suggest that it is more difficult to create a new firm in Malaysia when an opportunity arises than in neighboring countries like Singapore, Hong Kong, or Thailand, all of which rank higher than Malaysia on these measures. Therefore, existing firms have little to fear from new competition and can maintain wages below productivity without worrying that their workers will have access to other higher-paying opportunities.

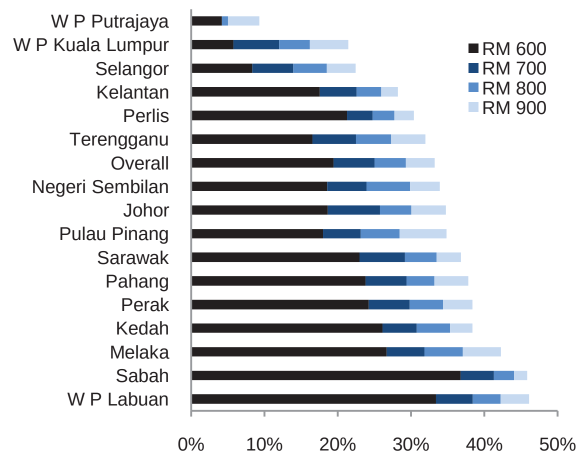
Figure 3.18. Regulation and administrative costs are key obstacles in doing business in Malaysia



Source: Productivity and Investment Climate Survey, 2007.

Figure 3.19. The variability of wages in manufacturing and construction differs by geographic area

Share of workers earning less than various wage levels



Source: Enterprise Surveys, Department of Statistics, 2010

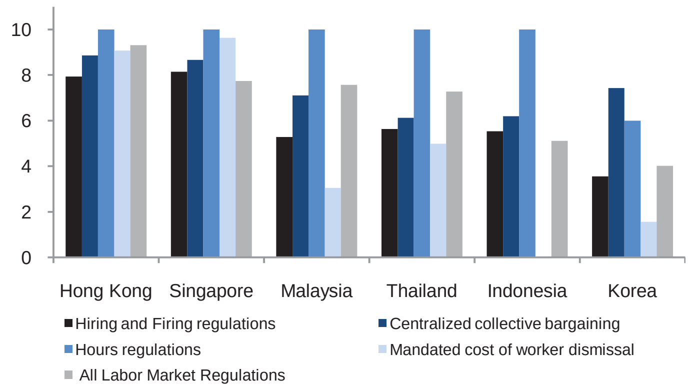
Non-competitiveness is also evidenced by the fact that wages have not been growing in line with labor productivity growth. According to the Malaysia Productivity Corporation wages in Malaysia are kept low mainly because industry profits are often derived not from innovation and creativity but from low wages Malaysia Productivity Corporation, 2009). The fact that employers can keep wages at low levels despite their productivity gains implies that workers at the bottom of the wage distribution will be unable to maintain a decent standard of living. And low wages can encourage workers at the top of the wage distribution to migrate to other countries where they will be better rewarded for their skills.

Recent analysis has confirmed that wages remain low in relative terms for certain categories of workers (mainly the low skilled). For example, about 66 percent of all formal workers in the manufacturing and construction sectors earned less than RM 900. This represented 18.8 percent of the working age population in Malaysia in 2008. Within the same sectors, 44 percent earned RM 600 or less, indicating that there is large variability despite the fact that, at both wage levels, over 91 percent of workers had less than a secondary education (World Bank, 2010d). The variability of wages also differs by geographic area. For example, in Sabah, more than 35 percent of workers in construction and manufacturing earn RM 600 or less, while in W.P. Putrajaya, only about 3 percent of workers in the same sectors earn that amount (Figure 3.20).

Rigidity of Labor Market Regulations

Excessive regulation imposes economic costs on firms. Much of the literature has found that too much regulation, especially product market and labor regulation, deters labor productivity growth (Klapper et al, 2006). There are several ways in which regulation can affect the aggregate performance of the economy. First, it affects the allocation of resources among firms and sectors with different productivity levels, thus reducing overall efficiency. Second, regulation can affect the level of productivity of existing firms by changing their incentives to use factors of production of more or less intensely. Third, regulation gives firms a disincentive to innovate and upgrade their technology and expand their operational capacity. While labor regulations may induce higher capital intensity, when they impose excessive costs, they can lead to unemployment, underemployment, and informality.

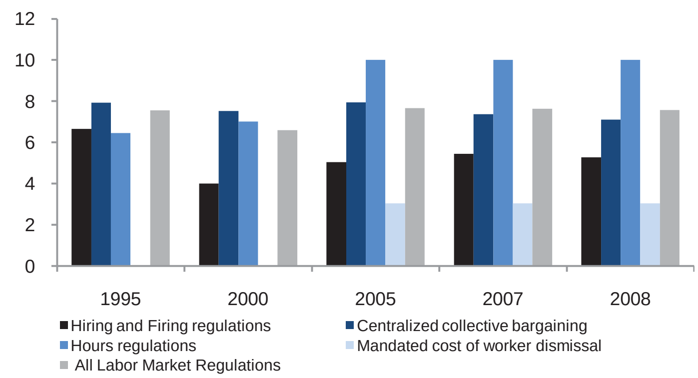
Figure 3.20. Malaysia ranks low in the region in terms of labor market flexibility



Source: Fraser Index of Freedom, 2009

A worldwide survey of labor market flexibility, which rates all countries according to six distinct categories—hiring and minimum wage, hiring and firing, centralized collective bargaining, hours worked, mandated costs of worker dismissal, and conscription—shows that Malaysia moved down in the ranking over a 20-year period (dropping from 15th in 1990 to 22nd in 2008). Although Malaysia still ranks well relative to most countries, it is far below Singapore (1st in the ranking on labor flexibility) and Hong Kong (3rd in the overall ranking). Figure 3.21 shows that its low score is mainly due to the burden put on firms by the mandated costs associated with worker dismissal and by hiring and firing regulations.

Figure 3.21. Hiring and firing and labor dismissal regulations lower the overall labor regulation ranking



Source: Fraser Index of Freedom, 2009

A concern raised by employers during recent consultations with World Bank labor experts was that labor regulations have not been adjusted to reflect market changes and economic fluctuations. As a result, firms wanting to expand or invest have been deterred from doing so. Over time, Malaysia's ranking with respect to hiring and firing regulations has gone down (Figure 3.22). Its rating for collective bargaining has also moved down slightly, but, relative to other countries, Malaysia still has low unionization (estimated at 11 percent of all workers) so its rating in this category remains high. With respect to regulations regarding worker dismissals, its score remains very low, far below a perfect 10. On the other hand, in Malaysia, regulations on the number of hours that employers can impose on workers remain flexible, indicating that employers can potentially pay the same wage for longer shifts.

Policy Options for Strengthening the Functioning of Labor Markets

One of the most important ways in which people can contribute to a country's economic progress is by being productive members who actively participate in the labor market. On the other hand, persistent unemployment and/or underemployment act as a form of social exclusion, thus limiting any strategy of inclusive growth (Felipe, 2010). So to ensure that adequate employment opportunities are created and are available to all those who want them, policymakers must design interventions that promote investment but keep a balance between efficiency and equity (Thomas, 2007). This section focuses on several areas—reducing labor mobility costs and information asymmetries, providing more training and comprehensive employment services, increasing market competition by reducing the administrative and regulatory burden, and easing labor market rigidities—in which the Malaysian government can intervene to further its inclusive growth strategy.

Reducing Job-Search Costs and Disseminating Market Information More Widely

Market forces often encourage the geographic concentration of people and economic activities. As a result, workers are often drawn to migrate to those areas to access better jobs. To ensure that migration improves the welfare of workers and continues to promote inclusive growth, the government could consider adopting policies that will reduce any negative effects resulting from internal migration on migrants and their communities. These policies would need to focus on reducing information costs, increasing access to employment services, and other dimensions reviewed below such as encouraging human capital formation and increasing access to social protection benefits.

Generally, information barriers in labor markets limit workers' access to suitable employment opportunities. Workers looking for jobs have only limited information about where those jobs are and about their characteristics. On the other side, employers have only limited information about the types of people who are available to work. Prior to moving, migrants need to find out whether their skill set is in demand in other places and whether the potential remuneration would be worth the move. The government can ease the high costs of the job search process either by providing employment-related information itself or by supporting or encouraging NGOs or the private sector to do so.

However, if the government chooses to provide labor market information, it is important that the information is closely based on industry demand, is accurate, caters to all kinds of different workers, and is regularly updated. To reach the maximum number of workers, it would be better to have a decentralized system that is customized to the needs of workers in each locality. But, all information services would need to be linked with each other through information technology to provide the most comprehensive job market information system and to prevent having employers post jobs in various places.

Providers of job information services can also offer intermediation and counseling service that caters specifically to poor and vulnerable groups. This service would aim to prepare workers for the job search process and, whenever possible, match them with jobs that offer pre-employment training. Counseling and intermediation services can also involve providing job lists, helping people prepare their curriculum vitas, explaining what a particular job entails, and preparing workers for interviews.

Providing More Training and Comprehensive Employment Services

Many best practice examples of employment services around the world not only provide information services but also training and competency assessment programs. This labor market access service is typically designed as a one-stop shop where workers can conduct their job-search and receive training to ensure they have the skills that are in demand on the job market.

As workers become more skilled, their productivity increases and their incomes rise. Given that most internal migrants tend to have few skills and low levels of education, improving their job-relevant skills though vocational training is crucial. However, the training would not just be aimed at helping potential migrant workers to move to new areas; it would also need to be more broadly aimed at improving the abilities of workers in general.

Two types of training can be provided—pre-employment training and on-the-job training.

