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MALAYSIA ECONOMIC MONITOR

Repositioning for Growth

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PREFACE

The *Malaysia Economic Monitor* is a new report of the World Bank that reviews recent economic developments in Malaysia, provides views on the outlook for the Malaysian economy, and helps inform key policy issues. This inaugural edition marks the beginning of series that will come out twice a year.

With ‘Repositioning for Growth’ as the theme of this first issue, the *Malaysia Economic Monitor* comes at an opportune time. Malaysia is emerging from one of the worst export slumps in its economic history. Against this backdrop, the report addresses a number of pertinent questions. How deeply was the Malaysian economy affected by the crisis? Will the rebound translate into a sustained recovery? How can Malaysia revitalize growth and climb up the income ladder?

The *Malaysia Economic Monitor* is part of a wider effort of promoting the sharing of knowledge among internal and external stakeholders—a requisite for the innovation- and knowledge-driven economy and a key pillar of the World Bank’s partnership with the Government of Malaysia. In this spirit, the Monitor is made available to a broad audience, including decision makers, private sector leaders, market participants, civil society, think tanks, and journalists. The Monitor provides the opportunity for external parties to provide independent contributions.

This first-time edition reflects the accumulated work that the World Bank has produced over the past few years on the Malaysian economy. It reviews developments following the onset of the current crisis episode, provides the broad contours of a strategy for high income and growth, and touches upon several issues of analytical interest. Future editions of the Monitor will review incremental developments over a six-month horizon and zoom in on particular themes. This inaugural edition therefore provides a baseline to what is yet to come.

The *Malaysia Economic Monitor* was prepared by Philip Schellekens (Task Team Leader), with contributions from Frederico Gil Sander, Yue Li, Magnus Lindelow, Xubei Luo, Chanin Manopiniwes, Martin Reichhuber, Vatcharin Sirimaneetham, and Ashley Taylor. An external contribution was provided by Maslynnawati Ahmad and Hamri Tuah of Khazanah Research and Investment Strategy. Vikram Nehru and Mathew Verghis provided guidance. Ahmad Ahsan, Ivailo Izvorski, Manny Jimenez, Jamil Salmi, Xiaoqing Yu, and Shahid Yusuf participated in the internal review process and Manu Bhaskaran commented as part of the external review. Indra Irnawan designed the cover and back. Vacharas Pasuksuwan and Ruangrong Thongampai assisted in production aspects, Pichaya Fitts in external relations, and Anissa Amador Tria in web production.

The *Malaysia Economic Monitor* benefited from fruitful interactions with various government and private sector parties in Malaysia, including among others the Bank Negara Malaysia, the Prime Minister’s Economic Council, the Economic Planning Unit, Khazanah Nasional Berhad, the Ministry of Finance, and the National Economic Advisory Council, as well as various firms in the manufacturing and services sectors, think tanks and academics. Last but not least, a special word of thanks goes to the Economic Planning Unit and Khazanah for their help with the logistics of the launch of this Monitor.

EXECUTIVE SUMMARY

Malaysia is emerging from one of the worst export slumps in its economic history as manufacturing and exports have started growing again. With East Asia leading the recovery and advanced economies showing progressive improvement, the Malaysian economy is projected to grow at 4.1 percent in 2010, following a contraction of 2.3 percent in 2009. The medium-term outlook remains promising with growth reaching 5.6 and 5.9 percent in 2011 and 2012, respectively, though that will depend on sustained global recovery from the crisis.

The Malaysian economy was one of the hardest hit in the East Asia region, but it remained fundamentally resilient. As global demand plummeted in the last quarter of 2008, manufacturing firms braced for impact by cutting production, running down inventories, and slashing investment. Given the importance of exports in the economy (some 120 percent of GDP last year), the resulting impact on GDP was pronounced. But the turmoil in manufacturing did not lead to a broad-based recession. Private consumption and service sector activity was resilient: growth stalled but levels remained intact. The crisis was mostly a manufacturing-for-exports crisis.

Sound fundamentals and responsive policies provided support. Strong financial supervision and limited exposures to toxic securities and troubled financial institutions shielded the economy from financial contagion. High levels of international reserves relieved the impact of capital outflows. Sound household and corporate balance sheets cushioned the impact of the downturn. On the policy side, accommodative monetary and credit policies protected the flow of credit. Successive fiscal stimulus packages (10 percent of GDP, including credit guarantees) helped boost confidence and construction activity, and are expected to lend further support throughout next year.

The small rise in the unemployment rate masks the significance of the social impact of the crisis. By mid-year unemployment reached a peak of 4 percent. Underneath this was a reallocation of labor across sectors, with services hiring and manufacturing retrenching. Some 8 percent of the manufacturing workforce, more than 120,000 workers, was shed, with foreign workers taking a disproportionate hit. Job losses, shorter working hours, and lower wages are likely to have raised absolute and relative poverty in urban areas. Lower commodity prices are likely to have been detrimental to rural livelihoods.

The upturn in economic activity has yet to turn into a sustained recovery. Industrial production and exports have recently increased, but whether this represents the beginning of a sustained recovery is still unclear. The strength of the recovery, and particularly export growth, continues to hinge on the firming up of final demand from advanced economies. Inventories will likely be a key driver of near-term growth. Consumption and fixed investment are expected to pick up initially slowly. With output still below potential, inflation and asset prices are likely to remain subdued.

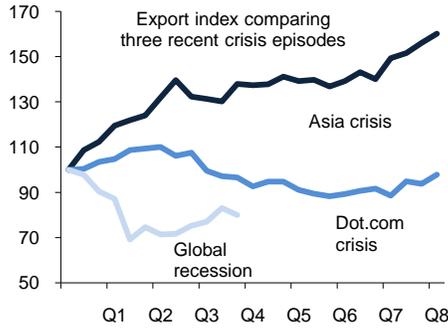
Managing the economy's recovery will be a delicate balancing act. Withdrawing policy support too early runs the risk of choking off the recovery. But extending support for too long may hamper the credibility of medium-term fiscal consolidation, reduce the room for future stimulus, increase the risk of asset price bubbles, and constrain private sector initiative once demand picks up. The authorities are mindful of these risks and have conditioned the pace of consolidation on the strength of the recovery.

The overriding medium-term challenge is for the Malaysian economy to join the select group of high-income countries. Malaysia has experienced solid growth over the last decades, but has relied on an economic model predominantly based on capital accumulation, although private investment rates never recovered from their 20 percentage point fall after the Asian 1997/98 crisis and are now among the lowest in the region. For Malaysia to climb the next step up the income ladder, it needs to focus on improving the investment climate to raise investment rates and focus on productivity growth. Against this backdrop, the authorities are developing a 'New Economic Model,' which will be squarely centered on boosting productivity. Promising reforms have already been announced in the areas of services and foreign direct investment, which will help revitalize private investment.

What will it take to join the league of high-income countries? Moving up the income ladder is a difficult challenge—one which only a few countries have successfully met in the post-war period. Malaysia will need to address a number of weaknesses. An integrated strategy requires four key elements:

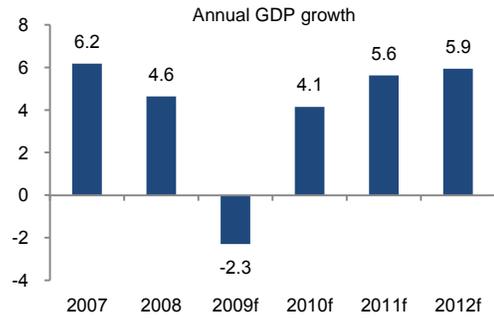
- **Specializing the economy further.** Given limited resources—both public and private—and the need to achieve agglomeration economies, it is important to focus on a few high value-added, innovation-based sectors with strong potential. Improvements to the enabling environment can facilitate this through the building of an internally-competitive and business-friendly economy and the provision of appropriate soft and hard infrastructure to support the knowledge economy. Focused technology, innovation and urbanization policies can nurture niches of growth by building on existing strengths in sectors such as electronics, resource-based industries, and Islamic finance.
- **Improving the skills of the workforce.** Greater specialization will assist in accelerating growth and create demand for skilled labor—and increase social and private returns to education and skills upgrading. To ensure this demand can be satisfied—with skilled labor currently at only 25 percent of the labor force—simultaneous efforts are required to improve the quantity and quality of skilled labor. This requires attention to incentives, competition, and merit-based recruitment in education, as well as curriculum development, better teacher training, and leveraging efforts with help of the private sector.
- **Making growth more inclusive.** Inclusiveness policies are yet another building block of a competitive, dynamic and flexible economy. They not only help households cope with poverty, but are also essential in promoting entrepreneurship and risk-taking. Effective social insurance programs could help mitigate unemployment risks and ensure adequate pension coverage. Well-targeted social safety nets would protect the needy in times of adversity and reduce fiscal costs.
- **Bolstering public finances.** Fiscal consolidation and reform will help address investor concerns about the rise in the fiscal deficit, broaden the narrow revenue base, lessen the significant role of subsidies in expenditures, and reduce the crowding-out of private initiative. Fiscal rules could be considered to stabilize public finances going forward. Shifts in expenditure patterns from bricks and mortar to initiatives in the areas of specialization, skills and inclusiveness will also help.

The export slump and recovery ...



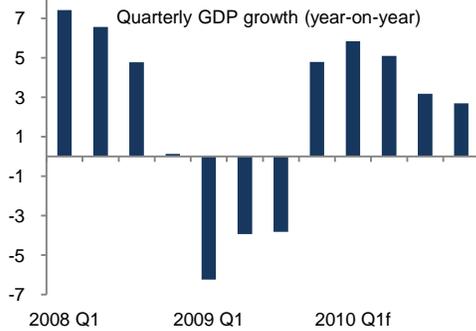
Source: CEIC and World Bank staff calculations
 Note: Export index equals 100 for Jul 1997 (Asia crisis), Mar 2000 (Dot.com crisis) and Sep 2008 (current global recession)

... will drive expected growth next year



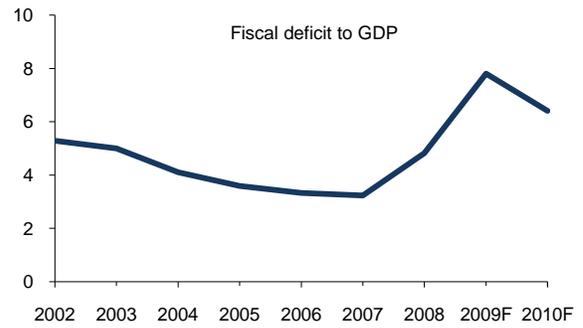
Source: CEIC and World Bank staff projections.

As quarterly growth resumes ...



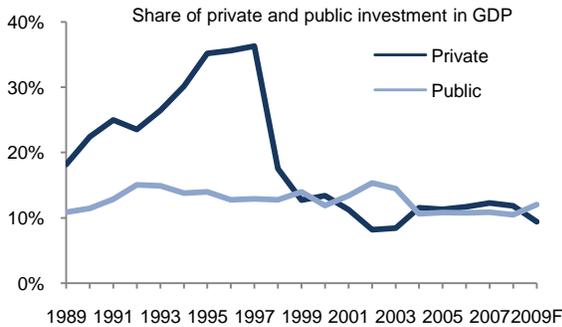
Source: CEIC and World Bank staff projections.

... the withdrawal of policy support requires careful management



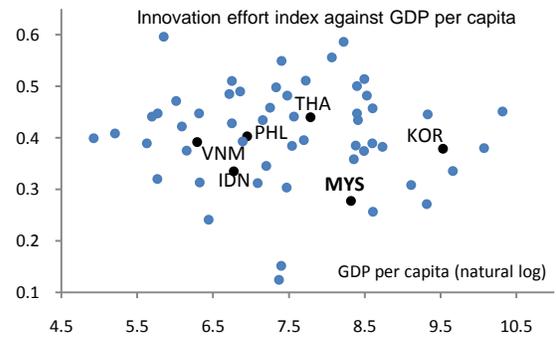
Source: CEIC and World Bank staff projections.

Sustained growth requires a pick-up in private investment



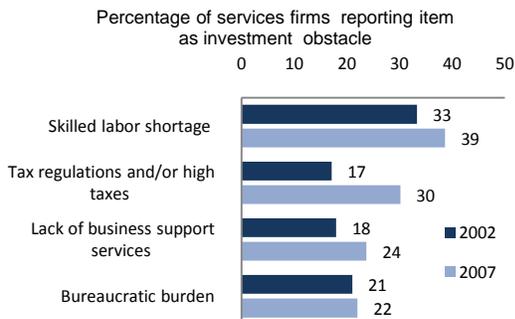
Source: CEIC and World Bank staff calculations.

... and greater innovation efforts by firms



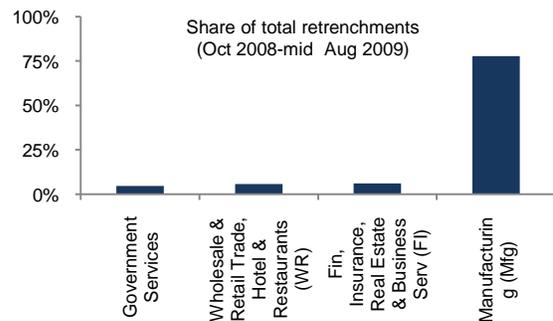
Source: WDI and World Bank staff calculations.
 Note: Index captures efforts on product development, product upgrading, process improvement, and foreign joint ventures.

Climbing up the income ladder requires, among other things, addressing skill shortages



Source: World Bank (2005 and 2009b).

... and targeting safety nets to protect against adversity



Source: Department of Labor.