- First, pre-employment training needs to be provided before the worker migrates and/or finds a job. The government's role is to ensure that these training centers follow an accreditation system, thus guaranteeing that workers receive quality training and employers know (and trust) what is being taught. People in low-income groups, particularly school drop-outs or students in post- Sijil Pelajaran Malaysia (SPM), can be targeted to participate in the training, to receive scholarships, and to receive a graduation bonus that can be used to cover transport costs or housing costs if they choose to migrate.

- Second, skills training and on-the job training. The government can give firms financial incentives to provide on-the-job training and apprenticeships. These can be especially reserved for trainees in the low-skilled and low-income segment of the workforce. The government could use levies, as it currently does, to raise the necessary resources to fund these training opportunities but would also need to ensure that the training is targeted to poor and vulnerable groups.

A further area where government can help internal migrant workers is by expanding its social protection coverage in order to help workers while they are in transition and have no income. A later section of this chapter will elaborate on this point.

Increasing Competition, Reducing Administrative and Regulatory Burdens

Bureaucratic red-tape and excessive business regulation often have an adverse impact on economic performance. There are two complementary explanations for why they have this effect. The first is the efficiency costs involved for firms in fulfilling bureaucratic requirements and complying with regulations. Because excessive regulation can prevent firms from allocating their resources towards efficient uses (or forcing them to spend them inefficiently) this can exacerbate firms' financial problems during recessionary periods and, thus, reduce growth. The second explanation is the efficiency costs involved in evading regulation if firms decide to try to circumvent the legal framework by becoming informal enterprises (Loayza, Servén, and Sugawara 2010).

There are several ways to improve the regulatory environment to attract new firms, induce further investments by firms, and increase competitiveness in the market (Quimiao Fan, 2006).

- First, a comprehensive review could be undertaken of the regulatory environment with the goal of streamlining, updating, or eliminating all regulations that impose high administrative costs. Such review would start with an analysis of whether the rules and regulations included in the Industrial Relations Act of 1967 still support the government's goal of turning Malaysia into a knowledge-based, high value-added, and high-income economy. This review could be repeated at regular intervals. After the financial crisis of 1997, Korea reviewed 11,000 of its business regulations and eliminated 50 percent of them, which contributed to its economic recovery. China undertook a similar approach prior to joining the World Trade Organization.

- Second, current procedures governing how new investments can be made and how businesses can be set up and operated could be reviewed. Through this review, the government will be able to assess whether existing rules and procedures can be streamlined and simplified. The government could make use of technology as much as possible to increase accessibility to administrative processes and reduce business costs.

- Third, the government may consider adopting innovative ways to reduce delays and uncertainty regarding applications of licenses and contracts. For example, what is known as the "silence-in-consent" rule switches the burden of action onto public administrators by setting a time limit from them to respond to applications to register a new firm or product. If administrators fail to act within that pre-set time limit, the business is automatically approved. In Spain and Serbia, this strategy has substantially reduced the amount of time required to register a business or a product.

- Fourth, the government may also consider moving away from requiring firms to obtain permits before they begin their activities (*ex-ante* license) to *ex-post* controls. Obtaining permits can be a very cumbersome process for small and medium-sized enterprises (SMEs), and in many cases, the process can be vulnerable to corruption. By moving to ex-post control, a firm would send a notification to the public authorities of its existence but would be able to start operating as soon as that was done. The government would conduct regular audits to ensure compliance.

Easing Rigidities in Labor Market Regulation

The combination of rigid labor regulation and weak income protection can discourage investment and limit job creation. High costs of labor in Malaysia are mainly the result of difficulties in hiring and dismissing workers; an example is mandatory severance payments that firms must make to workers when they are dismissed. Passing legislation that would reduce these costs may likely accelerate dynamism in the labor market—both of job creation and job destruction—thereby increasing turnover, particularly in the formal sector. While high turnover in the labor market may seem to be an unwanted development from the perspective of workers, there is growing evidence that the lower turnover associated with the high costs of dismissal (as is the case in Malaysia) is associated with lower productivity growth.

How can government reduce the regulatory burden on firms and, thus, promote productivity increases? The Malaysian government could consider reviewing its current regulations to determine whether they are consistent with promoting productivity and inclusive growth, particularly those in the Employment Act of 1955 and the Industrial Relations Act of 1967. Two areas on which policymakers could focus are dismissal costs and hiring and firing regulations.

Best practices around the world show that innovation and job creation increase when governments eliminate inflexible rules regarding the firing of workers and adopt flexible laws that give employers more capacity to manage their human resources. For example, if the law allows firms to terminate redundant workers and to hire workers on flexible contracts (for part-time or seasonal work), then businesses can adjust their workforce as needed to increase their productivity.

However, the government also has a duty to help workers who lose their jobs and prevent them from falling into poverty. The most effective way to do this would be to increase the mobility of workers—among firms, sectors, and localities—through a combination of income protection policies and a more proactive approach to upgrading their skills (World Bank, 2010e). On the income protection side, providing social protection is an alternative to imposing high dismissal costs on firms. For example, many countries have introduced unemployment benefits based on savings, a relatively new system that is an alternative to the traditional unemployment insurance system (Robalino et al, 2009). This approach reduces work disincentives by allowing workers to keep their own unused unemployment contributions. Another advantage of this system is that it can also be extended to informal sector workers, who, as shown earlier, account for more than 30 percent of the Malaysian workforce.

On the skills side, government can develop skills training by improving the quality and increasing the acceptability of technical degrees. It can also encourage the private sector to keep training centers of its needs so that they can adapt their courses and training approaches accordingly. Skill upgrades, especially among the poor and vulnerable, are very likely to increase both productivity and wages. Various skill upgrading approaches, as discussed earlier, could be considered.

Two areas where the government can foster increases in productivity and wages are by supporting access to financial instruments and promoting performance-based pay. The Malaysian government's plan to promote financial inclusion and a productivity-linked wage system is in line with this recommendation. Box 11 elaborates on what the government is doing to promote financial inclusion.

Designing New Regulations with the Needs of SMEs in Mind

One policy that governments consider to increase competitiveness in the market is to implement a minimum wage policy. For all firms, especially SMEs, any kind of mandated benefit is a burden that amounts to a kind of luxury good. Therefore, governments must bear in mind what a minimum wage can and cannot achieve and what risks are associated with its implementation. Specifically, the evidence suggests that a minimum wage will not reduce poverty or increase firm productivity. Instead, when designed correctly (namely setting the right wage level), it can make the labor market more efficient by making it more competitive. Also, if it is well implemented, it can increase the wages of low-income workers. Otherwise, it can negatively affect employment and exacerbate informality.

GUEST CONTRIBUTION OF BANK NEGARA MALAYSIA

BOX 11. FINANCIAL INCLUSION IN MALAYSIA

Malaysia's financial sector development policies have facilitated the nation's balanced growth through the realization of the social and economic benefits of broader financial inclusion. This includes deliberate measures taken to complement market oriented developments in enhancing and expanding financial services to the broader community and economic sectors. The commitment to financial inclusion is reflected in the new Central Bank of Malaysia Act 2009 which incorporates financial inclusion as an objective of the Central Bank.

Financial Inclusion and Economic Development

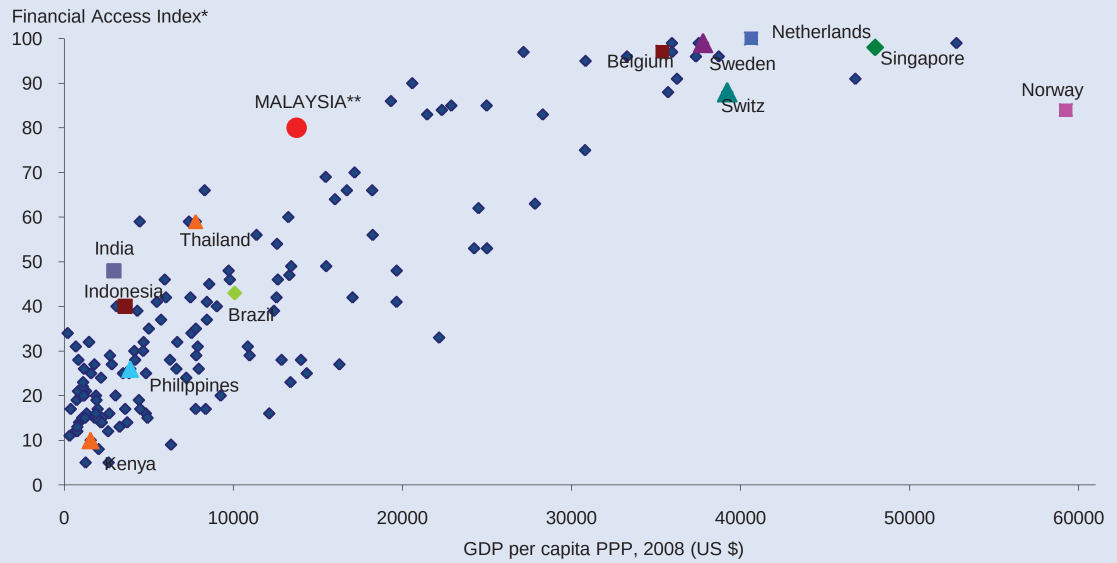
Financial inclusion represents an important agenda in ensuring sustainable long-term economic growth. Empirically, there is a strong positive correlation between the level of financial inclusion and the stage of development of an economy (Figure 3.23). While the direction of causality can clearly be from the latter to the former – that is, as an economy becomes more developed, greater proportion of the population will have formal access to the financial sector – there is also growing evidence that a higher degree of financial inclusion will contribute to overall economic development (World Bank, 2008). A high degree of financial inclusion implies that all segments of the economy, in particular the disadvantaged segments, have access to quality essential financial services. Through financial inclusion, the lower income segment of the society would have the means to build up savings which would allow them to accumulate capital. This increases their economic potential for the future while providing financial buffers that can be drawn on in times of need. Financial inclusion also promotes broader access to financing for society to participate in a range of economic activities. As a consequence, broader segments of the economy can be empowered with the opportunity to progress. This in turn, encourages more inclusive economic development and promotes greater social cohesion, by providing the different segments of society with the opportunity to participate in, and contribute to, the economic progress of the country.

Financial Inclusion in Malaysia: Policy Approach and Achievements

Malaysia's financial inclusion agenda has developed in concert with the development of the overall financial sector which has strengthened significantly in the recent decade in terms of stability, outreach and diversity. Efforts to promote greater financial inclusion in Malaysia encompassed four broad strategies:

(i) strengthening development financial institutions (DFIs);
(ii) leveraging on the commercial banks' distribution network, product and risk management capabilities;
(iii) building a comprehensive supporting infrastructure for the effective management of risks by financial institutions to reach out to the underserved; and
(iv) putting in place a comprehensive consumer protection, redress and education framework, hence promoting greater confidence and knowledge among consumers to utilize financial services

Figure 3.22. Positive correlation between access to financial services and GNI per capita



Source: Honohan (2008), CIA World Factbook and World Development Indicators, data for 154 countries
**The index is a composite cross-country indicator of the percentage of the adult population with access to some intermediary account*
***This figure includes deposits at specialised state financial institutions*

Development financial institutions (DFIs) in Malaysia are specialized financial institutions established by the Government with specific mandates to further the strategic national agenda such as supporting infrastructure development, fostering trade linkages and advancing financial inclusion. To strengthen the DFIs and ensure that these institutions perform mandated roles effectively and efficiently, the Government introduced an enhanced regulatory regime for DFIs through the enactment of the Development Financial Institutions Act 2002 (DFIA). Under this regime, BNM assumed responsibility for the regulation and supervision of these institutions to ensure that DFIs perform mandated roles in an effective and prudent manner, supported by strong corporate governance and sound financial and business practices. The relevant ministries of the respective DFIs continue to retain the responsibility for providing broad policy direction for the achievement of the strategic mandates of each DFI. This arrangement has enhanced the roles and capacity of DFIs in achieving the financial inclusion agenda. The national savings bank in particular was given a strengthened mandate to mobilize savings in underserved areas, promote micro-financing and rationalize the postal banking system. The agriculture bank, in turn, was transformed to deepen access to financing for the agriculture sector while the SME Bank was established to create a DFI focused on serving the SME sector.

With the development of a sound, progressive and diverse financial system in Malaysia, a key strategy for financial inclusion was to leverage on the enhanced capacity and capabilities of commercial banks to provide affordable quality financial services to all segments of society. To this objective, all commercial banks were mandated to make available basic banking accounts with no fees or charges imposed for a defined set of services to all Malaysians and small businesses. For access to financing, the microfinance industry was introduced in collaboration with commercial banks and DFIs, to provide micro-enterprises with the access to uncollateralized business financing in a fast, easy and convenient manner at over 1,800 access points nationwide. This was accompanied by broad-ranging initiatives to increase public awareness of micro-financing opportunities, including a national branding strategy through the creation of a microfinance logo, advertising and promotional platform.

The supporting financial infrastructure has also been instrumental in creating the preconditions required for financial institutions to reach out to the underserved. In this regard, BNM established the Central Credit Reference Information System (CCRIS) to reduce information asymmetry and to improve the credit decision making processes of financial institutions. For small businesses, the SME Credit Bureau was set up to allow SMEs to build their track record and establish their credit standing. The Credit Guarantee Corporation was also established to provide credit guarantees to viable small businesses with inadequate track record and collateral, thus enhancing the ability to access financing from commercial banks. This was supplemented with several SME funds, special purpose guarantee schemes and venture capital funds to stimulate the growth of the technology and agriculture sectors. These supporting infrastructures have provided financial institutions with the liquidity, risk capital and risk augments necessary to enable financial institutions to support the underserved SMEs in a sustainable manner.

Efforts to provide financial services to the wider outreach also needs to be accompanied by the confidence and trust in the financial services being offered and the knowledge to utilize such services effectively. Recognizing this, significant attention has also been directed on developing a comprehensive consumer protection, redress and education framework to achieve these pre-conditions. The focus has been on promoting stronger transparency and disclosure standards in financial institutions, strengthening the mechanisms for consumer protection and enhancing consumer education. Financial institutions in Malaysia are required to comply with general and specific disclosure requirements that aim to ensure that disclosures to consumers are timely, clear and concise, accurate, relevant, and comparable. To protect the interest of consumers, the Consumer and Market Conduct Department was established in the Central Bank to formulate and implement policies that promote the fair and responsible treatment of consumers and to supervise and enforce compliance with such policies. Further, the Financial Mediation Bureau was established to ensure that consumers of all financial service providers under the purview of Bank Negara Malaysia have recourse to an independent, fair and impartial dispute resolution mechanism. To enhance awareness of households on financial matters, the Consumer Education Programme (CEP) implemented by the Central Bank has supported increased financial literacy among the various target groups of consumers through various media, roadshows, stakeholder engagements and educational programs. This is reinforced by the expansion of public access points, ranging from the advisory units at financial institutions to BNMLINK and BNMTELELINK service centers at the Central Bank, where the public can interact directly with the financial institutions or the Central Bank to obtain information and financial advisory services, or resolve any complaints on financial institutions.

The pursuit of financial inclusion in Malaysia adopts a collaborative approach that involves the government and the private sector. This approach effectively combines the innovation and enterprise of the private sector with the pivotal role assumed by the public sector. In this respect, the role of the Government and the Central Bank have been particularly important in creating an enabling environment for the drive to raise the levels of financial inclusion, to strengthen the institutional structures, promoting long-term safety and soundness, facilitating a cohesive strategy through effective interagency coordination and catalyzing the industry commitment to the financial inclusion agenda.

The financial inclusion agenda in Malaysia is now well advanced with significantly increased participation in the financial system. It is estimated that more than 80 percent of Malaysia's adult population have deposit accounts, ranking the country in the top quartile of the global economy. The presence of bank branches nationwide has grown more than ten-fold since 1990, from 298 to 2,981 as at end-2009, while the number of automated teller machines (ATMs) recorded an increase from 1,193 in 1990 to 8,982 as at end-2009. The SME's share of business financing provided by financial institutions has increased from 21.2 percent in 1996 to 39.8 percent as at end-June 2010. For micro enterprises, micro financing outstanding through financial institutions grew rapidly from RM 84 million in 2006 to RM 709 million as at end-June 2010. In aggregate, these achievements in financial inclusion have positioned Malaysia among the top 10 (out of 139) countries ranked by the World Economic Forum in terms of "Ease of Access to Loans" (Table 3.2).

Table 3.2. Selected indicators of financial access: Cross-country comparison

		Savings	Loans	Outreach	
	Countries	Deposit accounts (per thousand adults)	Loan accounts (per thousand adults)	ATMs (per hundred thousand adults)	Branches (per hundred thousand adults)
Developed economies	Belgium	3,969	n.a.	138.3	48.5
	Sweden	n.a.	n.a.	36.6	25.9
	Singapore	2,236	915	49.8	10.5
	Netherlands	1,766	1,085	64.1	25.4
Developing economies	Malaysia	**2,063**	**964**	**54.0**	**11.4**
	Brazil	1,065	534	112.1	12.7
	Indonesia	505	197	14.4	7.7
	Philippines	499	n.a.	14.3	11.8
	Bangladesh	317	41	n.a.	5.2
	Thailand	1,449	273	71.3	11.0

Source: Financial Access 2010.

Challenges in Financial Inclusion Moving Forward

Despite significant achievements, several challenges remain in the continuing efforts to promote greater financial inclusion. Eight very sparsely populated and remote districts in East Malaysia remain underserved. The poverty rate, whilst low at 3.8 percent, still affects over 220,000 households in Malaysia. Particular challenges for policy makers include finding cost-effective and innovative ways to reach the underserved in remote areas. In addition, to expand not just the breadth but also the depth of financial inclusion to include other financial services such as micro insurance, further raising the level of financial literacy, effectively protecting vulnerable customers from falling prey to predatory and dishonest practices and maintaining a high quality of financial services provided. Moving forward, as Malaysia transitions to becoming a developed country by 2020, the current financial inclusion strategies will also need to take into account the changing economic and social structure that will evolve. These considerations and strategies for greater financial inclusion are outlined in the new financial sector blueprint that will chart the overall development path of the financial sector, so as to ensure an inclusive and sustainable growth as Malaysia advances towards becoming a high value-added and high income nation.

PROMOTING INVESTMENT IN HUMAN CAPITAL

Despite Malaysia's impressive development in the last few years, many Malaysians have not been able to fully benefit from the country's growth. One major challenge is that many workers lack the necessary skills to be productive in the fast changing and increasingly competitive labor market. With the goals of increasing Malaysia's human capital and maintaining its competitive edge, the most recent Education Development Plan for Malaysia (2001-2010) stresses the need to go beyond widening access and increasing enrollment in education and to focus on improving the quality and increasing the efficiency and effectiveness of education and skills development. The need to intensify human capital development in Malaysia was also recently raised by the Prime Minister in the Budget 2011 speech (Malaysia Budget Speech 2011). Thus, much of the analysis done by the government on this point agrees on the importance to address the constraints and undertake reforms options outlined here.

This section highlights three issues that hampered the acquisition and productive use of skills: (i) the inadequate quality of basic education, which negatively affects students' ability to learn; (ii) the fragmentation of the training system, which leads to inefficient teaching of relevant skills; and (ii) the fact that the skills being taught often do not reflect the demand in the labor market, which results in inefficient allocations and limits trainees' earning potential. Paying special attention to the implication of these issues for those workers who have not so far benefitted from Malaysia's development gains, this section will recommend various policy reforms for the Malaysian government to consider in order to invest in its human capital most effectively.