CONTENTS

PREFACE	3
EXECUTIVE SUMMARY	4
CONTENTS	7
1. RECENT ECONOMIC DEVELOPMENTS	12
The External Environment Was Challenging	12
But The Malaysian Economy Remained Fundamentally Resilient	15
The Crisis Was Mostly a Manufacturing-For-Exports Crisis.....	16
Exports Were Hit Hard, But Are Now Recovering	21
The Small Rise in Unemployment Masked the Significance of the Social Impact.....	29
Financial Conditions Remained Robust	32
2. ECONOMIC OUTLOOK	36
The Global Outlook Has Improved Markedly	36
Malaysia’s Economic Recovery Is Solidifying	39
The Recovery Is Expected to Bring Significant Growth Next Year.....	40
The Current Account Surplus Will Likely Narrow	48
Fiscal Consolidation Efforts Are Expected to Curb the Headline Deficit	49
Output Is Expected to Gradually Recover to Potential	49
Downside Risks Overshadow the Outlook	50
3. REPOSITIONING FOR GROWTH	52
Why A New Economic Model for Malaysia?	52
Private Sector Initiative Has Been Subdued	53
Global and Regional Competition Will Likely Intensify	58
What Are The Pathways to High Income?.....	59
Specializing the Economy Further	60
Improving the Skills of the Workforce.....	65
Making Growth More Inclusive	70
Bolstering Public Finances	73
APPENDIX	76
REFERENCES	79

BOXES

Box 1. Why Did Malaysia Enter the Recession Later Than Other East Asian Economies?.....	19
Box 2. Supply Chain Management: Insights from Japanese firms in the E&E Sector	23
Box 3. Comparisons between the Current Crisis and the Asian Financial Crisis.....	43
Box 4. Malaysia’s Intraregional Trade and US Import Demand.....	46
Box 5. Investment and Savings in Malaysia	54
Box 6. Determinants of Private Investment in Malaysia: The Role of Public Infrastructure	56
Box 7. Innovation Efforts by Malaysian Manufacturing Firms.....	63
Box 8. Skill Shortages and the Perceptions by Manufacturing and Services Firms	68

FIGURES

Figure 1.1. EU and US: Confidence is picking up.....	13
Figure 1.2. EU and US: Stock markets are rebounding	13
Figure 1.3. EU and US: Quarterly GDP growth has resumed	14
Figure 1.4. EU and US: Industrial production has bottomed out.....	14
Figure 1.5. EU and US: Sales growth is resuming.....	14
Figure 1.6. EU and US: New orders are coming in	14
Figure 1.7. Emerging East Asia: Foreign reserve levels accumulated rapidly.....	15
Figure 1.8. Quarter-on-quarter growth has returned.....	17
Figure 1.9. Year-on-year growth still needs to catch up.....	17
Figure 1.10. Manufacturing drove the recession.....	17
Figure 1.11. Leading and coincident indicators have improved, but lagging indicators not yet	17
Figure 1.12. Industrial production fell deeply but has stabilized and is recovering	17
Figure 1.13. Inflation has not been a concern	17
Figure 1.14. Malaysia entered the recession later than other East Asian economies	20
Figure 1.15. Malaysia’s private consumption was much more robust.....	20
Figure 1.16. Public consumption was also supportive.....	20
Figure 1.17. The drop in investment was comparable to that in other countries.....	20
Figure 1.18. ...and the same goes for the exports of goods and services.....	20
Figure 1.19. Crude palm oil and rubber prices peaked early 2008.....	20
Figure 1.20. The implementation of fiscal stimulus measures is ongoing.....	21
Figure 1.21. The global recession provoked a severe export slump.....	22
Figure 1.22. E&E and commodities drove the slump and E&E is driving the recovery	22
Figure 1.23. Intraregional exports collapsed, but have started to recover	22

Figure 1.24. Commodity prices are picking up again, especially palm oil	22
Figure 1.25. The E&E sector drove the contraction of GDP growth	24
Figure 1.26. Case study: This firm froze hiring, which led to a 20-percent cut in headcount	24
Figure 1.27. Case study: This firm managed to slash inventories just one month after sales fell.....	25
Figure 1.28. Intermediate imports and non-commodity exports are closely related	26
Figure 1.29. Intermediate imports drove the contraction of imports	26
Figure 1.30. Current account remains at high surplus.....	26
Figure 1.31. Tourist arrivals recovered after a dip.....	26
Figure 1.32. The decline of FDI was one of the most severe in East Asia.....	27
Figure 1.33. Portfolio and other investments registered net outflows, but pressures have eased	27
Figure 1.34. The ringgit stabilized after depreciating against the US dollar.....	28
Figure 1.35. The performance against regional currencies was mixed	28
Figure 1.36. Labor market conditions are improving.....	29
Figure 1.37. The cost of firing is rather high	29
Figure 1.38. The unemployment rate rose as GDP growth fell	30
Figure 1.39. Unemployment lags GDP growth one to three quarters.....	30
Figure 1.40. Retrenchments were concentrated in manufacturing	30
Figure 1.41. Labor reallocated across sectors.....	30
Figure 1.42. Manufacturing wages fell and then generally recovered	31
Figure 1.43. A larger part of permanent layoffs fell on foreign workers.....	31
Figure 1.44. Manufacturing, construction and agriculture employed fewer foreign workers.....	31
Figure 1.45. The last decade saw an estimated decline in poverty incidence.....	31
Figure 1.46. Capital ratios have increased	33
Figure 1.47. Profitability has declined	33
Figure 1.48. Nonperforming loan ratios are overall at low levels	33
Figure 1.49. Liquidity surplus remained robust	33
Figure 1.50. The banking system's share of external assets to total assets has been low	33
Figure 1.51. Banks lend primarily to households.....	33
Figure 1.52. The distribution of NPLs tilted increasingly to manufacturing	35
Figure 1.53. Loan disbursements dropped as approval rates and credit demand fell	35
Figure 1.54. Government bond yields have remain low.....	35
Figure 1.55. Equity prices have rebounded	35
Figure 2.1. EU and US: Unemployment has risen sharply	37
Figure 2.2. Selected Countries: G-3 import demand did not recover as quickly as China's	37
Figure 2.3. G-7: Inflation will likely remain low	39

Figure 2.4. Malaysia's economy is recovering	40
Figure 2.5. Private consumption and exports are expected to improve	40
Figure 2.6. Quarterly growth is resuming	40
Figure 2.7. Consumer price inflation may pick up from a low base	40
Figure 2.8. Compared with 1997/98, this crisis showed different expenditure patterns	44
Figure 2.9. The impact on sectoral activity was also different from 1997/98	45
Figure 2.10. China is overtaking the US as an export destination	46
Figure 2.11. Weaker linkages between US import demand and regional exports before the Asia crisis...	47
Figure 2.12. ...but much stronger linkages after the Asia crisis	47
Figure 2.13. Linkages have increased but not steadily	47
Figure 2.14. The current account surplus remains comfortably high.....	48
Figure 2.15. Fiscal consolidation next year is expected to curb the fiscal deficit curbed in 2010.....	48
Figure 2.16. The collapse in government revenue drove the expansion of the fiscal deficit.....	48
Figure 2.17. The share of trade to GDP has increased markedly over the last few decades	50
Figure 3.1. The economy was a structural shift to services and manufacturing	52
Figure 3.2. Private investment has remained subdued	53
Figure 3.3. Investment fell but after the Asian crisis and never recovered.....	54
Figure 3.4. ... which was almost entirely due to the collapse in private investment.....	54
Figure 3.5. As a result, the savings and investment balance of the private sector dramatically rose	55
Figure 3.6. ...which unlike other countries flipped the net foreign asset position into a large surplus	55
Figure 3.7. Broadband subscription is still low	62
Figure 3.8. Malaysian exports are highly technology-intensive	63
Figure 3.9. But innovation efforts by firms are lag those in the region.....	63
Figure 3.10. The level of educational attainment has improved somewhat	65
Figure 3.11. The share of skilled labor is low	66
Figure 3.12. Vocational education is not yet widespread.....	67
Figure 3.13. Hiring and firing practices are comparatively rigid.....	67
Figure 3.14. Skill shortages are the main investment climate concern of manufacturing firms.....	68
Figure 3.15. ... and this also holds true for services firms.....	68
Figure 3.16. Manufacturing firms are concerned about crime, taxes and macro instability	69
Figure 3.17. Services firms worry about crime, skills, and anti-competitive practices	69
Figure 3.18. Manufacturing firms see skill inadequacies as the key reason for vacancies.....	69
Figure 3.19. ... and this is even more the case for services firms	69
Figure 3.20. The bottom three deciles each account for less than 5 percent of total income	70
Figure 3.21. Income inequality is significant, not unlike the rest of the region	70

Figure 3.22. Poverty incidence is subject to large spatial disparities...	71
Figure 3.23. ...which is not due to population shares being larger in states with high poverty incidence	71
Figure 3.24. Many countries in the region anticipate fiscal consolidation	73
Figure 3.25. The fiscal deficit is financed mainly domestically	74
Figure 3.26. Government revenue growth moderated	75
Figure 3.27. Subsidies drove government expenditure growth	75

TABLES

Table 2.1. East Asia and G-3: The Outlook Has Significantly Improved	38
Table 2.2. Thanks to China, developing East Asia remains the fastest-growing region in the world	39
Table 2.3. Manufacturing Firms Believe the Worst is Over	42
Table 3.1. The long-run and short-run results of the private investment equation	57
Table 3.1. Key thrusts of Budget 2010	59
Table 3.3. Innovation efforts by firms generally declined between 2002 and 2007	64
Table 3.4. Skill shortages take on many forms	65
Table 3.5. Malaysian 13-year olds are outperformed in math and science	66
Table 3.6. The federal headline deficit is generally larger than the public sector deficit (except 2008)	74

APPENDIX TABLES

Appendix Table 1: Economic developments	76
Appendix Table 2. Developments and projections: real GDP levels	77
Appendix Table 3. Developments and projections: real GDP growth and other indicators	78

1. RECENT ECONOMIC DEVELOPMENTS

With East Asia in recovery mode and advanced economies progressively improving, the Malaysian economy is emerging from one of the worst export slumps in its economic history. As global demand plummeted end of last year, manufacturing firms braced for impact by cutting production, running down inventories, and slashing investment. Given the importance of exports in the economy, the resulting impact on GDP was pronounced. But the turmoil in manufacturing did not lead to a broad-based recession. Private consumption and service sector activity was resilient: growth stalled but levels remained intact. The crisis was mostly a manufacturing-for-exports crisis.

The economy was one of the hardest hit in the East Asia region, but it remained resilient. Sound fundamentals and responsive policies provided support. Strong financial supervision and limited exposures to toxic securities and troubled financial institutions shielded the economy from financial contagion. High levels of international reserves relieved the impact of capital outflows. Sound household and corporate balance sheets cushioned the impact of the downturn. On the policy side, accommodative monetary and credit policies protected the flow of credit. Successive fiscal stimulus packages helped boost confidence and construction activity, and hereby contributed to the cushioning of the downturn.

The small rise in the unemployment rate masks the significance of the social impact of the crisis. Underneath this, however, was a reallocation of labor across sectors, with services hiring and manufacturing retrenching large numbers of workers. Job losses, shorter working hours, and lower wages are likely to have raised absolute and relative poverty in urban areas. Lower commodity prices are likely to have been detrimental to rural livelihoods.

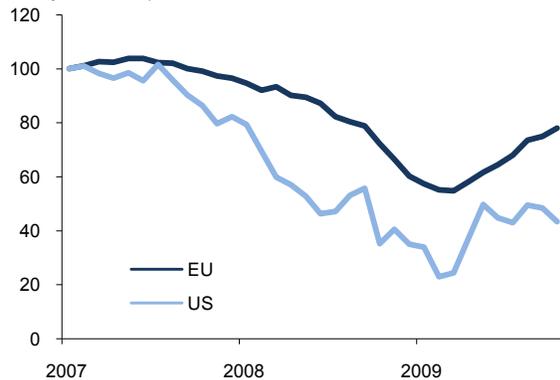
THE EXTERNAL ENVIRONMENT WAS CHALLENGING

The global economic crisis had a severe impact on Malaysia's trading partners, which was transmitted in three phases:

- At the outset of the crisis was the financial phase which began in the U.S. subprime market mid-2007. The crisis accelerated following the collapse of Lehman Brothers, just as markets were assuming the worst was over, and only recently subsided because of extraordinary monetary and financial support in advanced economies.
- Not long after the financial shock came the real economy phase. Advanced economies entered the recession well before the Lehman shock but the failure exacerbated the contraction. Damaging macro-financial interactions put a damper on private demand.
- Then came labor markets, lagging—as is typically the case—behind financials and production. As businesses around the world braced for impact, working hours were cut, earnings were reduced, workers were shed, and eventually firms were closed.

Figure 1.1. EU and US: Confidence is picking up

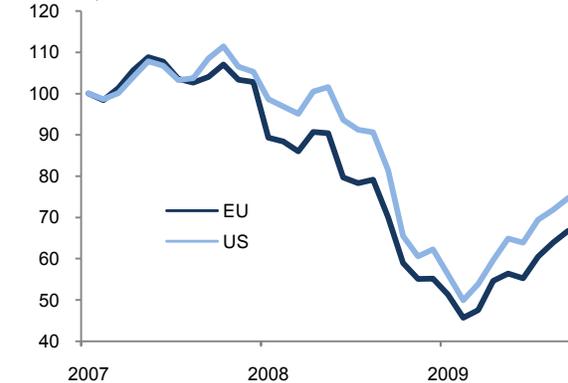
US consumer confidence index and EU economic sentiments index (January 2007=100)



Source: CEIC and World Bank staff calculations.

Figure 1.2. EU and US: Stock markets are rebounding

EU Dow Jones Euro Stoxx and US NYSE Composite (January 2007=100)



Source: CEIC and World Bank staff calculations.

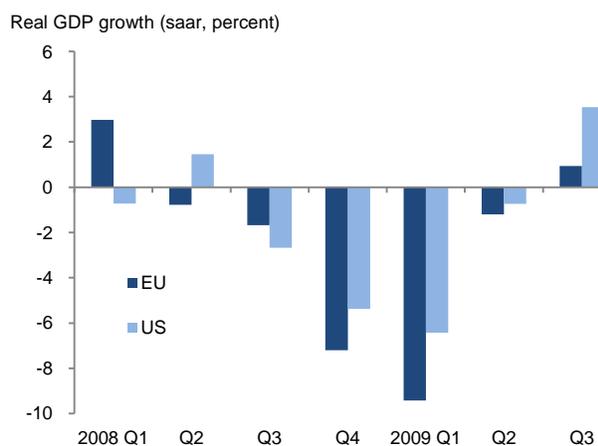
The US and European economies were dealt the full blow of the three phases of the crisis, and experienced the interplay between financial distress, receding growth and rising unemployment.

- The financial phase of the crisis was initially most pronounced in the United States, but the advanced and emerging economies of Europe quickly followed suit. The fallout put unprecedented strain on financial systems, and led to a considerable expansion of state involvement.
- The real economy soon followed and national income, trade and potential output all significantly declined. Policymakers attempted to mitigate the contractionary forces with unprecedented policy measures.
- Labor markets adjusted primarily through layoffs in the United States, with unemployment now at levels not seen since the 1980s. In Europe, the adjustment occurred predominantly through cutting hours and hoarding labor, even though unemployment has risen significantly in several countries.

Signs of stabilization and modest recovery appeared around March-April, and have since gradually solidified (Figure 1.1-Figure 1.6).

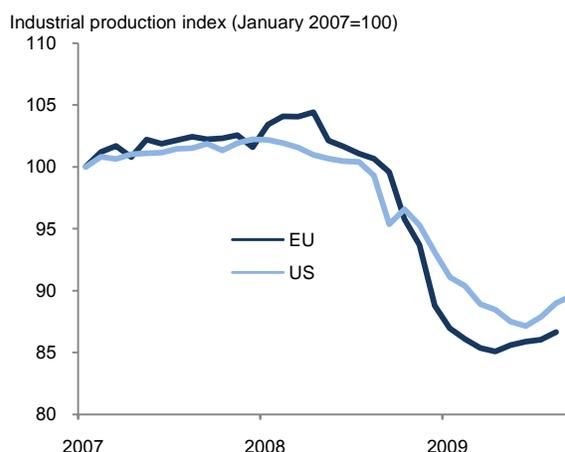
- Financial conditions have stabilized thanks to wide-ranging government interventions in financial institutions and markets. Confidence has returned especially in the EU and risk appetite has increased. As a result, stock markets have rallied and the price of risk on corporate and sovereign instruments has fallen.
- Recent indicators suggest the worst is over. The US economy expanded faster than expected in the third quarter at 3.5 percent (saar), due to less rapid destocking and monetary and fiscal stimulus. Other high frequency indicators point to improvements as well. Inventory levels have fallen relative to sales, auguring well for future production. Non-manufacturing indices started rising again. Sentiment in the E.U. has improved since early 2009. Industrial output rose recently, and the purchasing managers index too, even though levels are still below pre-crisis levels.