Key Challenges in Human Capital Development

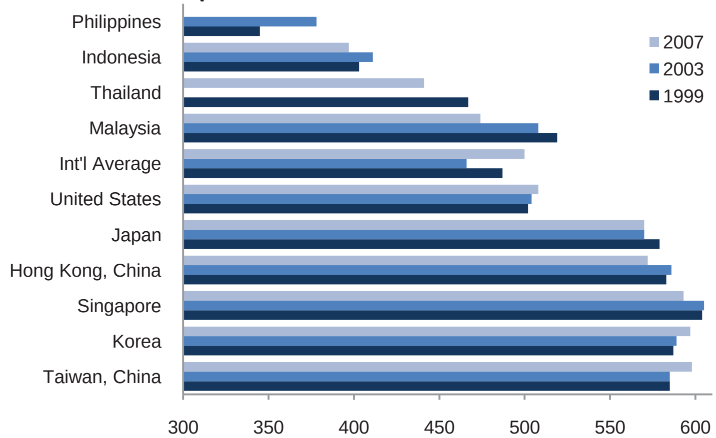
Skills and knowledge are critical to increasing productivity, particularly as Malaysia, like many other middle-income countries, is seeking to transform itself into an innovative economy no longer based primarily on low-cost manufacturing, unskilled labor, and low wages.

Uneven Quality of Basic Education

Having achieved almost universal access to basic education, Malaysia is now focusing on improving the quality of that education, which could be improved further both in terms of raising average levels and reducing the considerable dispersion in equality. Arguably, knowledge and skills acquired at the basic education phase has great implication on the individual's capability for continuous learning, adaptability to a changing labor market environment, creativity, and capacity to produce. Performance of Malaysia's basic education has shown some worrying signs and significant disparity across different segments of the population.

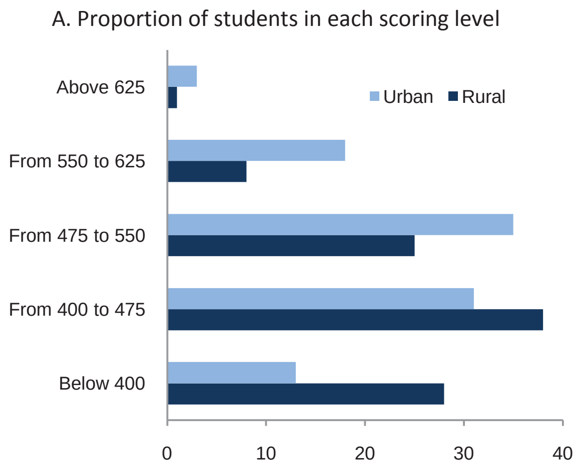
Despite scoring higher than other middle-income countries in critical subjects like mathematics, the test scores of Malaysia's students have declined over time. Also, compared with higher-income economies in East Asia and other countries around the world, Malaysia continues to lag behind in mathematics scores (Figure 3.24). These results indicate not only that students—and eventually workers—are not ready to compete with students from higher income countries but also that their competitiveness in mathematics has been worsening over time.

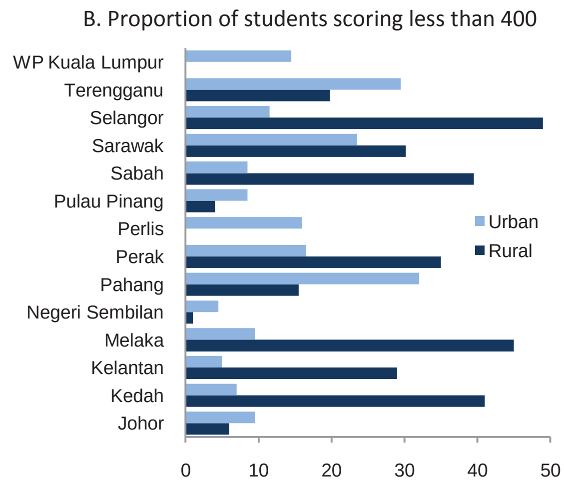
Figure 3.23. Malaysian students have decreasing scores in maths, and low scores compared to others



Source: TIMSS Scores in Mathematics.

Figure 3.24. The quality of education varies across geographic areas





Source: TIMSS Scores in Mathematics

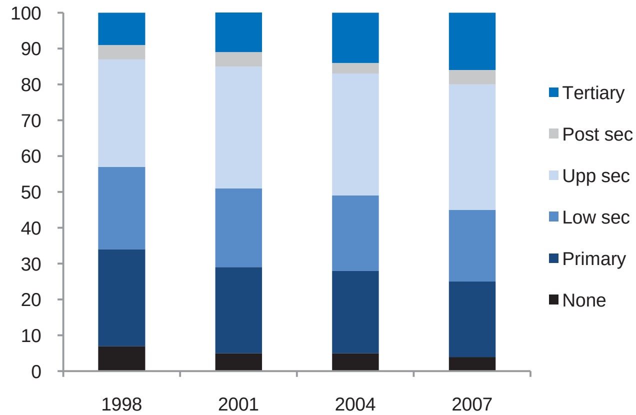
The national averages in test scores mask significant variations across the country. In part, these variations reflect disparities in access to quality education. Many primary schools located in rural and remote areas fail to provide their students with an adequate education. A lack of resources is one reason for their relatively poor performance, but other factors also come into play. For example, there is a high turnover of teachers in these schools as well as a shortage of teachers in English, mathematics, and science. Due to the small size of these schools, many teachers in rural schools are expected to cover several grades at the same time (multi-grade teaching), which means that they are unable to impart each grade's curricula separately**.** Also, the infrastructure of these schools is often inadequate. Some schools do not have electricity for 24 hours a day or an adequate source of water.

Potentially as a result of less favorable conditions in rural schools, students from rural and remote schools perform significantly worse on tests than their peers in urban areas (Figure 3.25, panel A). Figure 3.25 (panel B) shows the proportion of students scoring less than 400 on the TIMSS achievement test. Disparities within states between rural and urban areas are most prevalent in poorer states like Sabah, Kelantan, and Melaka.

Low Skill Base of the Labor Force

Studies show that the Malaysian workforce as a whole as few skills. About 80 percent of workers are only educated to the SPM or upper-secondary level or equivalent (Boston Consulting Group, 2009) (Figure 3.26). This low educational endowment and skills level is particularly pronounced among the poor. About 62 percent of poor households were headed by a person with primary education or less, and only 1 percent of poor households had a head with a tertiary level of education. This implies that, even if labor market opportunities in higher paying sectors become available, many of the poor will be unable to take advantage of them.

Figure 3.25. The educational level of the workforce is still relatively low



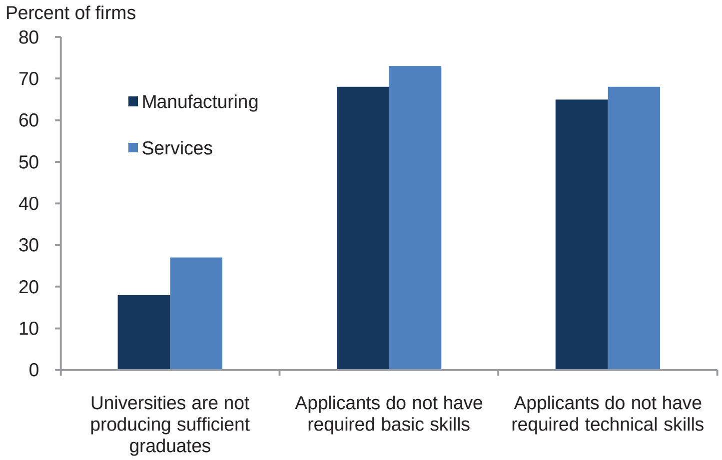
Source: Department of Statistics.

Mismatch between Skills Supplied and Needed

The skills shortage and the lack of efficient job placement services has meant that firms have had to hire less qualified workers or workers without the appropriate skills and qualifications. This has in turn resulted in productivity losses for many firms. A recent report on the investment climate in Malaysia found that many workers felt that their jobs required more education and/or skills than what they had and that their training was not suitable for their job. Only seven percent of manufacturing workers felt that they had chosen the right field of study for the job that they were performing. Furthermore, 17 percent of manufacturing workers felt that they were employed in areas in which the ideal field of education is completely different from their own (World Bank, 2009a).

Another way to see how well the educational and training system is doing in meeting market demand is by measuring the time it takes for firms to fill job vacancies. The 2007 Investment Climate Survey found that it took Malaysian firms four weeks to fill a vacancy for a professional or skilled production job. The main reasons given by the firms for this long process were that the applicants did not have the required basic skills or the right technical skills needed to carry out the jobs in question (Figure 3.27).

Figure 3.26. Applicants' lack of skills leads to job vacancies



Source: Malaysia PICS 2002 and 2007

Low Take-Up and Variable Quality of Technical and Vocational Education

To address the shortage of skills, the Malaysian government has been strengthening technical and vocational education and training (TVET). The country's new economic plan identifies TVET as a priority for promoting development and inclusiveness in the coming years. As in other middle-income countries in Asia, there are three distinct ways for students to continue their post basic education in Malaysia: (i) traditional higher education (universities and other institutions of higher learning) under the purview of the Ministry of Education or Higher Education; (ii) technical and vocational education (polytechnics and community colleges); and (iii) skills training institutions. The latter two are provided by various ministries (for example, the Ministry of Higher Education, Ministry of Human Resources, Ministry of Youth and Sports, and Ministry of Rural and Regional Development) and by private sector providers. The National Occupational Skill Standard (NOSS) certifies most skills programs. The National Occupational Core Curriculum is a new form of training documentation, and differs from NOSS training resources because it is used for the National Dual Training System.

Despite the seemingly comprehensive approach to vocational training in Malaysia, the take-up rate of TVET opportunities is very low. More than 25 percent of students in 2007 went from the SPM level directly into the workforce. A recent study attributed it partly to the fragmentation of the training system, which overwhelms students and parents as they lack the necessary information in order to make informed decisions among the plethora of available options. It also pointed out that the quality of the training offered is very variable, which leads industry to distrust the qualifications produced by the vocational training sector as a whole (EPU, 2009). Similarly, a past study found that the complicated financial schemes available for vocational training in Malaysia may have led to low take-up rates by students (Tzannatos and Johnes, 1997). Further analysis is needed to establish the main reasons behind this low take-up rate.

Limited Private Sector Involvement in Provision of Skills Training

A recent assessment of the Malaysian National Dual Training System has yielded some insight into why skill training programs remain mismatched with industry in Malaysia (Pang, 2010). The NDTS was modeled after the very successful German vocational training system. However, the study found that the two systems are very different in one critical respect –the role played by the private sector in shaping the program. In the Malaysian system, unlike the German one, the government plays a critical role in developing, funding, implementing, and overseeing the system, while the private sector plays a supportive role. In terms of coordination and quality control, the Malaysian system is centralized, mostly through the Economic Planning Unit and the Department of Skills Development, with no role for employers and workers organizations.

Policy Options for Enhancing Human Capital Development

A comprehensive approach is needed to increasing the capacity of individuals to take advantage of economic opportunities, increase their incomes, and lead more productive lives. As argued in a recent World Bank publication (World Bank, 2010f), this approach would involve five broadly defined steps: (i) getting children off to the right start by developing their technical, cognitive, and behavioral skills through early child development interventions; (ii) ensuring that all students can learn by building a stronger education system with clear standards, good teachers, and a properly regulated environment; (iii) building the skills that employers demand by developing the right incentives to encourage both pre-employment and on-the-job training programs and institutions; (iv) encouraging entrepreneurship and innovation by fostering investments in knowledge and creativity and (v) matching the supply of skills to demand by reducing regulation and giving the labor market more flexibility.

Consistent with the priorities identified by the Malaysia government, this section highlights a few potential policies for, in particular, improving the quality of basic education and ensuring that workers have the skills required by the market.

Raising the Quality of Basic Education

A combination of reforms and alternative approaches is needed to improve the quality of basic education. First, improving the quality of what is taught (pedagogy) would encourage students to think critically and imaginatively. As has been well established in the education literature and practice, the traditional rote learning approach does not achieve this and can have significant negative effects on students' test scores in the areas of science and mathematics, thus restricting their long-term competitiveness on the job market. Second, recruiting high-quality teachers and giving them incentives to deliver high-quality services, implement curriculum reform, and work in rural areas would help to reduce the significant shortages of teachers in rural areas, particularly in critical subjects.

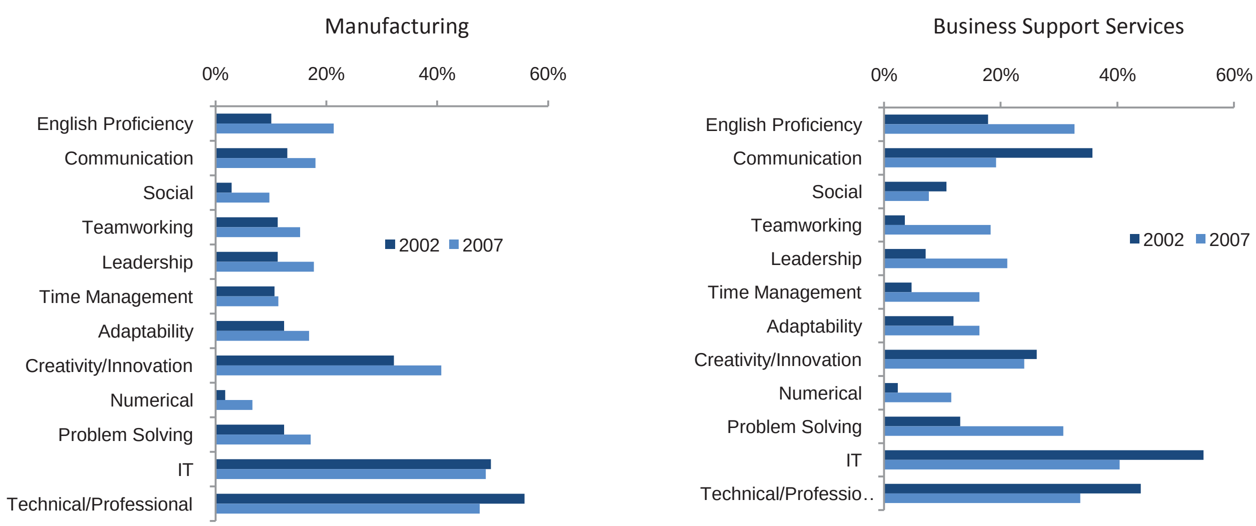
The government might consider adopting a mixture of policies to narrow gaps in school quality and access between rural and urban communities. This mixture might include adapting curriculum reform to the circumstances prevailing in rural areas while keeping it within the national system. It might also include increases in public expenditure and the provision of financial assistance to poor and rural households to help them to afford the costs associated with education. Finally, improving teacher quality would remain a high policy priority.

Another way to improve the conditions in rural and remote schools is to empower the communities in which they are located to demand equal access to quality services. In recent years, much has been written about how to empower rural populations, particularly with respect to improving the delivery of education to the rural poor (FAO/UNESCO, 2002; World Bank, 2003a; and World Bank, 2003b). These studies have found that communities can be an effective voice for what their schools need and in how they are governed (often in the form of community schools).

Strengthening Employer and Industry-Led Skills Development

Developing an employer-led skills development system will be a crucial step in improving the performance of Malaysia's TVET system. The government could consider adopting measures to encourage employers or industry representatives to participate in the skills standard and certification process, designing the curriculum, providing apprenticeships, and offering internship and scholarship programs to workers to improve their skills. As Figure 3.28 indicates, the needs of industries vary greatly and change significantly over time. Therefore, it is only when those industries and employers are closely involved in training decisions that the training system can respond effectively to their needs.

Figure 3.27. Several key skills/competencies are needed to keep up with emerging technologies



Source: Malaysia PICS 2002 and 2007.

Vocational skills training is often more successful when integrated with second-chance education in such critical areas as mathematics and sciences combined with training of soft skills to enhance the job readiness and communication skills of the trainees.

It is important to widen the sources of funding for skills development to introduce incentives and improve quality. Ensuring the involvement of the private sector through employer-financed training and scholarship programs can raise the overall quality of skills training in general. Then public financing could be targeted to specific groups such as the poor, youth, and disadvantaged segments of the labor force. This would be in line with the role of the government to improve equity and create opportunities for the excluded.

Improving the Structure of the TVET System

Malaysia has the potential to establish a governance framework for the TVET that might offer a valuable example to other middle-income countries. First, the government needs to understand how well the institutions established to support the TVET system have functioned by assessing the performance and impact of the system and by discovering what issues need to be addressed. A good example of these institutions is the Human Resource Development Fund, which was established in 1992 (but reformed since then) to support the training of currently employed workers. It would be useful to analyze the reasons why so few employers have taken advantage of this program and what disincentives may exist that are preventing them from doing so. Similarly, the experience of the Department of Skills Development (formerly known as the National Vocational Training Council)—established by the Ministry of Human Resources to promote and coordinate skills training strategies in line with industry requirements—may offer valuable lessons to other countries that are considering adopting a similar institutional arrangement.

As Malaysia becomes a high-income country, the government needs to become more proactive in encouraging and facilitating the private provision of skills. For this to happen, the fragmented qualification system will need to be rationalized, as will the various accreditation and quality standards. While the government will continue to support the less advantaged in accessing skills training opportunities, the provision of the training can be diversified and competitively outsourced to encourage participation and improve quality.

Tackling the fragmented institutional structure and providing pathways between vocational training tracks and general education is a complex and challenging agenda. Consolidating and coordinating many small programs would be a good intermediate step toward a more integrated system.

PROVIDING SOCIAL PROTECTION FOR THE POOR AND VULNERABLE

Social protection consists of policy instruments designed to assist those left behind in the development process, those who are poor, vulnerable, and those whose well being can be severely negatively affected by various shocks. Contrary to the general perception of social protection as a narrowly defined cash transfer program, a social protection system includes a range of public interventions that can protect the poor and vulnerable, while promoting competitiveness and growth. In this section, we focus on the social safety net and social insurance as the key components of a social protection system. They combine with the labor market policies and regulations discussed in the previous section to form the broader social protection system. A well functioning social protection system can not only reduce absolute poverty and vulnerability, it can also enhance people's capacity to manage risks, cushion the impact of crises or economic adjustments, and enable them to take greater advantage of economic opportunities. As experiences in other OECD and middle-income countries show, actively developing social protection institutions that meet the particular need of the country has always been essential to foster growth and long-term prosperity.

Since the 1997-98 East Asia financial crisis, the Malaysian government has given greater attention to developing programs and policies to protect the poor and vulnerable and to ease the effects of shocks and crises. The financial crisis revealed the fact that large segments of the population were unprotected, prompting the government to reallocate resources to support the social sectors and to establish programs aimed at reducing vulnerability. In 2003, the government introduced a national policy focused on social welfare and community development to improve existing programs as well as to establish new programs such as public works initiatives to generate earning opportunities for the poor. During the more recent global food, fuel, and financial crises, Malaysia implemented economic stimulus packages that included programs to help people to cope with losses and remain productive. Although the bulk of these resources were devoted to building or improving infrastructure (including schools, health clinics, and low-cost housing), some of the funds were spent on programs to enhance human capital (such as skill training funds, youth skills programs, and even early childhood development).

In spite of the progress that has been made, further efforts are warranted to strengthen the orientation of Malaysia's social protection programs and policies towards yielding better outcomes. While Malaysia has been spending a significant amount of its fiscal resources on social protection, much of that has been devoted to non-targeted programs and, therefore, has not been focused on the poor. At the same time, programs that are designed to be targeted are not succeeding in reaching the poor and vulnerable. More fundamentally, the current system lacks a clearly articulated design principle and a coherent structure. As a result, there has been a proliferation of programs that address specific issues in a piecemeal way, leading to fragmented policy and administration, and only limited impact on the ground.