Figure 1.3. EU and US: Quarterly GDP growth has resumed



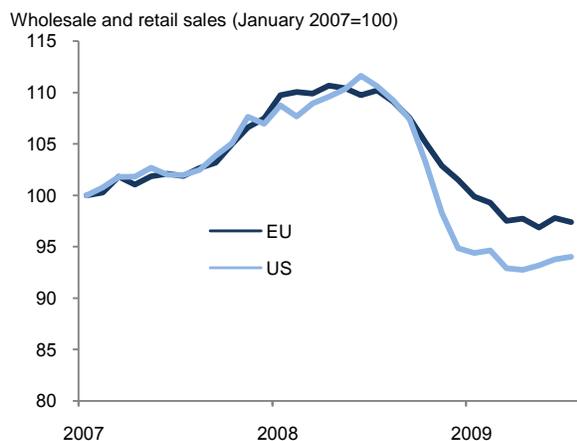
Source: CEIC and World Bank staff calculations

Figure 1.4. EU and US: Industrial production has bottomed out



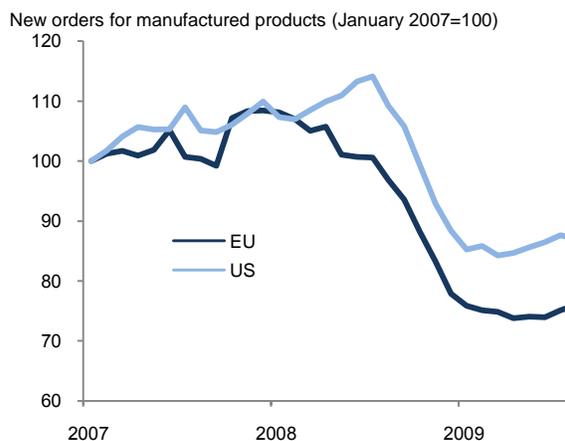
Source: CEIC and World Bank staff calculations.

Figure 1.5. EU and US: Sales growth is resuming



Source: CEIC and World Bank staff calculations

Figure 1.6. EU and US: New orders are coming in



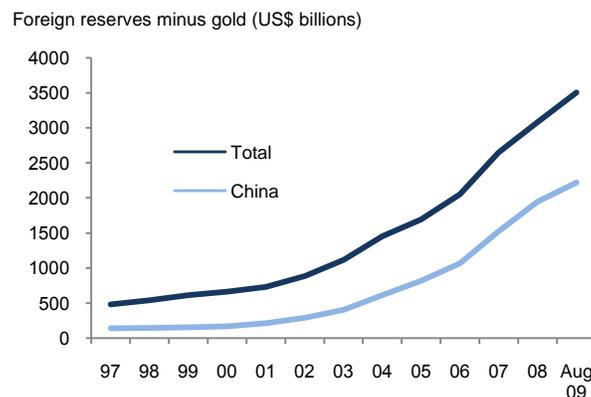
Source: CEIC and World Bank staff calculations

Thanks to strong initial conditions, the overall adjustment process in East Asia to the three phases of the crisis turned out to be generally less severe.

- The region was largely spared the financial phase of the crisis, as exposures to toxic securities and troubled financial institutions were limited. Banks generally had much less foreign borrowing compared to the 1997-98 Asian crisis, and domestic liquidity was ample. In addition, the regional economy was in a much better capacity to withstand the shock, having accumulated large foreign reserve levels following years of current account surpluses (Figure 1.7). The improvements in prudential standards over the past decade also contributed, and financial systems were less prone to asset quality problems.

- The region's economy nevertheless experienced a severe contraction in production and income, primarily on account of trade-related channels. The sudden fall in end-user demand in the United States and Europe reverberated through global supply chains and caused a precipitous impact on industrial output of East Asia's manufacturing sites. As a consequence, trade—particularly intra-firm and intra-industry—collapsed. In parallel, as risk appetite retrenched, capital flowed out with adverse impact on asset prices and currencies.
- Labor markets weakened in the face of the manufacturing-led decline in output, but it appears that this impact was relatively muted. Unlike the 1997-98 Asian crisis episode, private consumption remained relatively resilient and external demand as well as investment suffered the largest impact. In addition, as mentioned earlier, this time around East Asia could not export its way out of the recession since it faced a synchronized decline in the demand for its goods and services. Overall, the labor market impact was muted, except for employment in sectors exposed to external demand.

Figure 1.7. Emerging East Asia: Foreign reserve levels accumulated rapidly



Source: Haver and World Bank staff calculations
 Note: Total reserves include those from CHN, IDN, MYS, PHL, THA, HKG, KOR, SGP and TWN.

BUT THE MALAYSIAN ECONOMY REMAINED FUNDAMENTALLY RESILIENT

The Malaysian economy was one of the hardest hit in the East Asia region, but it remained fundamentally resilient. In terms of the phases of the crisis, the real economy impact was the most pronounced:

- Malaysia, as most other countries in the region, was largely spared from the financial spillovers and contagion that took place within and among the financial systems of the United States and advanced European economies.
- While the global collapse in trade affected Malaysia's large export-oriented manufacturing sector profoundly, the high import content of its exports provided a buffer and the decline in exports quickly led to a curb in import demand. Negative inward spillovers to domestic demand emerged but these proved short-lived. But the turmoil in manufacturing did not lead to a broad-based recession. Private consumption and service sector activity was resilient: growth stalled but levels remained intact.

- As the production of tradables experienced a sharp contraction, registered employment in the capital-intensive manufacturing industry sector fell, but the labor market impact on the economy more widely remained rather well contained. Unemployment has risen but the rise has been marginal. This however masks the significance of the social impact of the crisis as will be discussed.

The Crisis Was Mostly a Manufacturing-For-Exports Crisis

In spite of initial concerns, the crisis remained a manufacturing-for-exports crisis and did not significantly spill over into the rest of the economy. As the shock of falling external demand reeled through their global and regional supply chains, manufacturing firms cut production, ran down inventory stocks, and reduced fixed investment. Initial concerns were that the downturn would become more broad-based. However, the domestic private sector entered the downturn in a relatively strong position, with private sector consumption remaining rather resilient. The generally limited domestic economic footprint of manufacturing multinational corporations (MNCs), as reflected in the high import content of Malaysia's exports, helped curb the inward spillovers into domestic demand. The resilience of private consumption also helps explain why Malaysia entered the recession one quarter later than other countries in the region (Box 1).

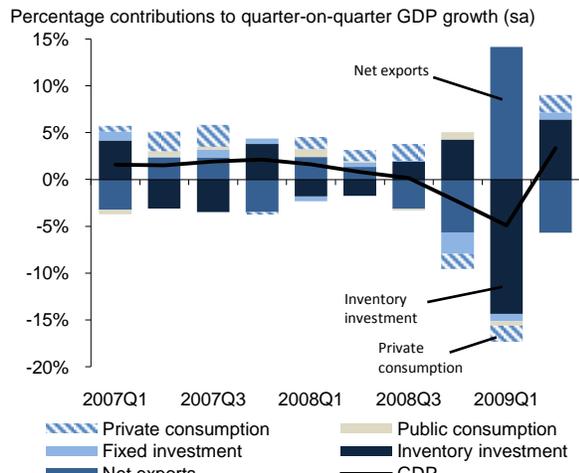
Activity showed signs of stabilization in the second quarter, with private consumption and fixed investment rising on the back of stimulus spending (Figure 1.8-Figure 1.10). On a seasonally adjusted basis, output rose again after 8-9 percent decline (qoq) in the previous two quarters. The annual contraction in real GDP moderated from -6.2 percent in the first quarter to -3.9 percent in the second. Private consumption and fixed investment both recovered with the former making a positive contribution to annual growth. The rise in fixed investment included the impact of the stimulus spending. On the supply side, the manufacturing sector, which had suffered deeply, made some recovery in the second quarter. The all-important services sector—accounting more than half of total activity and a third of total jobs—remained resilient and played a major role in the GDP stabilization.

Industrial production has improved too, with capacity utilization in the export-oriented sectors rising again (Figure 1.11-Figure 1.12). Components of Malaysia's leading index of economic activity pointed to improvements as early as the first quarter of 2009.¹ However, only in recent months have coincident indicators, such as industrial production, reported positive growth. The recovery in industrial production has lagged that in other countries within the region, largely due to the fact that the Malaysian economy was also affected by the global slowdown one quarter later.² Capacity utilization

¹ The coincident index includes: industrial production, real gross imports, real salaries and wages in manufacturing, total employment in manufacturing, real sales in manufacturing, and real contributions to the EPF. The leading index includes: the level of real M1 money supply, Bursa Malaysia's stock market index, the real total trade of eight major trading partners, inverted CPI growth for services and industrial material price inflation, the ratio of price to unit labor cost in manufacturing, the number of housing permits approved and the number of new companies registered. The lagged index components include: the 7-day call money rate, the level of real excess lending to private sector, investment projects approved, the number of defaulters, the Employees Provident Fund (inverted) and new vehicles registered.

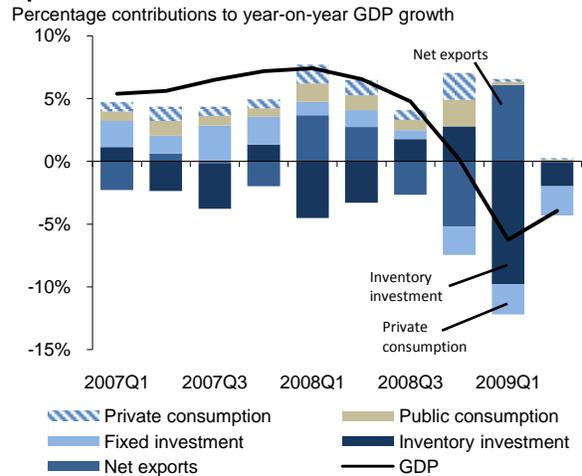
² The later recovery in industrial production can also be attributed to unplanned shutdowns in the mining sector (especially petroleum).

Figure 1.8. Quarter-on-quarter growth has returned



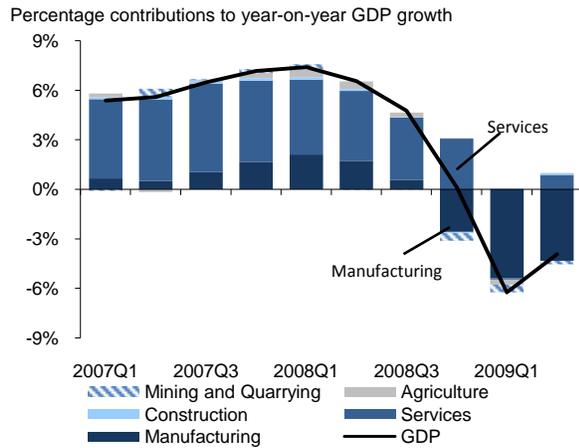
Source: Haver and World Bank staff calculations.

Figure 1.9. Year-on-year growth still needs to catch up



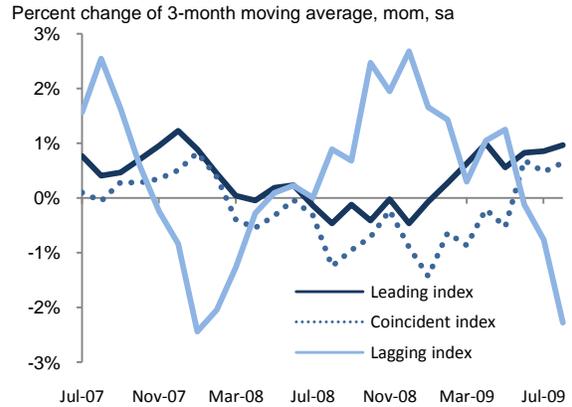
Source: CEIC and World Bank staff calculations.

Figure 1.10. Manufacturing drove the recession



Source: CEIC and World Bank staff calculations.

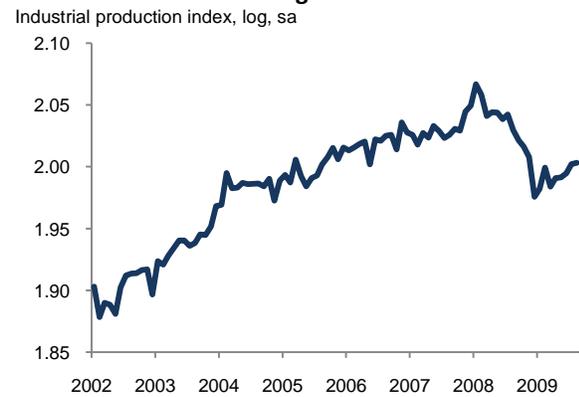
Figure 1.11. Leading and coincident indicators have improved, but lagging indicators not yet



Source: CEIC and World Bank staff calculations.

Notes: Seasonal adjustment based on X.12.

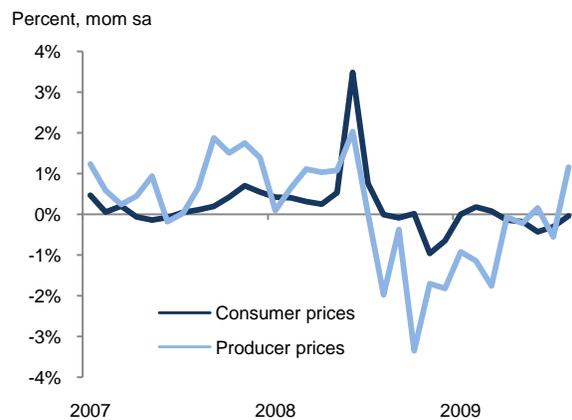
Figure 1.12. Industrial production fell deeply but has stabilized and is recovering



Source: CEIC and World Bank staff calculations.

Notes: Seasonal adjustment based on X.12.

Figure 1.13. Inflation has not been a concern



Source: CEIC and World Bank staff calculations.

Notes: Seasonal adjustment based on X.12.

registered a notable increase for export-oriented industries, up from 61 percent in the first quarter to 73 percent in the second. This is consistent with other indicators, such as lower levels of retrenchments and increased vacancy levels in manufacturing. The recovery of capacity utilization in the domestic-oriented industries has been less pronounced with around 40 percent of capacity remaining unutilized in the second quarter.

Inflationary pressures have been muted, due to weakened domestic demand, reduced costs, and base effects (Figure 1.13). Annual consumer price inflation moved into negative territory in June for the first time since March 1987, which was primarily the result of the base effects due to the high level of food and fuel prices in 2008. Food price inflation fell to 1 percent year-on-year in the month of September from around 10 percent at the beginning of 2009, with transport prices also contributing to the lowering of prices. After monthly contractions from mid-2008 to mid-2009, the producer price index has shown recent signs of recovery. Again, due to base effects, there remains deflation in producer prices on an annual basis, driven particularly by prices for local production, down -13.3 percent year-on-year in August, although import producer prices also fell by 2.9 percent. The gap between consumer and producer price annual inflation rates, whilst falling somewhat in recent months, remains around 7.5 percentage points. The low levels of capacity utilization, as discussed above, may weigh against a swift re-emergence of inflationary pressures in the short-term.

While in large part driven by external developments, recent improvements in economic conditions have also been helped by the easing of fiscal policy.³ The Malaysian authorities announced two fiscal stimulus packages. These packages entertained multiple objectives, ranging from sustaining demand to mitigating the crisis impact and addressing medium-term growth issues.

- The first stimulus package, announced in November 2008, amounted to approximately 1 percent of GDP (RM7 billion) and was allocated mostly to spending measures for projects with high-multiplier effects, mostly relating to infrastructure. These measures were financed by savings in fuel subsidies, which were cut mid-2008 to reduce the fiscal burden amidst fast-rising global fuel prices.
- The second fiscal stimulus package was announced in March 2009 in the amount of RM60 billion or 9 percent of GDP. The second package is spread however over two years and includes spending measures (RM15 billion), guarantee funds (RM25 billion), equity investments (RM10 billion), private finance and off-budget initiatives (RM7 billion) and tax incentives (RM3 billion). The direct fiscal injection implied by the package is estimated at about 3.5 percent of GDP over two years, and is consists of about 80 percent of spending measures (mostly investment expenditure) and 20 percent tax cuts.

³ Fiscal policy issues will be discussed more fully in the next parts.

BOX 1. WHY DID MALAYSIA ENTER THE RECESSION LATER THAN OTHER EAST ASIAN ECONOMIES?

Malaysia seems to have entered the recession a quarter later than most other regional economies. When Malaysian yearly GDP growth stalled at 0.1 percent in the last quarter of 2008, other countries in the region, such as Thailand and the four Newly Industrialized Economies, were already well into an economic contraction. As shown in Figure 1.14, this ranged from -2.6 percent in Hong Kong SAR to -8.6 percent in Taiwan (China).

The key factor for this differential performance was the more robust performance of both private and public consumption in Malaysia (Figure 1.15 and Figure 1.16). Clearly this mattered since Malaysia's consumption expenditure makes up some two-thirds of GDP (52 percent and 14 percent of GDP for private and public spending respectively). This is comparable to Hong Kong SAR, Korea and Taiwan (China), and higher than Singapore and Thailand.

The rate of decline in fixed investment and exports was similar to that of other countries, so this was not a likely reason (Figure 1.17 and Figure 1.18). Similarly, base effects are not the reason either, since the Malaysian economy expanded 7.2 percent in the last quarter of 2007, which is much higher than the other five economies considered here.

What then explained the robust growth of private consumption? The peak of commodity prices in the first half of 2008 tells part of the story. Between October 2006 and March 2008, crude palm oil price jumped by 144 percent (Figure 1.19). This helped build wealth among 1.4 million workers, of which 570,000 directly employed in the industry and the remainder indirectly (Malaysian Palm Oil Council, 2008). A similar outcome applies to workers in the rubber plantations, as rubber prices rose 43 percent between August 2007 and July 2008. Private consumption in Thailand, another country with large commodity exports, was also stronger in the second half of last year compared to the NIEs.

The stimulus impact of Budget 2009 played a role too. As the slowdown started to appear, government announced an expansionary Budget for 2009 in August 2008. Measures such as tax exemptions on interest from deposits previously levied at 5 percent, lower road tax for diesel vehicles, and free electricity bills for low-volume users were introduced with immediate effect and may have strengthened consumption tax rebates and lower income taxes also helped, as did measures to help the business sector which would result in positive spillovers into private consumption.

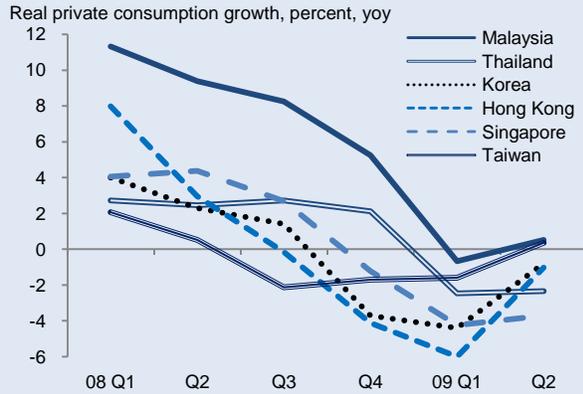
What drove public consumption? Higher subsidies to support rising food and fuel prices were key. Despite a reduction in fuel price subsidies mid-2008, total subsidies stood at nearly 20 percent of government revenue in 2008. In the second half alone, they were 1.5 times that of the similar period in 2007. Price subsidies have been used to support many basic food items. Another contributory factor was the public sector pay hike in mid-2007. Emoluments as a result increased 26 percent in 2008 year-on-year. For the first time in 15 years, about one million government officials received a pay increase by as much as 35 percent.

Figure 1.14. Malaysia entered the recession later than other East Asian economies



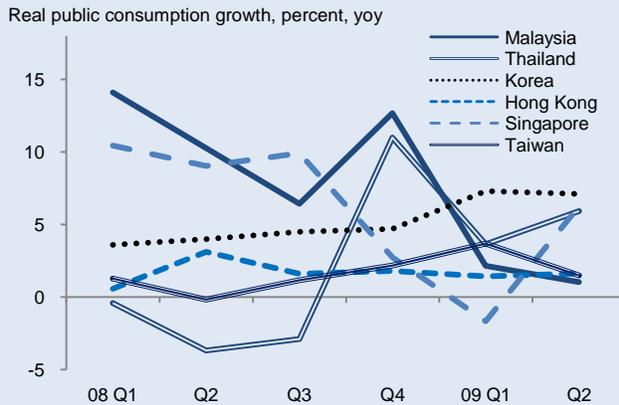
Source: CEIC and World Bank staff calculations.

Figure 1.15. Malaysia's private consumption was much more robust



Source: CEIC and World Bank staff calculations.

Figure 1.16. Public consumption was also supportive



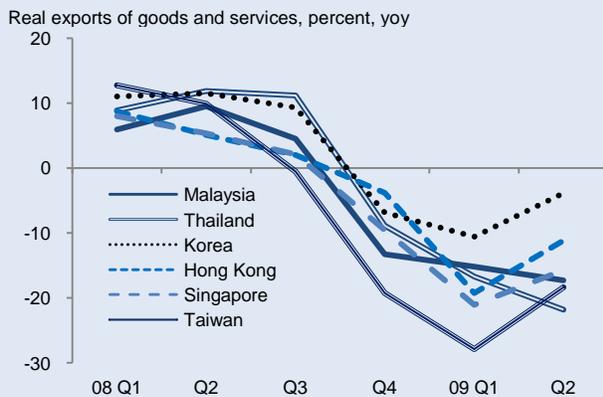
Source: CEIC and World Bank staff calculations.

Figure 1.17. The drop in investment was comparable to that in other countries



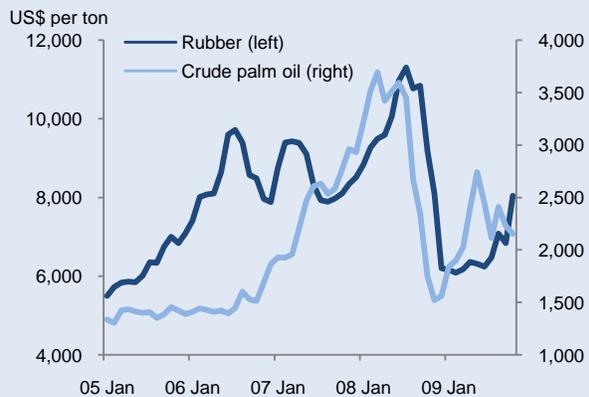
Source: CEIC and World Bank staff calculations.

Figure 1.18. ...and the same goes for the exports of goods and services



Source: CEIC and World Bank staff calculations.

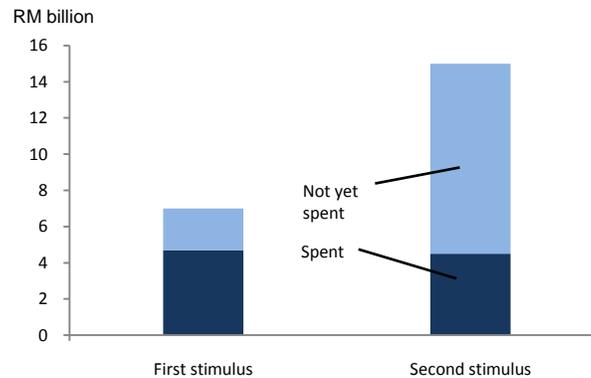
Figure 1.19. Crude palm oil and rubber prices peaked early 2008



Source: CEIC and World Bank staff calculations.

The stimulus measures helped shore up confidence and provided direct support to the construction sector, but the overall impact on the economy during the first two quarters of 2009 was likely limited. Decision and implementation lags affected the speed and rate of disbursement. As of end-October 2009, 66 percent of stimulus expenditures were spent for the first package, whereas this was so far 30 percent for the second package (Figure 1.20). Fiscal stimulus also typically takes time to multiply itself into higher income and growth, a process which is in Malaysia hampered by import and remittance leakages due the high degree of openness of the economy.

Figure 1.20. The implementation of fiscal stimulus measures is ongoing



Source: Ministry of Finance and World Bank staff calculations.

Exports Were Hit Hard, But Are Now Recovering

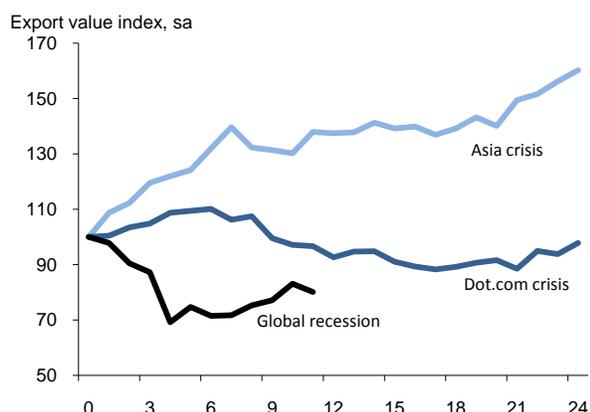
The current export slump is one of the most severe in Malaysia's economic history (Figure 1.21).

- As global conditions deteriorated, Malaysia's exports contracted sharply in the second half of 2008 and continued to do so early 2009. In the past, the decline in exports was either limited, as during the Asian financial crisis in 1997/98, or gradual as following the puncturing of the technology bubble in 2001. During the current episode, exports plunged both rapidly and sharply—in 8 months Malaysia's total exports declined by 31 percent on a seasonally adjusted basis.
- While the steep decline in exports deeply affected the manufacturing sector, the impact on the economy as a whole was mitigated by the compression in processing imports. Malaysia's economy is highly dependent on external markets with an export-to-GDP ratio of 1.2 and a trade-to-GDP ratio of 2.2 in 2008. More than 40 percent of Malaysia's exports are electrical and electronics (E&E) products with high import content and produced in large part by firms under foreign ownership. This helped reduce the economy-wide significance of the shock.

Exports are recovering now (Figure 1.22).

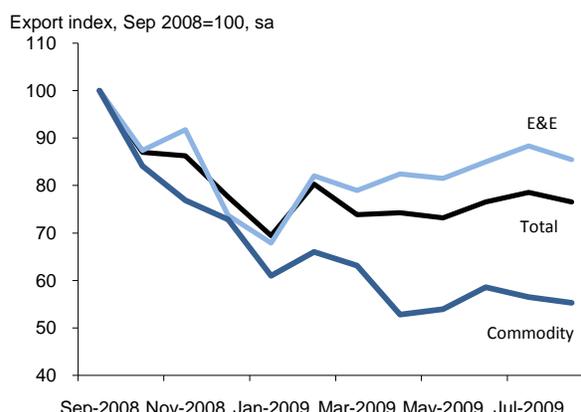
- Renewed demand abroad, driven by a turn in the global inventory cycle and import demand from China, helped the export recovery. Malaysia's exports began to gradually climb out of the trough in the second quarter. On a month-on-month seasonally adjusted basis, exports resumed growth for two successive months in June/July. Total exports grew at 4.6 percent and 2.6 percent (month-on-month sa) in June and July, respectively; non-commodity exports at 3.3 percent and 4.6 percent.

Figure 1.21. The global recession provoked a severe export slump



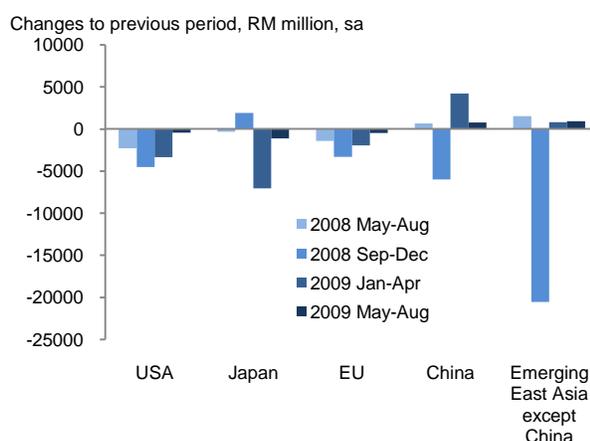
Source: CEIC and World Bank staff calculations
 Note: Export index = 100 for Jul 1997 (Asia crisis), Mar 2000 (Dot.com crisis and Sep 2008 (current crisis).

Figure 1.22. E&E and commodities drove the slump and E&E is driving the recovery



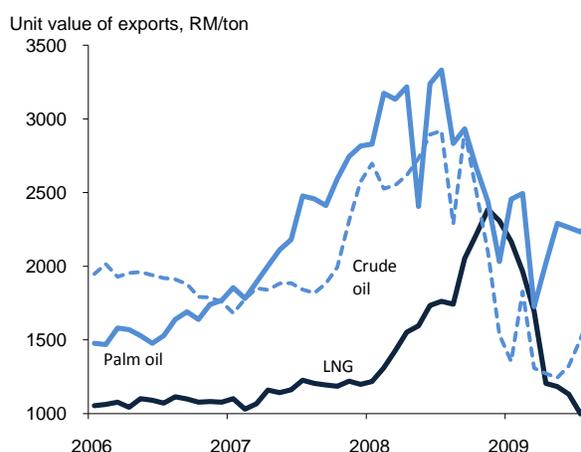
Source: CEIC and World Bank staff calculations.

Figure 1.23. Intraregional exports collapsed, but have started to recover



Source: CEIC and World Bank staff calculations

Figure 1.24. Commodity prices are picking up again, especially palm oil



Source: CEIC and World Bank staff calculations

- Key drivers were stronger demand from China and other emerging East Asian economies while the decline in the demand of G-3 also moderated (Figure 1.23). Demand from China picked up sharply in the first four months of 2009 by increasing RM4.2 billion or 25 percent over the previous period on a seasonally adjusted basis and the growth trend has continued till August 2009. Demand from other East Asian economies, including Singapore, Thailand, and Hong Kong SAR, has also resumed modest growth since 2009. The demand from G-3 remained a drag to exports growth but declined at a more moderate pace over May-August.

- The better performance of E&E goods was key (Figure 1.22 and Box 2). Accounting for over 40 percent of total exports, E&E exports have driven the recent recovery of exports. This was helped first by the turnaround in the global inventory cycle, with firms starting to restock in response to rising orders. A second factor was the economic stimulus package of China. Although most of China's stimulus package is infrastructure-oriented investment, measures such as subsidies for rural consumption of electronic appliances have boosted domestic demand and buoyed imports⁴.
- The recovery of commodity exports lagged due to subdued prices and weakened demand in most markets (Figure 1.22 and Figure 1.24). Global commodity prices witnessed a sharp contraction in the second half of 2008 as a correction to overshooting in the first half. The trend reversed somewhat early 2009. Yet, export prices for LNG, crude oil and petroleum products have remained below previous levels due to demand weakness and large overhang of stocks globally. The exception is palm oil where lower production domestically and in the region lifted export prices much closer to the pre-crisis level. Global demand uncertainties meant that volume gains remained patchy.