This section aims to discuss these challenges in greater detail and present some options for strengthening the social protection system.

Key Challenges in the Social Protection System

Efficiency in the Use of Resources

Malaysia’s social spending in its broadest definition includes three major components – social services including items such as health, education, and housing; social insurance expenditure dominated by pensions and health; and general social assistance including a range of subsidies and social transfers.

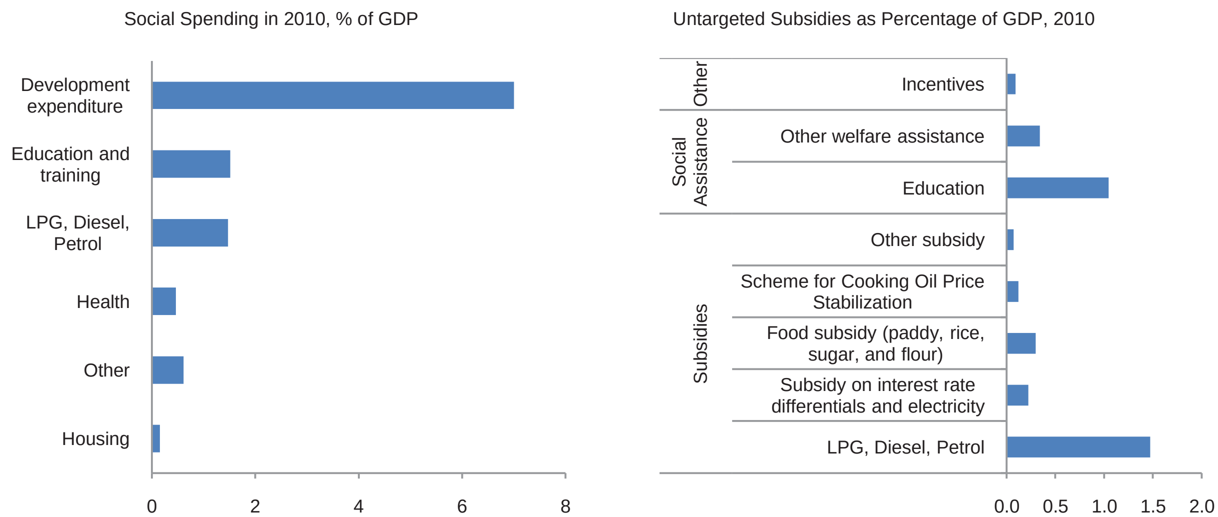
At the aggregate level, Malaysia has been spending a significant amount of public resources on social assistance. The total level of expenditure on subsidies, incentives, and social assistance transfers amounts to 3.68 percent of GDP in 2010, of which 1.39 percent was spent on social safety net programs (Ministry of Finance, 2010). This percentage is on a par with what is spent in other countries of the world. As a recent study of 87 developing and transition countries has shown, the median spending on social safety net programs was 1.4 percent of GDP between 1996 and 2006 (Weigand and Grosh, 2008).

However, the bulk of these resources are devoted to untargeted subsidies, which are unlikely to reduce poverty. Subsidies for food, fuel, and other products comprise about 60 percent of social protection spending in Malaysia in 2010 (Figure 3.29). Energy subsidies alone account for 1.89 percent of GDP. These subsidies are not targeted to any particular segment of the population by design. Since richer households tend to consume more of these commodities (for example, petrol), these subsidies tend to disproportionately benefit higher-income households. A recent report has shown that poor households benefit least from subsidies; specifically, the poorest 10 percent of households receive less than 5 percent of the benefits from the gasoline and diesel subsidies (IMF, 2009).

Effectiveness in Reaching the Poor

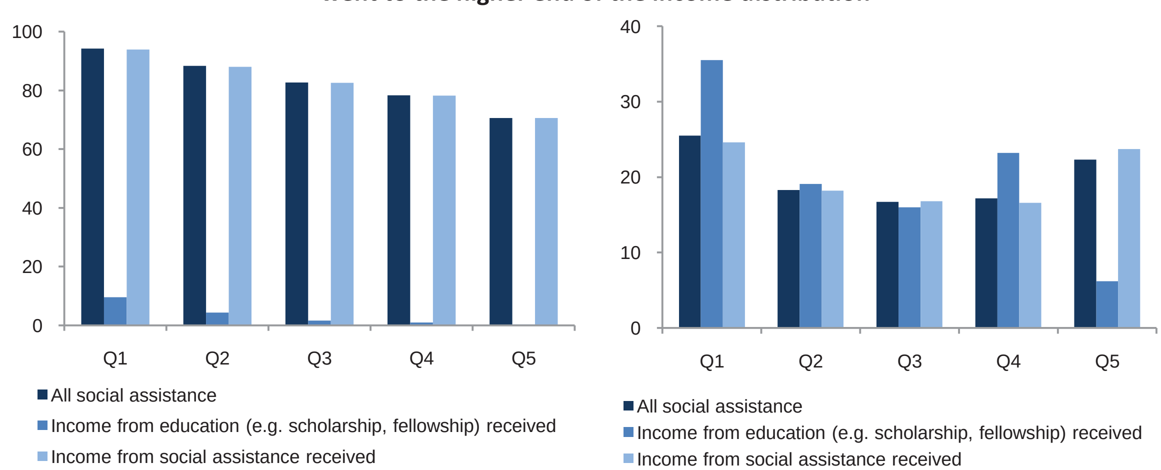
The second challenge is to make social safety net effective in reaching the poor. Malaysia has several targeted social assistance programs, including education support for poor households (in the form of tuition aid, scholarships, and poor students' trust funds) as well as support for vulnerable groups such as the disabled, foster children, and the elderly. Those programs in which poverty is the targeting principle use a simple means-testing method that relies largely on self-reporting of income.

Figure 3.28. Malaysia spends a lot on the social sectors but much sp spending is on untargeted subsidies



Source: Ministry of Finance, 2010.

Figure 3.29. A significant portion of beneficiaries are non-poor and most of the benefit payments went to the higher end of the income distribution

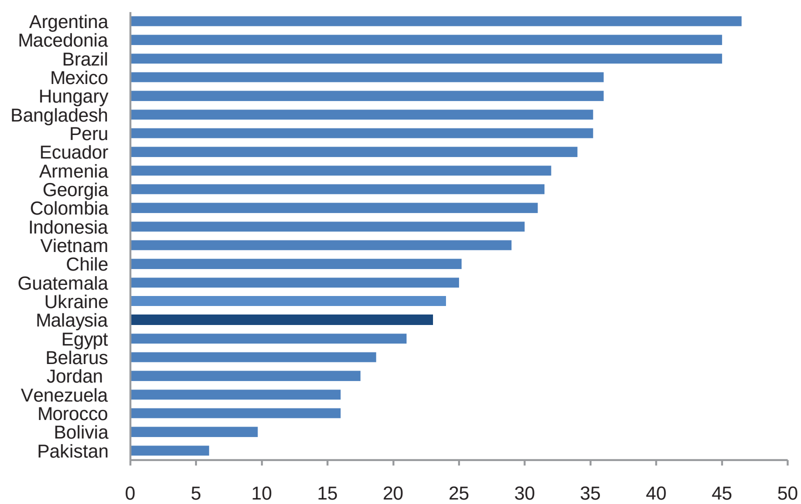


Source: World Bank staff estimates.
Note: The left panel shows the ratio of the number of individuals who live in a household where at least one member receives a transfer to the total number of individuals in the group. The left panel measures the transfer amounts received by the group as a percent of total transfers received by the population.

The empirical analysis done for this report revealed that these targeted social assistance programs do not target very efficiently. As Figure 3.30 (left panel) illustrates, the beneficiaries of social assistance programs are evenly distributed across income quintiles, with over 70 percent of households in the top 20 percent of the income distribution receiving some social assistance benefits. Figure 3.30 (right panel) further shows that only 25.5 percent of social assistance goes to the poorest 20 percent of the population, and about 44 percent go to the poorest 40 percent, indicating deficient poverty targeting. This weak targeting performance severely undermines the effectiveness of social protection programs in fostering inclusive growth. However, social assistance programs that offer educational scholarships or fellowships have a much better targeting performance.

The fact that significant components of the social assistance program in Malaysia are not designed to target the poor and the way in which targeting is designed and implemented in the programs that are targeted has led to the program's weak targeting performance. Figure 3.31 further illustrates these findings in comparison with some other countries.

Figure 3.30. The targeting accuracy of social assistance in Malaysia is low compared with other countries (percentage of benefits received by the poorest quintile)



Source : World Bank HDNSP-SSN Team calculations.
Note: Estimates are adjusted to make figures internationally comparable.