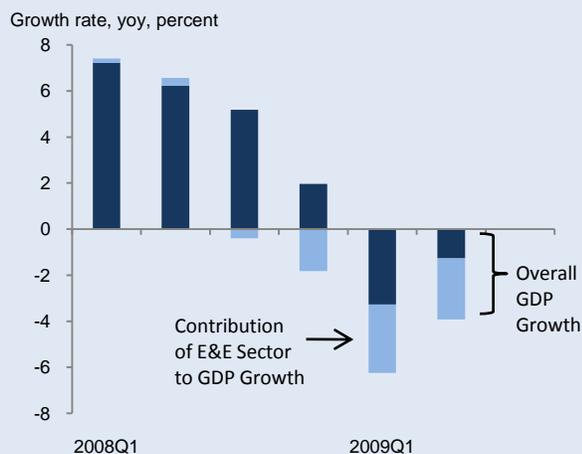
BOX 2. SUPPLY CHAIN MANAGEMENT: INSIGHTS FROM JAPANESE FIRMS IN THE E&E SECTOR

The electrical and electronics (E&E) sector makes a large contribution to the economy of Malaysia, representing 38 percent of exports and 9 percent of GDP in 2008. Drastic production cuts in the E&E sector have also been a key contributor to the sharp drop in GDP observed in the fourth quarter of 2008 and first quarter of 2009 (Figure 1.25)—and the industry is now playing an important part in the economic recovery. Because of the significance of the E&E sector at the macro level, it is essential to understand the impact of the crisis and nascent recovery at the firm level. What has allowed firms to cut production so quickly? How are firms seeing the prospects for the recovery? In answering these questions, this Box will draw upon Anantavasilpa, Ratchada and others (2009), a forthcoming study on Japanese supply chains in the E&E industry in Malaysia and Thailand.

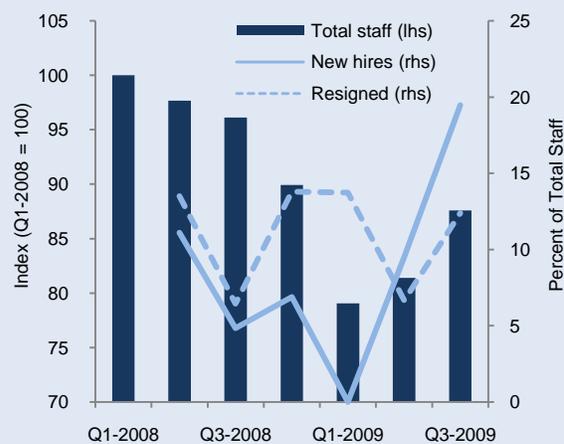
Zooming into a particular subset of firms, namely Japanese MNCs in the E&E sector, it is argued that the supply chain management practices of these firms are key. Following decades of FDI, Japanese MNCs have contributed to the massive expansion of trade both between Malaysia and the rest of the region, and within Malaysia, as supporting industries have followed their larger clients. Reflecting these developments, as well as a move towards less vertical integration of production within firms, there are now over 1,300 Japanese and Japanese related companies in Malaysia, and their supply chains have come to embody complex linkages—both regionally and locally. As will be argued, the efforts by firms to manage total supply chain costs provide important clues to the impact of the crisis and prospects for a recovery.

Perhaps the most distinctive feature of the current crisis episode was the very rapid adjustment of production in response to cuts in forecasts for final demand. Purchase contracts for firms' output are usually specified on a monthly basis (depending on the level of customization of the products). Therefore, when forecasts of final demand were reduced around September and October, buyers were able to cut their orders immediately, affecting deliveries starting in November and December. As orders

⁴ World Bank (2009c).

Figure 1.25. The E&E sector drove the contraction of GDP growth

Source: CEIC and World Bank staff calculations

Figure 1.26. Case study: This firm froze hiring, which led to a 20-percent cut in headcount

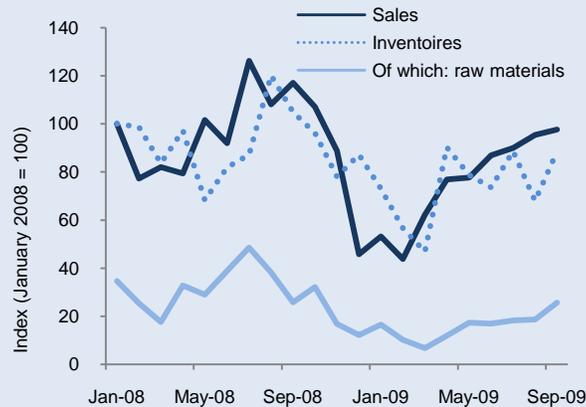
Source: E&E firm and World Bank staff calculations.

for their products were cut, firms reduced or shut down production without much lag. This was thanks to the use of short-term supply contracts that matched contracts for their outputs, flexibility in adjusting labor costs, and improved management of inventories of both inputs and outputs (including the increased use of suppliers located in Malaysia). As a result, some of the companies interviewed dropped production by 60 to 75 percent in December 2008.

Firms cut labor inputs by reducing hours, slashing contract labor and freezing hiring. Outright wage cuts were not reported, but companies cut second and third shifts and shut down plants (especially around holidays) with proportional cuts in salary payments. Few regular staff were laid off, reflecting a structural shortage of skilled and semi-skilled labor, but many contract workers, especially foreign workers (who comprise as much as 40 percent of the labor force in the companies interviewed), were not renewed or had their contracts terminated. This appeared to be the main mechanism through which companies reduced headcount, with one firm reporting that its staff was reduced by 25 percent, mostly from cutting foreign contract workers. Other firms implemented hiring freezes, which reduced headcounts given normal attrition following the payment of year-end bonuses (staff turnover was reported to be very high in general, likely due to chronic labor shortages). Figure 1.26 illustrates how an actual firm accomplished labor reductions through turnover.

Adjustments to material inputs were linked to tight management of inventories, especially through the use of short-term supply contracts, information technology, and local suppliers. Supply contracts (including for business services, such as logistics), are usually adjusted quarterly and typically only specify prices and quality, while quantities are adjusted more frequently. Figure 1.27 shows an example for an actual firm that illustrates this point. In addition, a gradual move to local supporting industries also reduced the need for inventories. For example, a supplier who ten years ago had to buy critical inputs in bulk because of freight costs now can place orders from a local supplier on an almost daily basis. Finally, the use of information technology in supply chain management has allowed firms to have an accurate and timely picture of their input needs, inventory situation and orders, contributing to a quick transmission of final demand drop through the entire supply chain.

Figure 1.27. Case study: This firm managed to slash inventories just one month after sales fell



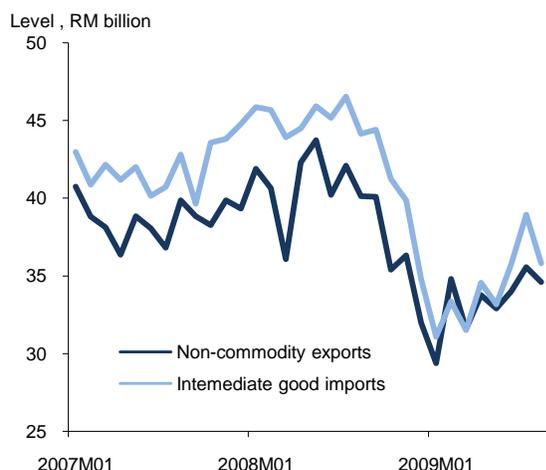
Source: E&E firm and World Bank staff calculations.

Some of the factors that contributed to the speed of the contraction are playing a role in the recovery as well. Because final demand dropped by less than forecast at the onset of the crisis, orders had to be filled from existing inventories. The advances in inventory management described earlier implied that inventory levels were low, so the run-down in inventories in the first quarter quickly led to new orders. The ability to quickly adjust costs downward in the downturn protected their balance sheets, which were relatively healthy at the onset of the crisis to begin with. The soundness of corporate balance sheets contributed to a quick restart of production as few firms faced constraints to finance the working capital required. One additional reason for the financial soundness of a number of smaller Malaysian E&E firms has been lack of investment in recent years, which meant firms had higher levels of retained earnings that could be used as a buffer in case of a shock.

In other cases, responses to the crisis created frictions that slowed recovery, especially with respect to labor inputs, and shortage of semi-skilled and unskilled workers was widely reported in firm interviews. By April and May firms were already trying to re-hire workers, but they faced difficulties in filling vacancies. Firms attributed shortages partly to government efforts to reduce the economy's dependence on foreign workers, which contributed to delays in renewed labor inflows. Some companies claimed that production was still below order levels due to worker shortages and as a consequence were offering higher wages. Frictions created by suppliers' ability to restart production were also reported, but appeared less salient than labor issues.

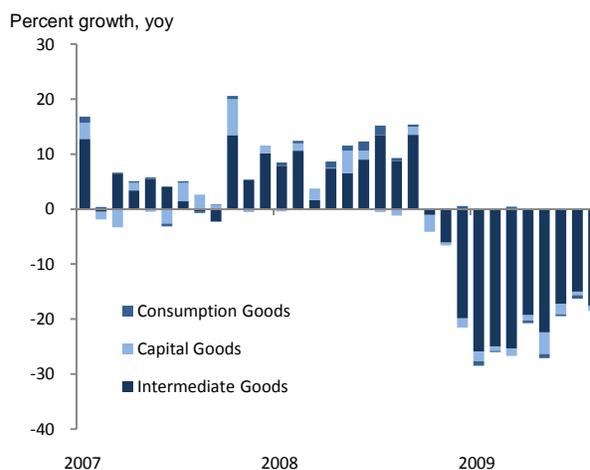
Firms were unsure about the outlook for the recovery, but the impact of expectations within the supply chain is limited since in the near term firms are "expectations takers" from the parent companies. Improvements in inventory management have decreased the horizon of forecasting at the level of the firms within the supply chain, which are able to quickly ramp up production in response to increased orders – at least while capacity utilization is still well below potential. However, the uncertain outlook may have important implications in the medium-term, as some firms may delay capital expenditures needed to increase capacity. Because of limited vertical integration, bottlenecks may emerge that could initially limit the speed of the recovery.

Figure 1.28. Intermediate imports and non-commodity exports are closely related



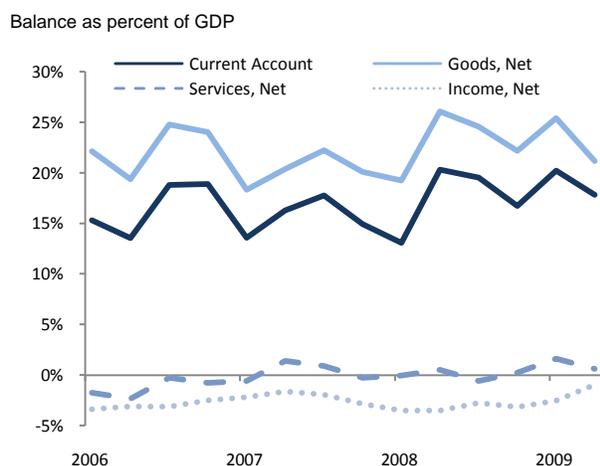
Source: CEIC and World Bank staff calculations.

Figure 1.29. Intermediate imports drove the contraction of imports



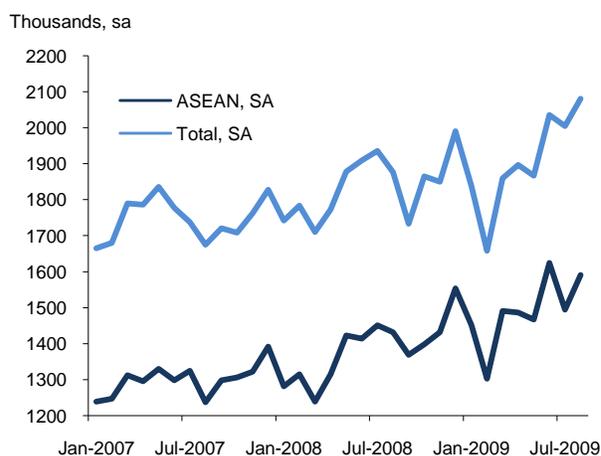
Source: CEIC and World Bank staff calculations.

Figure 1.30. Current account remains at high surplus



Source: CEIC and World Bank staff calculations.

Figure 1.31. Tourist arrivals recovered after a dip

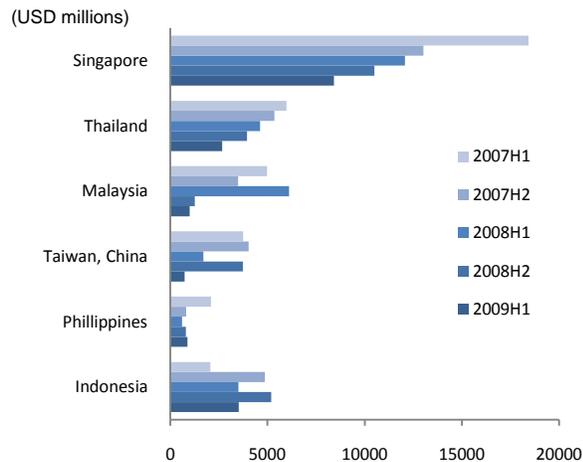


Source: CEIC and World Bank staff calculations.

With export growth improving, the recovery of imports was even more pronounced (Figure 1.28-Figure 1.29). Import growth reached 7.8 percent (month-on-month sa) in June, followed by 9.0 percent in July. The improvement is closely linked to domestic inventory rebuilding in anticipation of a recovery in exports. The bulk of Malaysia’s imports, 70 per cent, were intermediates primarily for re-export in 2008. On the back of improved sentiment and re-stocking activity, intermediate imports started to pick up in the second quarter accompanying the movement in exports and contributed the most to import recovery.

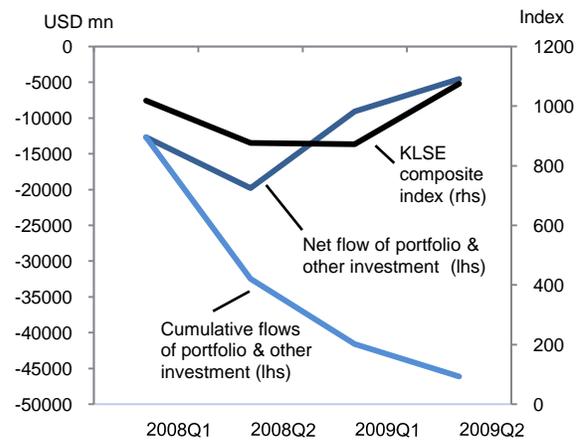
In spite of recent improvements, however, the recovery of trade appears not yet firmly established. Most recently, exports declined for two consecutive months on a seasonally adjusted basis (-3.0 percent in August and -1.9 percent in September). Imports also fell sharply in August by -8.7 percent and only grew slightly by 0.9 percent in September. These recent developments point to the remaining weakness in external conditions and the impact of uncertainty on the speed of restocking.

Figure 1.32. The decline of FDI was one of the most severe in East Asia



Source: CEIC and World Bank staff calculations.

Figure 1.33. Portfolio and other investments registered net outflows, but pressures have eased



Source: CEIC and World Bank staff calculations.

The current account maintained a large surplus.