Consistency among Social Protection Programs

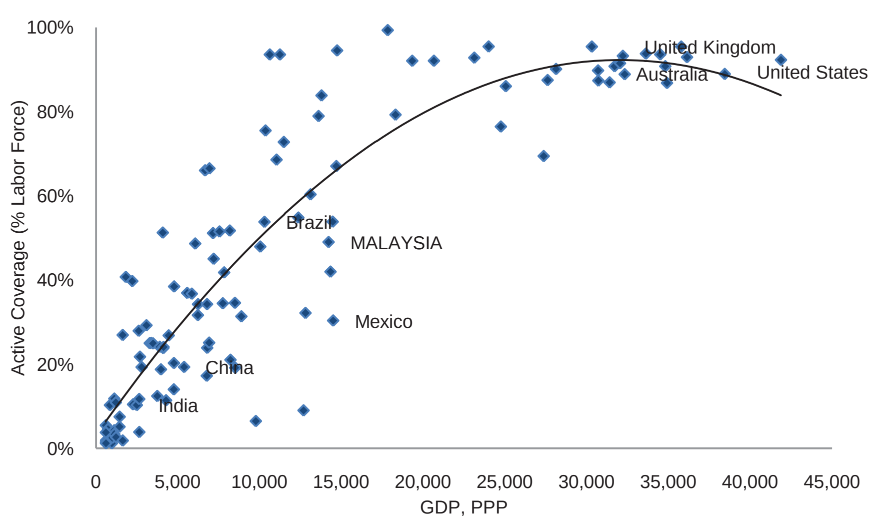
Despite the strong commitment of the Malaysian government to reducing poverty and helping people manage risks and shocks, it seems to have no clearly articulated vision of the basic principles behind its policies, of how various programs are to relate to each other in achieving the overall objective, and of what are the best ways for institutions to ensure the effective implementation of its social protection programs. In the absence of such a vision or of a focus on program results, there has been a proliferation of small and weakly coordinated programs. As a consequence, gaps have emerged between these many different programs through which some of the poor and vulnerable in Malaysia are falling.

The multiplicity of small programs hampers the effectiveness of the system in achieving positive outcomes. As discussed earlier, a wide range of social protection initiatives were introduced over time to address specific issues and needs, often on a piecemeal basis. Many small programs are often run by one institution. For example, at least 12 small programs aiming at assisting children, disabled, and the elderly are managed by the Ministry of Women, Family, and Community Development. Some others are related to disasters, skills training, and apprenticeship. This Ministry is responsible for operating a general assistance program to the poor that is governed by the states, as well as some federal assistance program for parliamentary districts. Another example is the fact that about 10 different ministries or agencies are involved in providing education-related support. Given that the programs target beneficiaries from different perspectives, it is easy to see room for duplication as well as the possibility of under-coverage of the poor and needy, leading to ineffective support and/or the waste of resources.

Coverage of Existing Schemes

The existing system also leaves certain segments of Malaysia's population or its labor force unprotected against certain risks. This begs the question of how the government sees the role of the states and individuals when it comes to certain risks. The pension insurance program in Malaysia covers a significantly smaller proportion of the active labor force than countries at a similar income level (Figure 3.32). Also, it is limited to public sector employees, those in formal jobs, and veterans. Measured as the percentage of all workers who make contributions to the public pension schemes (and consequently can draw from public pensions when reaching pension age), Malaysia's pension system has a coverage rate of about 64.5 percent. This leaves more than 35 percent of the employed (and consequently an even higher percent of the total labor force) outside the pension system. To at least partially address the concern of limited coverage with the existing pension system, the government announced the "1Malaysia Retirement Scheme" in 2009. The scheme, administered by the EPF, is structured as a basic voluntary contribution by workers, with a five percent (for every RM 100) matching contribution by government (up to a level and up to five years) In October of 2010, the government announced the launch of a new private pension fund that will cater specifically to the self-employed and private sector employees currently not covered under other systems.

Figure 3.31. The Pension System Coverage For Malaysia Is Low For Its Income Level



Source: HDNSP, World Bank staff calculations.

The recent global financial crisis and the lack of unemployment insurance in Malaysia have raised the question of what is the most effective way to help workers to insure themselves against employment shocks and to cushion the impact of those shocks in the short term.

Policy Options to Better Align the Social Protection System with Inclusive Growth

Taking a more strategic approach to social protection could ensure that programs are geared toward promoting inclusive growth. Greater clarity is needed on the goals and overall direction of Malaysia's social protection efforts. These goals could provide the basis for consolidating programs and increasing coordination among the relevant agencies.

Strengthening Malaysia's social protection system does not necessarily require the creation of more programs or the allocation of more resources. When the objective of the system has been clearly articulated, it will be possible to restructure and consolidate the social safety net system around the backbone of a poverty-based cash transfer program. This requires a more effective targeting mechanisms and a shift in resource allocation toward targeted programs. As has happened in other countries, phasing out non-targeted and costly subsidies can be best accomplished by introducing or scaling up a well-designed social assistance program. Consolidation and coordination across programs can be more easily accomplished by designating one central entity. Rather than creating any new institutions that could make the duplication of efforts even more likely, the government could consider streamlining the existing institutional arrangement. Malaysia's social safety net program will also need to be complemented by more broad-based social insurance mechanisms.

Ensuring Social Safety Net Programs Have a Clear and Consistent Poverty Focus

To target or not to target is a fundamental decision that needs to be made when SSN programs are designed. There seems to be a consensus in Malaysia that SSN programs should not be universal but targeted to the most needy. This consensus needs to be translated into consistent and tightly focused policies. Having this as the fundamental principle is key to ensuring that social safety net policies and interventions are redistributive and directly respond to the nature of poverty and vulnerability.

The first step towards a set of tightly focused social safety net programs is to develop a solid understanding of poverty and vulnerability in the country based on empirical data. With this information and analysis, existing programs need to be examined for their specific policy objectives, eligibility criteria, implementation approach, and the impact that they have on their intended beneficiaries. The exercise will reveal any programs that are not tightly focused on their objectives as well as the gaps among the poor and vulnerable where no SSN program is offering assistance.

Current interventions that do not follow this tight policy objective would need to either be eliminated or separated from the other social safety net schemes. As indicated earlier, there seems to be a strong case for eliminating some major price subsidies that are not only a major government expense and hamper the effectiveness of the price mechanism but also benefit the rich more than the poor. Phasing out such programs will free up resources to be spent on poverty targeted programs. There are also measures in the current programs that are not focused on the poor. They would need to be reviewed to see if they are serving other policy goals. One example would be to consider subsidies to the training of civil servants as part of the government's human resource policies rather than as social assistance.

It is important to point out that, recognizing the significant cost and lack of effectiveness of some existing interventions, the government has gradually been rationalizing price subsidies for petrol, diesel, liquefied petroleum gas, and sugar. While the reform process can be arduous and could be taken further (currently an estimated RM 7.82 billion is still budgeted to be spent on fuel and sugar subsidies), this is clearly an encouraging development. The success of these reforms requires the parallel development of a strengthened social assistance system with clearly articulated policy goals, a viable targeting mechanism, and more resources reallocated from untargeted programs.

Refining Targeting Mechanisms

The choice of targeting mechanisms depends critically on the poverty profile of the country and its administrative capacity. As in many countries, policymakers in Malaysia face two big challenges: (i) what to use as indicators given the high degree of informality in the economy and, consequently, the difficulty in observing true income and the fact that non-cash income can affect household well-being significantly and (ii) how the "means testing" process can be most effectively carried out to verify whether individual households meet the defined eligibility criteria.

Choosing means-testing approach and relevant indictors. Policymakers in Malaysia may need to consider moving beyond its current approach of focusing on per capita cash income as the basis for determining eligibility for targeted benefits. They may wish to consider the viability of two alternatives based on further analysis of household survey data. First, the government may want to consider a combination of income and assets when applying means-testing. Factors that can be taken into consideration include the ownership of assets and the living standard of the household (such as their housing conditions and their ownership of any durable consumption goods). To some extent this is already being done in Malaysia in some programs being implemented at the local level, but the criteria needs to be more formally spelt out and applied more systematically to reduce the degree of discretion. The second alternative to traditional means-testing is the so called "proxy means tests" (Box 12). PMT is often used when income information is highly unreliable and when the poverty profile is such that most of the poor can be identified by a few easily observable variables. Using these variables as proxies for to income, a score is calculated for each applicant and is used to establish program eligibility. PMT has the advantage of being objective, and it can help reduce the level of discretion and abuse. Meanwhile, given that the success of the PMT depends critically on collecting data, it is an approach that requires reasonably high administrative capacity to collect and process information. PMT has been widely adopted as the main targeting criteria in Latin America countries. In East Asia, it has been applied in the Philippines and Indonesia.

Depending on the nature and profile of poverty, a combination of targeting mechanisms can be chosen. In Philippines, geographic targeting is combined with the PMT method. Indonesia experiments with a combination of community involvement with PMT method. In China, community plays a big role as part of the formal incomes and asset-testing approach. As countries develop and the nature and profile of poverty evolve, targeting mechanisms may also need to be adjusted over time. There are examples where the balance of the program shifted from a geographically targeted poverty program to household based social assistance schemes where targeting is more refined. Similarly, many categorically targeted programs were consolidated into general poverty programs, for example, in Eastern Europe, substantially strengthened the poverty focus of the program.

Adopting a more unified targeting process. Implementing any targeting approach involves an institutional arrangement to collect and process information, to establish eligibility, and to apply the results to different programs. There are currently many agencies in Malaysia that are providing targeted benefits and that are operating their own targeting systems. This creates administrative inefficiencies and the potential for inconsistent treatment of households across programs. To address this issue, the government has recently set up the e-Kasih system to identify poor and ultra-poor households and manage a list of actual and potential beneficiaries. Adopting a centralized approach to targeting where a common criterion is used is a very sensible approach. As the e-Kasih program develops and matures, it is important to ensure that it fully serves the needs of the poverty programs, in particular that: (i) critical information required by the programs (on the recipient's income, household welfare situation, or their proxies) is collected consistently; (ii) information on both current and potential beneficiaries is available; and (iii) the staff managing the e-Kasih program have adequate knowledge of existing policies and programs and the capacity to serve their clients.

BOX 12. PROXY MEANS TESTS

Proxy means tests generate a score for applicant households based on easy-to-observe household characteristics such as the location and quality of the household's dwelling, its ownership of durable goods, and its demographic structure). The indicators used to calculate this score and their weights are derived from statistical analysis of data from detailed household surveys. Eligibility is determined by comparing the household's score against a pre-determined cutoff value.

The advantage of a PMT is that it requires less information than true means-testing and yet is objective. It does not measure income and may discourage work effort less than means testing. The drawback of PMT is that it requires sufficient administrative capacity to collect relevant information. It is more suitable to identifying the chronic poor in a stable environment but can be insensitive to quick changes resulting from an economic downturn or sudden shocks.

Moving from Fragmented Programs to a Coordinated Social Protection System

Bringing the various social safety net programs together under one coherent system will ensure that they adequately and efficiently cover the poor. Meanwhile, there is a need for the social safety net system to be coordinated with the government's broader social insurance and labor market policies.

The architecture of the social safety net system may take different shapes depending on the objectives of the government and the needs of the public. To assist various needs of the poor, the social safety net system will likely need to consist of a package of programs, what is essential is to ensure that the system is balanced and that the programs are complementing each other.

One possible framework for the Malaysian authority to consider would be to have a poverty-targeted cash transfer program as the backbone of the social safety net program, supplemented by categorically focused programs to address the specific needs of the vulnerable. Differing from the poverty targeted programs that Malaysia has now, this poverty focused program would need: (i) to be designed to cover most of the poor according certain means-testing criteria; (ii) to be consistently implemented across the country, rather than fragmented geographically or categorically (although the specific benefit level and eligible threshold can potentially vary depending on the cost of living and poverty situation); (iii) to follow the same targeting approach and the same centrally developed standards and criteria; (iv) to receive a resource allocation that is substantially larger than what the current poverty programs receive; and (v) to designate an agency to be in charge of the poverty program that will then coordinate with other agencies providing specialized support. In addition to the poverty targeted cash transfer program, specific assistance to vulnerable groups can be tailoring to their specific needs, but some of the current programs aiming to reach the same category of people can be consolidated to avoid duplication and waste of resources. More active interventions that aimed at supporting the poor can also be considered; for one example see Box 13.

BOX 13. YAYASAN USAHA MAJU: A MICRO-CREDIT SCHEME IN SABAH

The Yayasan Usaha Maju (YUM) micro credit scheme aims to enhance the role of women through entrepreneurship activities. YUM is a state-owned government agency established in 1995 and located in Sabah. The objectives of the YUM micro-credit scheme are to encourage participation among hardcore poor and poor families in economic enhancement programs, to lift their income levels above the poverty line threshold, to increase their capacity through training and counseling and to foster entrepreneurship.

The micro-credit scheme is modeled after the Grameen Bank in Bangladesh. Its main concept revolves around the provision of access to credit for the poor. In particular, rural poor women are targeted among rural poor families who are willing to help themselves, harness human potential and existing skills through an organized system of solidarity groups. The solidarity groups act to put in place a binding social contract instead of traditional forms of collateral required by conventional banks.

Among the direct benefits one counts the profits generated by the project itself. The exceptionally high repayment rates have indicated that these profits have been tangible, imparting real benefits to the project participants. These benefits accrue as a result of households being initially credit-constrained. The micro-credit scheme allows them to achieve a more optimal scale and composition of economic activity than would have otherwise been possible. The social responsibility system amplifies these benefits by not only imposing financial discipline but also providing assistance in the screening, monitoring and evaluating of the projects.

But the benefits go far beyond the direct income impact of the project. Other benefits include greater household savings, which reduces vulnerability to poverty, higher expenditures on child education and health expenditures, and a more inclusive participation in the labor force of especially rural poor women. Non-monetary benefits arising from empowerment, self-confidence and respect must be considered as well.

The Yayasan Usaha Maju (YUM) micro-credit scheme has been hailed as one of the success stories of poverty eradication in Sabah. Since its inception, the scheme has benefited thousands of poor families and more than 10 percent of the hardcore poor families in Sabah. The credit facilities have shown positive impact towards improving the standard of living of participants. Through the creation of gainful self-employment, participants have been able to generate sufficient income to escape from the vicious cycle of poverty.

Policy design of the poverty targeted cash transfer program will involve decisions in several key aspects – benefit design, financing, administration and governance, and monitoring. Decisions concerning the benefit requires specification of the benefit structure (e.g. flat, stepped, top-up), the benefit level (in relation to income, poverty line, other benefits), as well as the decision of whether to condition or not (see Box 14).

BOX 14. CONDITIONAL CASH TRANSFERS

One type of cash transfer program that is becoming increasingly popular among middle income and even some developed countries is the Conditional Cash Transfer (CCT) program. CCTs are programs that transfer cash, often to the mother, on the condition that beneficiary households will make pre-specified investments in the human capital of their children. For example, the condition may be that families must ensure their children have regular checkups, growth monitoring, vaccinations, and other preventive health care. Another condition may be that children be enrolled in school and must be present at school for 80 to 85 percent of all school days. Some measure of academic performance is also sometimes imposed. CCTs have two explicit goals - to reduce poverty, and to encourage the poor to invest in their human capital in order to increase their standards of living in the future.

How CCTs achieve their ultimate goals is a long and complex process. First, these programs, like other safety net programs, can only directly influence the intermediate outputs that are associated with behavioral changes by the beneficiaries. These outputs include making more and better investments in their human capital and economic opportunities (for example, use of education and health services), protecting their short-term employment and consumption, and improving their risk-coping behavior. At the second stage, these changes can be expected to lead to better final outcomes such as higher stocks of human capital (as a result of longer school attendance and better health and physical condition), increased productivity (as a result of greater cognitive ability), and better employment prospects. Finally, these improvements can result in higher incomes, consumption, and standards of living for the beneficiaries, hence reaching the ultimate development objective of the CCTs - to reduce poverty.

This kind of program is an increasingly popular instrument for human capital interventions. The first wave of CCTs began in Latin America (Brazil and Mexico) where many such programs have been shown to have increased household consumption, use of health care, and school enrollment. In many cases, these programs are implemented nationwide, whereas in others, they are regional or narrowly targeted to a specific population (for example, in Chile and Turkey). The CCT model has now spread to other regions around the world, including Asia, Africa, and Eastern Europe.

The role and design of CCTs are evolving over time, depending on the country context. In countries where poverty is more commonplace (such as Mexico, Colombia, Brazil), the traditional model is often applied. This model requires all beneficiary households to meet a standard set of conditions (school attendance and health checkups) that make them eligible for benefits. In countries where poverty is more localized (like Chile), CCTs are designed to be customized to the specific circumstances of extremely poor households. Poor households, with the help of a social worker, develop a customized action plan to lift themselves out of extreme poverty and develop a set of conditions to follow. Other countries focus the conditionality solely on education or health outcomes.

Overall, the effects of CCT program have been positive. First, virtually all CCTs that have been rigorously evaluated have had positive effects on school enrollment and some health outcomes, though sometimes these effects have been more apparent for some age groups than others. Second, given that CCTs give those households that are least likely to use health and education services an incentive to use them in the absence of the program, CCTs have helped to reduce pre-existing disparities in access to these services. Third, evidence on the longer-term benefits of CCTs is not conclusive, partly because not enough evaluations have looked at the long-term effects of CCTs and partly because factors outside the reach of a CCT program may still be hindering poor households from achieving their full potential. More research on this will be needed.

The suitability and success of the CCT program depends on many factors. It is most suitable when there are clear behavioral issues concerning human capital investment that can be addressed through such conditionality and that the groups where such conditions apply would reflect a significant part of the poor. The supply of health, education and other services upon which the cash transfer is conditioned should not present serious constraints. The program also requires high degree of coordination between various authorities, especially between the social welfare system and the health and education authorities.

Broadening the Coverage of Pension Insurance to Ensure Old-Age Security

Unlike SSN programs that tightly target the poor, the challenges faced by the pension system in Malaysia is how to close the coverage gap so that the majority of the population can participate. One key issue is whether and how to extend the program to cover workers in the urban informal sector and what to do about the old age security of the rural population. Some other middle-income countries have been experimenting with two new approaches. The first approach is to introduce a voluntary contributory scheme to cover informal sector workers with the government making a matching contribution. This is sometimes referred to as the Matching Defined Contribution (MDC). The second approach is to introduce universal or targeted non-contributory pensions (often called “social pensions”) that are often limited to the very old and provided at very modest level. It has the advantage of being administratively simplicity and of containing no work disincentive. Targeted social pensions exist in many OECD countries where, in some countries (Germany and Portugal), the incomes of the elderly are means-tested to establish their eligibility while in others (the Netherlands and the UK), their children’s income is taken into consideration as well. Brazil has developed an old age pension scheme for rural areas that covers more than 6 million beneficiaries, and China has rolled out voluntary rural pension pilot schemes with a government matching contribution.

Considering Unemployment Insurance to Protect Against Employment Shocks

As economies are more open and exposed to various shocks, the risk of job loss grows larger. This risk will be further amplified in Malaysia as the government engineers a structural transformation of its economy and invigorates the forces of competition in product and labor markets. In these circumstances, countries around the world have found it useful to consider introducing an unemployment insurance system. A system of this kind that covers most or all of the formal labor force can pool risks and cushion the impact of shocks. How expensive such a program will be and how much impact it will have on the amount of effort a recipient is willing to make will depend critically on the level of the benefit and the duration of the eligibility period. The clear benefits of a well-designed unemployment insurance system include supporting a high-income economy and balancing the need for a competitive economy with that of compassionate society.

Making Programs Results-Focused and Fostering a Learning Culture

The monitoring and evaluation of social protection programs needs to be strengthened significantly to ensure that they are judged on the basis of how well they perform. The factors that should be monitored include the timeliness and quality of information on the program's inputs, its implementation status, and the outputs it has delivered. Detailed analysis of household data will yield information on the program's coverage and incidence, as well as on how well the program is reaching its targeted beneficiaries. It will also make it possible to assess the program's impact on the consumption and well being of beneficiaries. Solid and rigorous impact evaluation is also necessary to assess the impact of particular interventions. Much of the information needed for such evaluations is collected but severely under-used in policymaking and program management. What is needed are a results-focused management requirement for all interventions, a well developed monitoring and evaluation system, and a strengthened capacity of the implementing agencies (and government) to assess and to learn from experiences

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