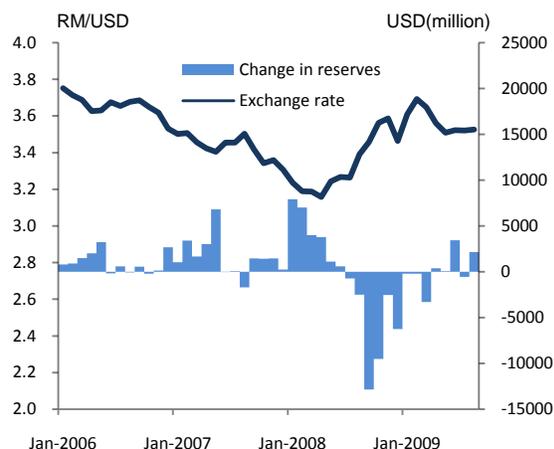
- The current account surplus remained at 17.8 percent of GDP, with the sizable trade surplus as main contributor. The intertwined movements of non-commodity exports and intermediate imports effectively cushioned external shocks in non-commodity sectors. Despite deep drops, commodity exports remained large. Due to their low import components, they helped keeping the trade surplus at 21.2 percent of GDP in the second quarter (Figure 1.30).
- The services account registered a small surplus since the last quarter of 2008. This change is driven by increasing net receipt of travel. Tourists from ASEAN countries, three quarters of total tourist inflows, have rebounded earlier this year (Figure 1.31). This reflects the relative strength of Malaysia's tourism industry, which was ranked 32 among 132 countries in the 2009 Travel and Tourism Competitiveness Index.⁵

The financial and capital account experienced a large degree of volatility.

- Global deleveraging and a broad-based domestic recession put Malaysia's financial account under stress late 2008 and early 2009. The pressure tapered off in the second quarter but the financial account still registered a net outflow at 15 percent of GDP.
- Direct investment recorded an outflow in the second quarter, reversing the net inflows of early 2009 (Figure 1.32). In cumulative terms, foreign direct investment (FDI) inflows plummeted since the second half of last year, totaling less than a quarter of what they were previously. This reflected the reluctance of foreign investors to make new commitments in the hard-hit manufacturing sector. The decline was among the most severe in East Asia.

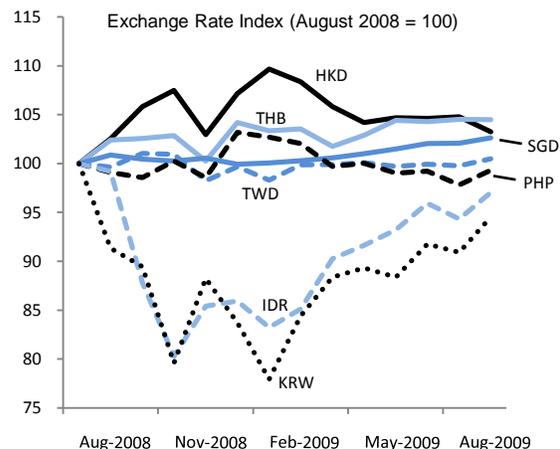
⁵ Ministry of Finance (2009).

Figure 1.34. The ringgit stabilized after depreciating against the US dollar



Source: CEIC and World Bank staff calculations.

Figure 1.35. The performance against regional currencies was mixed



Source: CEIC and World Bank staff calculations.

- The sum of portfolio and other investment have registered net outflows since the third quarter of 2008 as foreigners withdrew from equities and bond securities. The pressure, however, started to ease in the second quarter as investment sentiment improved—the stock market returned to the level of earlier last year between the first and the second quarter of 2009 (Figure 1.33). This volatility in capital flows indicated the increased exposure of domestic capital markets to external shocks following the gradual liberalization of foreign exchange controls.

The currency was affected by global deleveraging activities, but has stabilized.

- The ringgit has regained its strength against US dollar after oscillating around a depreciating trend. It reached its low in February/March against the US dollar, weakened by 8 percent from August last year. The managed floating exchange rate system adopted in 2005 offers the flexibility to stabilize the currency while allowing ringgit to adjust to global economic developments. The ample foreign exchange reserves also provided large maneuvering space. The reduction in reserves since July 2008 is suggestive of the central bank's efforts to stabilize ringgit (Figure 1.34).
- The ringgit continued to follow a depreciation trend in real effective terms and its performance against regional currencies was mixed. As of July 2009, ringgit was 5 percent weaker than year ago in real effective terms. Although other regional currencies were similarly affected by global deleveraging activities, intra-regional exchange rate performance showed differences—Hong Kong dollar, Thai baht, and Singapore dollar have strengthened against the Malaysian ringgit since August last year (Figure 1.35).
- Foreign exchange reserves resumed accumulation in April/May. As of mid-October, foreign exchange reserves amounted to USD95.9 billion, sufficient to finance close to 10 months of retained imports and about 4 times the short-term external debt.

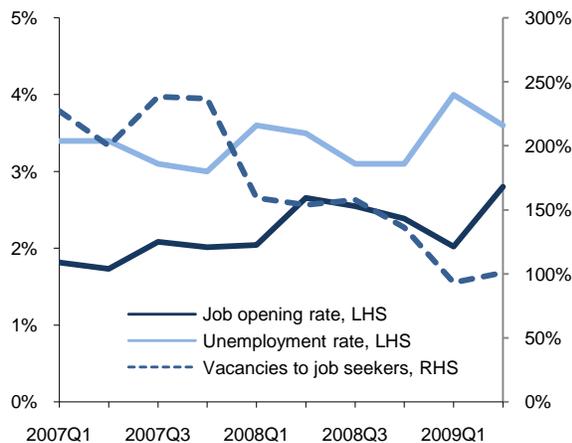
The Small Rise in Unemployment Masked the Significance of the Social Impact

The impact on aggregate unemployment has remained small, and labor market conditions are improving now. After a slight rise in the first quarter from 3.1 to 4 percent, due to increases in both the number of unemployed and the size of the labor force, the unemployment rate dropped back to 3.6 percent in the second quarter. July and August also saw reduced levels of retrenchment, down from the first half of the 2009 when retrenchments outnumbered those in 2008 as a whole. There has however been evidence of increased tightness in the labor market as shown in the falling ratio of vacancies to job seekers (Figure 1.36). However, data for the second quarter showed a greater rise in vacancies than in the number of active job seekers. The rise in vacancies also contributed to a rise in the job opening rate, i.e. the ratio of vacancies to total employment.

There are a number of potential explanations for the limited response in official unemployment data. First, many firms responded to the downturn in demand through temporary layoffs and reduced working hours. Hiring and firing restrictions also reduce the incentive to shed labor (Figure 1.37). Second, it may also be that the impact will only be seen with a lag as firms exhaust alternative possibilities before laying off workers. As shown in Figure 1.38 and Figure 1.39, the correlations between unemployment and quarterly GDP growth may be stronger in previous quarters rather than contemporaneously. Third, a large part of the workforce consists of unregistered foreign workers, who are not captured in the statistics yet are more vulnerable to the changes in the demand for labor.

The picture portrayed by aggregate labor market statistics is one of remarkable stability. In spite of the economy-wide turbulence, labor markets seem to have remained relatively unaffected. The overall unemployment rate has remained fairly constant and its recent increase has been modest. In addition, during the first quarter of 2009, which turned out to be the worst for economic activity, aggregate employment in fact grew by 2.2 percent, adding some 233,000 workers to the employment figures.

Figure 1.36. Labor market conditions are improving



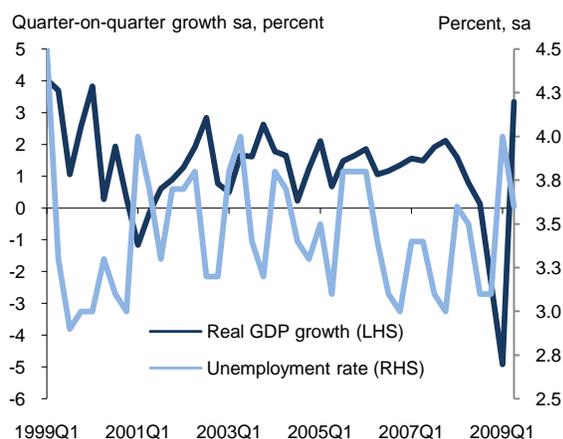
Source: CEIC and World Bank staff calculations.
 Note: Job opening rate=vacancies over vacancies and employment.

Figure 1.37. The cost of firing is rather high



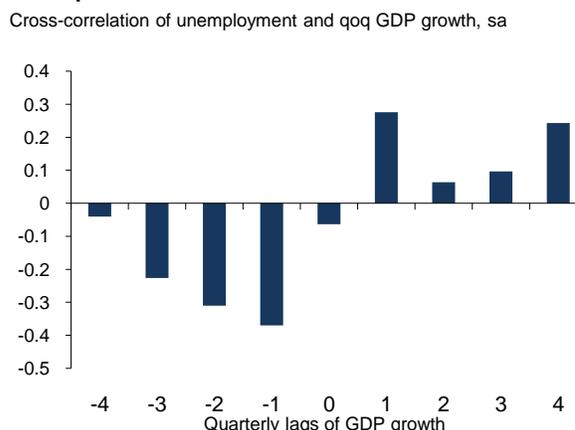
Source: Global Competitiveness Report 2008.

Figure 1.38. The unemployment rate rose as GDP growth fell



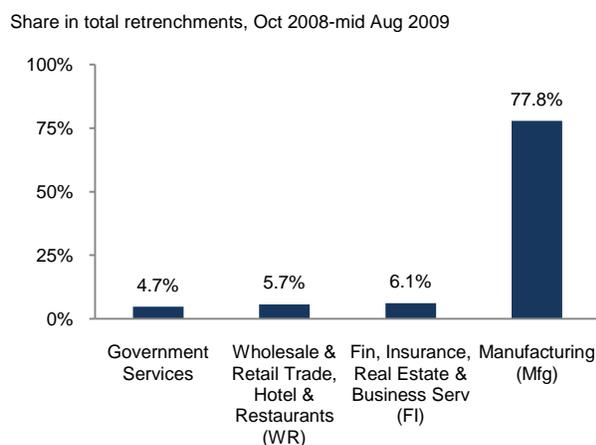
Source: Haver, CEIC and World Bank staff calculations.
Note: Seasonal adjustment with TRAMO-SEATS.

Figure 1.39. Unemployment lags GDP growth one to three quarters



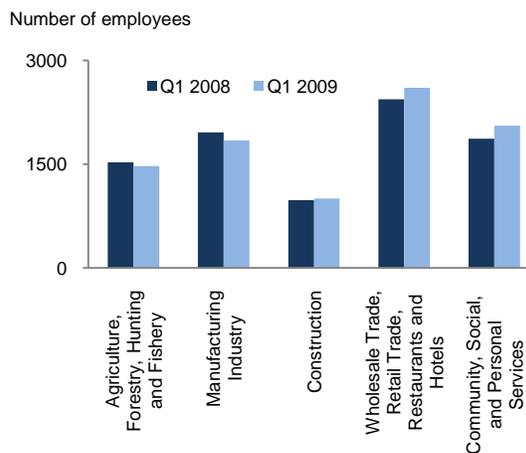
Source: Haver, CEIC and World Bank staff calculations.
Note: Seasonal adjustment with TRAMO-SEATS. Cross-correlations based on period 1998Q2 to 2009Q2.

Figure 1.40. Retrenchments were concentrated in manufacturing



Source: Department of Labor

Figure 1.41. Labor reallocated across sectors

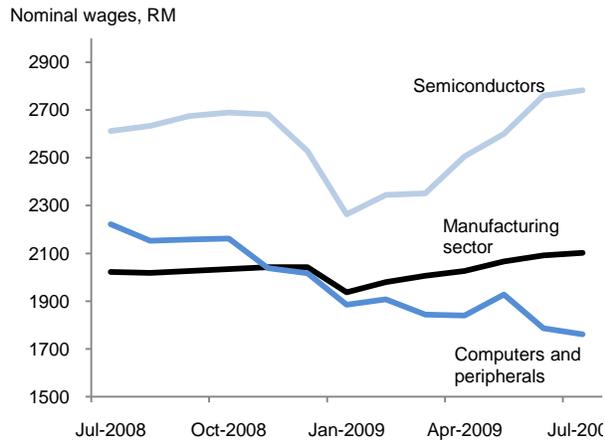


Source: Department of Statistics

A closer look at the numbers shows that the aggregate data masks to a significant degree gross flows into and out of employment as labor reallocates across sectors (Figure 1.40-Figure 1.42).

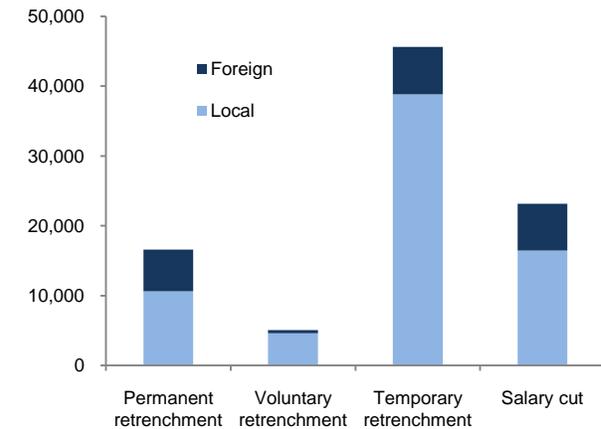
- The manufacturing sector, which was hit by far the most, shed some 120,000 employees in the first quarter of 2009. Real wages in manufacturing declined late 2008 and early 2009, but have largely recovered since. Disaggregating further within the manufacturing sector, the semi-conductor, rubber and motor vehicle industries seem to have experienced the biggest decline in employment.
- Counterbalancing this is the rise in employment in wholesale and retail trade as well as community, social and personal services. Employment in the health and social sector increased particularly strongly by almost 25 percent year-on-year. The other engine of employment growth has been retail trade. The number of employees in supermarkets, specialized and non-specialized shops increased by 8.4 percent in the first and 5.2 percent in the second quarter of 2009. Retail trade seems to have acted as a cushion, with the retrenchments in manufacturing being offset by hiring in retail trade.

Figure 1.42. Manufacturing wages fell and then generally recovered



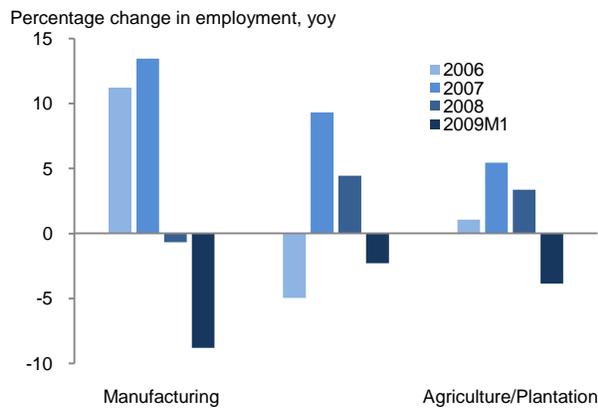
Source: Department of Statistics

Figure 1.43. A larger part of permanent layoffs fell on foreign workers



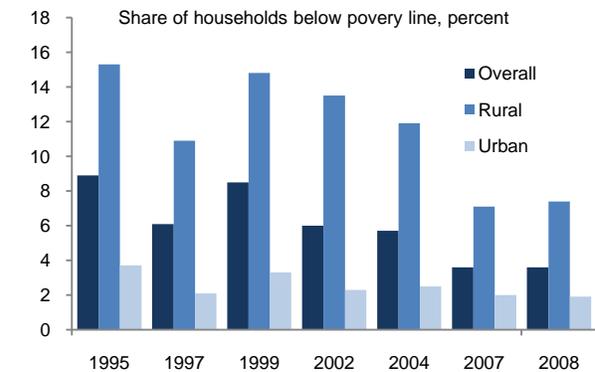
Source: Department of Labor

Figure 1.44. Manufacturing, construction and agriculture employed fewer foreign workers



Source: Department of Immigration

Figure 1.45. The last decade saw an estimated decline in poverty incidence



Source: EPU and World Bank staff calculations.

A second noteworthy feature of recent labor market adjustment has been the sizeable impact on foreign workers and female workers. Some 36 percent of reported retrenchments from October 2008 through mid-February 2009 were related to foreign workers (Figure 1.43)—where registered foreign workers represent roughly 10 percent of the labor force. The same holds true for deductions in wages and, although to a much lesser extent, temporary lay-offs. The cut-back in foreign worker employment was felt across the board, but especially in the manufacturing sector (Figure 1.44). About 60 percent of temporary lay-offs applied to female workers. Almost 57 percent of all reported wage cuts are associated with female workers. These outcomes can be in large part explained because foreign workers make up a large part of the assembly-related workforce and women take up a large share of employment in the electronics industry.

The aggregate data also masks the fact that poverty incidence is likely to have risen as the result of the downturn.

- Poverty levels in Malaysia, which suffered a reversal of their downward trend during the Asian crisis, have subsequently trended downwards reaching around 3.5 percent in 2007 and remaining broadly unchanged in 2008 (Figure 1.45). However, there remains a sharp division, with rural poverty at 7.4 percent and urban poverty at 1.9 percent in 2008. Rural poverty has also increased somewhat recently, whereas urban poverty remained roughly stable.
- While the data for 2009 is not available yet, the downturn is likely to have led to higher poverty incidence. Job losses, shorter working hours, and lower wages in the production and services sectors are likely to have raised urban poverty somewhat. Rural households that rely on remittances from their family members working in the urban areas will also suffer an impact. The positive income effect of the commodity price hike that peaked in mid-2008 on rural, net-producing households could be smaller than commonly estimated. Margins that farmers actually received are likely much lower than the rise in retail prices because input prices and transport cost also went up noticeably.
- Meanwhile, food prices have continued to rise every month this year (5.9 percent in the first eight months), as opposed to annual deflation in the overall CPI since June. This disproportionately hurts low-income groups as food items account for a higher share of their expenditures. Inflation has also been higher in Sabah (2.8 percent), which is the state with the highest incidence of poverty.

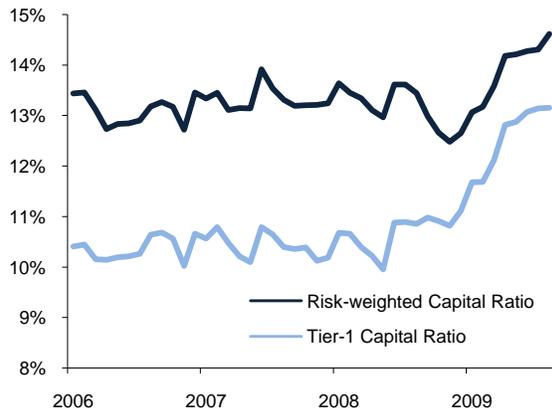
Financial Conditions Remained Robust

Financial soundness indicators suggest that the banking sector withstood the crisis well (Figure 1.46- Figure 1.49). The capital adequacy ratio of the banking system averaged at a comfortable 14.6 percent as of August, reflecting a rise from 13 percent early 2009. Core capital also saw an increase. Profitability however has taken a hit, in view of lower business activity, and led to a decline in the returns on assets and equity. The overall nonperforming (NPL) loan ratio remained low and stable at 2.1 percent. Liquidity indicators suggest continued good access to funding.

Policy actions contributed to these outcomes.

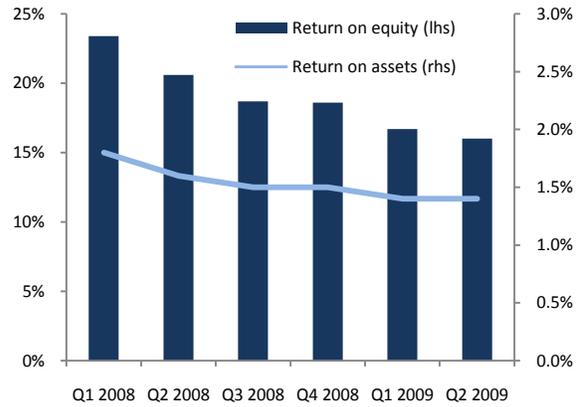
- Monetary policy has been accommodative. Between November 2008 and February 2009, the policy rate was cut three times from 3.5 percent to its current level of 2.0 percent. The reserve requirement was also decreased from 4 percent to 1 percent to reduce the cost of financial intermediation. These monetary policy actions have contributed to the falling of average lending rates to about 5 percent end of July. Rates were kept on hold in recent month, as the external environment started to stabilize, inflation continued to moderate and access to finance remained sufficiently smooth.
- Various measures were introduced to ease the flow of credit, making it easier for companies to borrow through credit enhancement schemes and corporate debt restructuring. The government undertook to guarantee 80 percent of loans made to finance working capital and 50-80 percent for loans to support industry restructuring. Incentives were also provided to strengthen the access to finance of SMEs. Helping primarily larger firms, a financial guarantee institution was set up to provide credit enhancement for bond issuances by viable corporations.

Figure 1.46. Capital ratios have increased



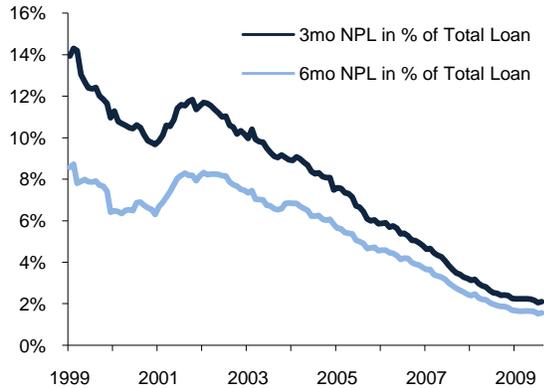
Source: Bank Negara Malaysia.

Figure 1.47. Profitability has declined



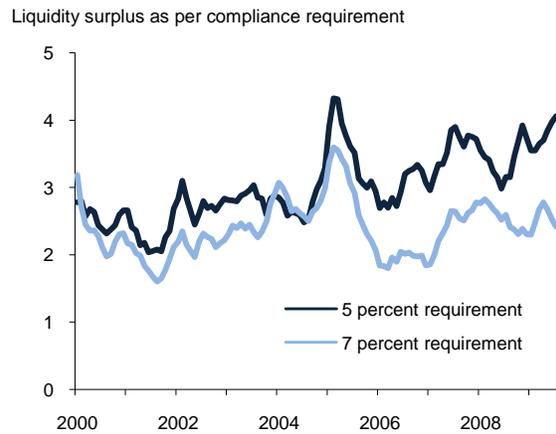
Source: Bank Negara Malaysia.

Figure 1.48. Nonperforming loan ratios are overall at low levels



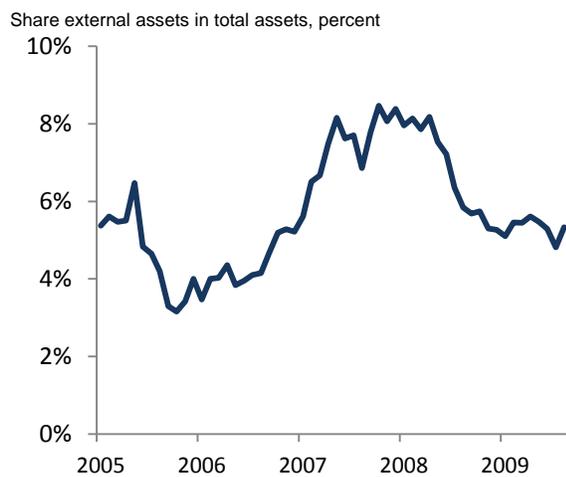
Source: Bank Negara Malaysia.

Figure 1.49. Liquidity surplus remained robust



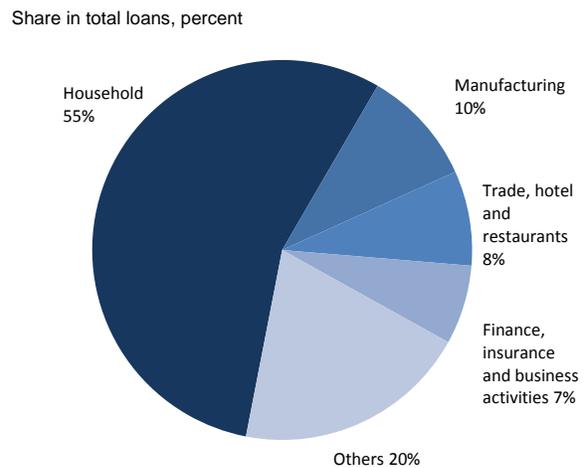
Source: Bank Negara Malaysia.

Figure 1.50. The banking system's share of external assets to total assets has been low



Source: Bank Negara Malaysia.

Figure 1.51. Banks lend primarily to households



Source: Bank Negara Malaysia.

- The Bank Negara Malaysia (BNM) has stepped up its macro-prudential surveillance as a measure of precaution and has conducted stress tests to examine the collective soundness of the banking sector. Supervisors have also been proactive in improving early warning systems to highlight emerging issues and developments. In addition, a blanket guarantee was introduced to all local and foreign currency deposits with all domestic and locally incorporated foreign banking institutions.

The limited exposure to external assets helped shield the banking system adverse developments (Figure 1.50). Most of the banking sector's assets are domestic assets. Malaysia's banks have remained rather shielded from toxic securities and problematic financial institution elsewhere. In isolated cases, banks with overseas operations experience a slight increase in NPLs, especially in those countries that were hit strongly by the crisis.

The good performance also derives from the banking system's large exposure to the household sector, which remained in good health (Figure 1.51).

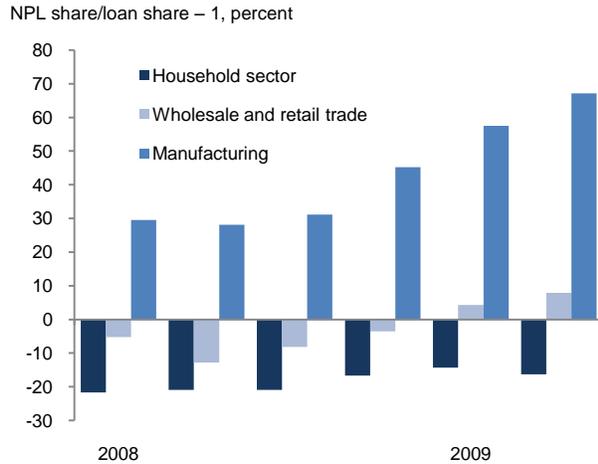
- Loans to the household sector make up the largest part of the bank lending, followed by loans to manufacturing and trade. Household debt in Malaysia rose from 47 to 67 percent of GDP between 200 and 2007, but moderated to 64 percent of GDP in 2008—still low compared to other countries such as Korea and Singapore.⁶ About one-half of household loans are for residential property purchases.
- Prior to the current crisis, households' financial positions were strengthened by improvements in their financial net worth and the ratio of debt service to disposable income fell with strong earnings growth. Indeed, as household debt grew the gross NPL ratio on housing loans fell from 9.5 percent in 2000, reaching 5.4 percent at June 2009. This is down slightly on the stable rate of 5.7 percent for the previous three quarters.

Underneath the aggregate picture lies, however, a significant degree of heterogeneity.

- The corporate sector suffered a larger crisis impact, which showed in its share of bad loans (Figure 1.52). The distribution of NPLs was tilted towards manufacturing. Considering that loans to households, manufacturing, and trade comprise the bulk of all lending, the manufacturing sector attracted an increase share of total NPLs. By the second quarter of 2009, the share of manufacturing NPLs to total NPLs exceeded the share of manufacturing loans to total loans by some 70. Household NPLs were on the other hand largely underrepresented relative to their importance in total lending.
- The differences between households and both small and large corporations also showed in the disbursement of loans (Figure 1.53). Households demand for credit grew at 11.5 percent (first seven months, yoy), saw a small decrease in loan approvals to loan applications, and registered an increase in loan disbursements. While large corporates and households continued to demand financing, new loan applications received by SMEs declined by 8.1 percent, in line with the worse business outlook. The ratio of loan approvals to loan applications also fell, especially for businesses and SMEs. Lower application and approval rates both led to a drop in loan disbursements, especially for SMEs.

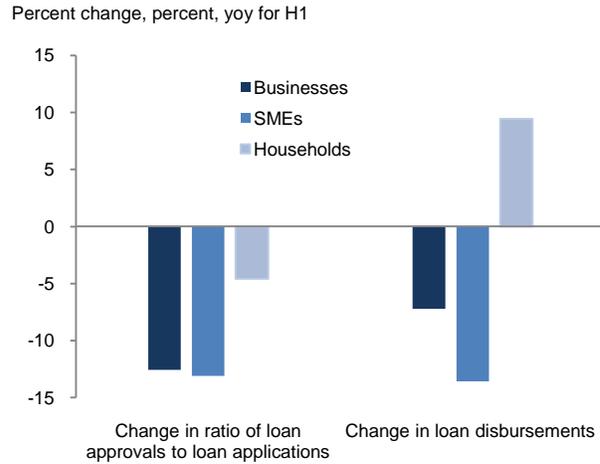
⁶ Endut and Toh (2009).

Figure 1.52. The distribution of NPLs tilted increasingly to manufacturing



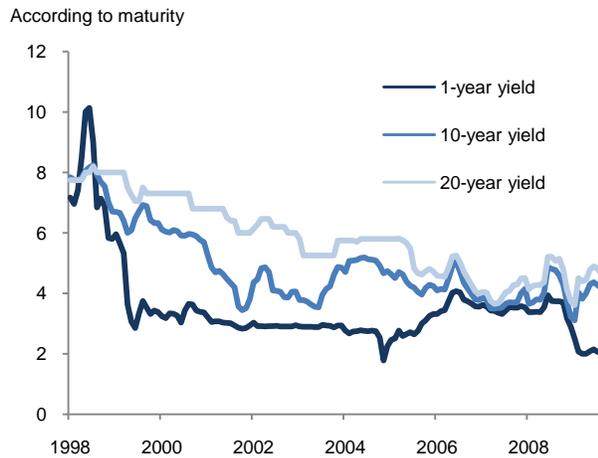
Source: CEIC and World Bank staff calculations.

Figure 1.53. Loan disbursements dropped as approval rates and credit demand fell



Source: CEIC and World Bank staff calculations.

Figure 1.54. Government bond yields have remain low



Source: CEIC.

Figure 1.55. Equity prices have rebounded



Source: CEIC.

Conditions in bond and equity markets showed some volatility (Figure 1.54 and Figure 1.55). Long-term government bond yields (MGS 10-year) have climbed since the beginning of the year from 3 to about 4 percent, driven by concerns about the increased supply related to stimulus spending. The stock market rose sharply at about 30 percent in less than six months—back to the level earlier last year. While the rise in stock market is also observed along with the sharp rise in the inflow of portfolio investment in the first and second quarters of 2009, there were corresponding large outflows resulting in new equity securities outflows of RM5.4 billion and RM5 billion respectively.

2. ECONOMIC OUTLOOK

With East Asia leading the recovery and advanced economies showing progressive improvement, the Malaysian economy is projected to grow at 4.1 percent in 2010, after a contraction of 2.3 percent in 2009. The medium-term outlook remains promising with growth reaching 5.6 and 5.9 percent in 2011 and 2012, respectively, though that will depend on sustained global recovery from the crisis.

The upturn in economic activity has yet to turn into a sustained recovery. Industrial production and exports have recently increased, but whether this represents the beginning of a sustained recovery is still unclear. The strength of the recovery, and particularly export growth, continues to hinge on the firming up of final demand from advanced economies. Inventories will likely be a key driver of near-term growth. Consumption and fixed investment are expected to pick up initially slowly. With output still below potential, inflation and asset prices are likely to remain subdued.

Managing the economy's recovery will be a delicate balancing act. Withdrawing policy support too early runs the risk of choking off the recovery. But extending support for too long may hamper the credibility of medium-term fiscal consolidation, reduce the room for future stimulus, increase the risk of asset price bubbles, and constrain private sector initiative once demand picks up. The authorities are mindful of these risks and have conditioned the pace of consolidation on the strength of the recovery.

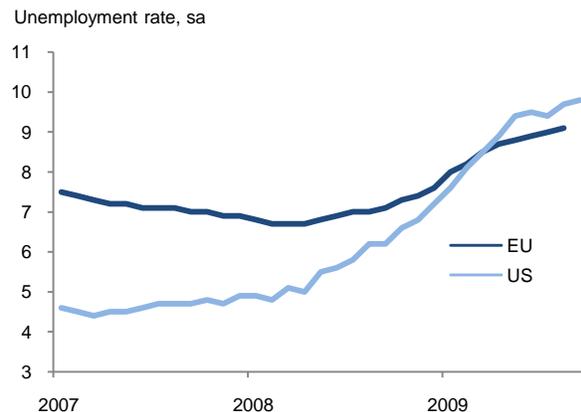
THE GLOBAL OUTLOOK HAS IMPROVED MARKEDLY

The U.S. and European economies are recovering, even though they not yet out of the woods.

- Credit remains tight for many corporate and household borrowers. Financial institutions also remain saddled with large stocks of impaired assets, with U.S. banks having recognized only slightly less than half of expected losses.⁷ Under these conditions, further deleveraging is needed and continued restructuring efforts will be required for banks to regain their capacity to support a recovery.
- Output is still below potential output and spare capacity is high, dampening the scope for investment demand. This argues for a protracted recovery. Moreover, with household balance sheets still under pressure, demand for durable goods and housing will likely remain subdued for the time being. The ongoing process of deleveraging of overstretched household and corporate balance sheets moderates near-term growth prospects.
- Labor markets continue to pose difficult challenges (Figure 2.1). Unemployment is high and still rising. Conditions will likely deteriorate further improving, as the real economy completes its adjustment and the lagged impact on labor markets is felt. Reduced spending power and greater incidence of unemployment produce impact upon aggregate demand and asset quality. This poses challenges in countries where fiscal space has been reduced by earlier stimulus measures.

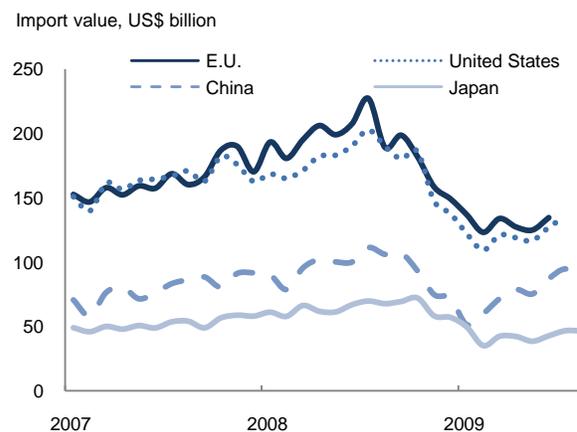
⁷ International Monetary Fund (2009c).

Figure 2.1. EU and US: Unemployment has risen sharply



Source: CEIC and World Bank staff calculations.

Figure 2.2. Selected Countries: G-3 import demand did not recover as quickly as China's



Source: World Bank (2009a).

Yet, East Asian economies are experiencing a strong rebound.

- A vigorous and timely fiscal and monetary stimulus in most countries in East Asia, led by China and Korea, helped by decisive measures in developed economies, moderated the decline in activity, stabilized financial market conditions, and set in train the regional recovery. Since midyear, activity has also been supported by the start of inventory restocking. In addition, the rebound in financial conditions on the back of increased risk appetite has also contributed to the inflow of capital and the easing of any financing constraints.
- The rebound came on the back of a renormalization of financial and trade flows. As the Lehman bankruptcy shocked expectations, financial and trade flows came under intense pressure. However, as conditions improved, the upswing was equally vigorous and the initial overreaction was quickly reversed.

Against this backdrop, the World Bank has uplifted its growth forecasts for East Asia but remains cautious about the near-term growth prospects of advanced economies. The growth forecast for G-3 economies in 2009 has deteriorated slightly to -3.5 percent, down from the earlier -3.1 percent forecast in April. A wide range of indicators suggest recovery, even though part of this reflects temporary fiscal stimulus measures, such as the scheme for new car purchases in the United States.⁸ The need to re-build household net worth, as evident in the rising personal saving rate in the United States, as well as the high and still-rising unemployment rate will weigh on consumer sentiment and spending. Compared to the US and the EU, Japan's output decline is forecast to be larger and the recovery of its economy is more dependent on the resumption of growth of external trade. In 2010, the recovery pace in advanced countries is likely to remain subdued, with modest positive growth compared to large negative growth in 2009 in most cases. Tight credit conditions and the repair of financial institutions will continue to hold back growth acceleration.

⁸ US vehicles sales dropped 41 percent month-on-month in September after the scheme ended in August. Auto sales expanded on average 21 percent in the preceding two months. The incentive program, also launched in a number of European economies, played a significant role in boosting industrial production and consumer spending in the past several months.

Table 2.1. East Asia and G-3: The Outlook Has Significantly Improved

Actual and forecast real GDP growth

	2008	2009f	2010f	Previous forecasts for 2009	
				Dec 08	Apr 09
East Asia	5.9	3.9	6.4	5.3	2.3
Developing East Asia	8.0	6.7	7.8	6.7	5.3
China	9.0	8.4	8.7	7.5	6.5
Indonesia	6.1	4.3	5.4	4.4	3.4
Malaysia	4.6	-2.3	4.1	3.7	-1.0
Philippines	3.8	1.4	3.1	3.0	1.9
Thailand	2.6	-2.7	3.5	3.6	-2.7
Vietnam	6.2	5.5	6.5	6.5	5.5
East Asia NIEs	1.5	-2.2	4.0	2.5	-4.4
G-3	0.3	-3.5	2.0	-0.4	-3.1
Global trade volumes	3.2	-11.4	4.0	-2.1	-6.0

Note: East Asia Newly Industrialized Economies (NIEs) include Hong Kong SAR, Republic of Korea, Singapore and Taiwan (China).
Source: World Bank (2009a).

The projection of global trade volume is downgraded to a contraction of 11.4 percent in 2009 (compared to 6 percent in April). Although exports have risen, solid Chinese domestic demand, fuelled by large fiscal stimulus support, has driven much of this. Import demand from G-3 economies has rebounded at a much slower speed (Figure 2.2), especially from Japan which is expected to experience a larger decline in trade than other high-income economies. A sustained recovery in world trade is only possible with a stronger turnaround in the US and the EU, given their market size. For 2010, the volume of global trade is expected to grow at 4 percent, still below 2008's performance.

Global capital flows are likely to recover moderately from the lows of 2009 but will remain smaller than the record highs reached in 2007. Cross-border lending is expected to remain subdued as international banks continue to recognize credit losses (now about half of the total projected) and inflows of FDI remain limited in view of the still large excess capacity. East Asia may receive a larger share of these inflows, however, due to a combination of investor expectations of stronger growth in the region than the rest of the world, the potential for currency appreciation and the growing liquidity and sophistication of the region's financial markets.

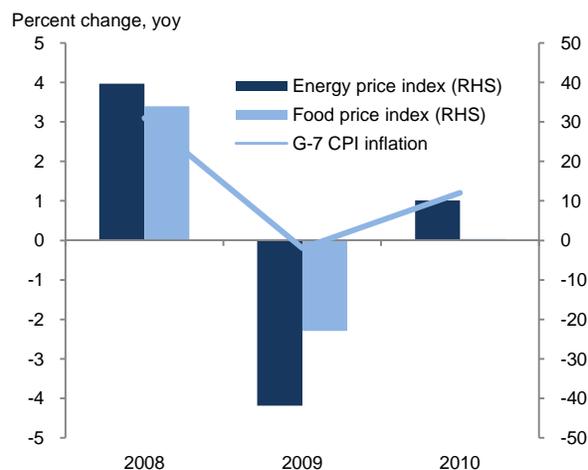
The growth projection for developing East Asia is 6.7 percent in 2009, up 1.4 percentage points from the previous estimate in April (Table 2.1).⁹ The forecast has in fact returned to the level predicted in December last year. Strong domestic demand will continue to drive robust growth in China, with varying degree of spillover effects through import orders on other regional economies. Largely supported by China, developing East Asia will enjoy the fastest growth in the world this year (Table 2.2). Output levels will nonetheless contract in economies that are manufacturing-led and export-oriented such as Thailand and the Newly Industrialized Economies (NIEs), although their outlook has improved given the rebound in exports during the second quarter of the year. Most East Asian economies are expected to enjoy reasonably strong growth in 2010.

⁹ Details on the regional picture are provided in the November 2009 East Asia and Pacific Update (World Bank, 2009a).

Table 2.2. Thanks to China, developing East Asia remains the fastest-growing region in the world

GDP growth, yoy, percent				
	2007	2008	2009F	2010F
Developing East Asia	11.4	8	6.7	7.8
Excluding China	6.2	4.8	1.1	4.5
Europe & Central Asia	7.1	4.3	-6.1	1.9
Latin America & Caribbean	5.5	3.9	-2.5	3
Middle East & North Africa	5.3	5.8	3	3.4
South Asia	8.5	5.7	5.3	6.4
Sub-Saharan Africa	6.5	4.9	0.7	3.8
OECD countries	2.5	0.4	-3.2	1.7

Source: World Bank (2009a).

Figure 2.3. G-7: Inflation will likely remain low

Source: World Bank staff projections.
Note: Food price inflation in 2010 is expected at zero.

Major advanced economies are expected to experience mild deflation this year and low inflation next year, as a result of a high-base effects, subdued demand, and overcapacity (Figure 2.3). Poor household balance sheet and weak employment conditions have limited producers' pricing power, especially for durable goods. Most commodity prices have also fallen noticeably from their historically high levels in 2008. The World Bank predicts that the average crude oil price will drop around 37 percent this year, after a 36-percent rise last year. Inflationary pressures should remain low in 2010, given the sluggish recovery in demand. Nonetheless, inflationary pressure cannot be completely ruled out. High levels of banks' excess reserves, following credit and monetary stimulus, could fuel a credit boom once demand picks up. Also, in many countries, the combination of fiscal stimulus and cheaper credit has produced sharp rises in asset prices. Some advanced economies have already raised policy rates.

MALAYSIA'S ECONOMIC RECOVERY IS SOLIDIFYING

Against the global and regional backdrop, Malaysia's outlook argues for a recovery, with the pace of the recovery necessarily reflecting external realities in the near-term and the internal efforts being made to boost productivity growth in the medium-term under the umbrella of the New Economic Model.¹⁰

- Factors arguing in favor of the recovery process include the recent rebound observed in East Asia. The economy is still running below capacity and will be able to accommodate this growth in a noninflationary manner. The strength of household and corporate balance sheets will also provide support to the recovery. Compared to the Asian financial crisis, Malaysia is in a better position to take advantage of a global recovery (Box 3).

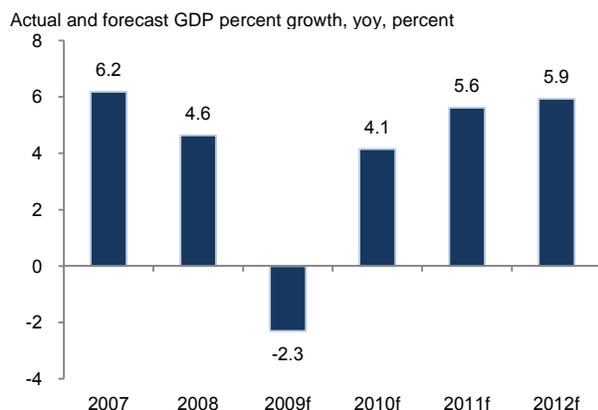
¹⁰ This will be discussed in the next part.

- However, dampening these positive factors however is the outlook for developed economies, which remains relatively subdued notwithstanding recent improvements and continues to overshadow the recent rebound in East Asia. Malaysia’s intraregional trade is still highly dependent on the US economy, so the sustainability of the US recovery will be critical (Box 4).

The Recovery Is Expected to Bring Significant Growth Next Year

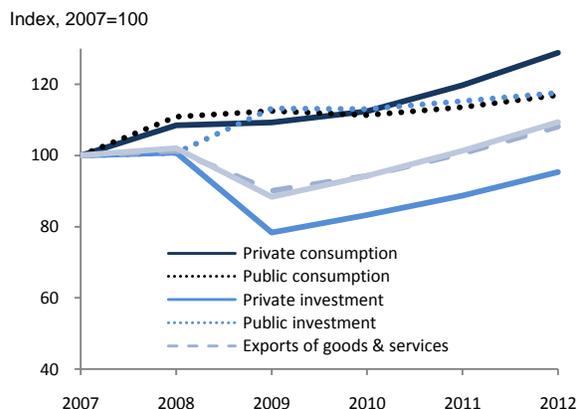
The World Bank forecasts the Malaysian economy to grow by 4.1 percent in 2010, following a contraction of 2.3 percent in 2009 (Figure 2.4-Figure 2.6). The next several quarters should benefit from continued improvements in exports and private consumption. Exports will likely gain momentum on the back of strong demand from emerging East Asian economies, particularly China, even if G-3 import demand only slowly recovers. Better export performance will fuel private consumption, as will the lagged effects of recent stimulus packages. Mild deflation is predicted this year given the effect of a high price base in 2008. Inflation is expected to reach low levels of around 1.5 percent in 2010, as commodity prices (including for oil) pick up and domestic demand strengthens (Figure 2.7).

Figure 2.4. Malaysia’s economy is recovering



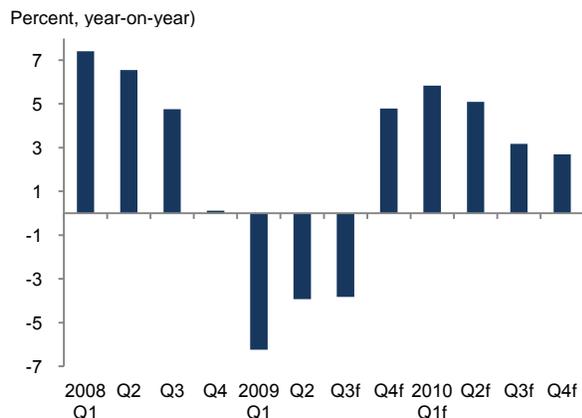
Source: CEIC and World Bank staff projections.

Figure 2.5. Private consumption and exports are expected to improve



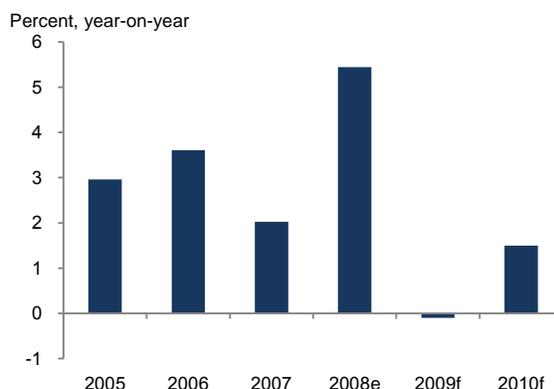
Source: CEIC and World Bank staff projections.

Figure 2.6. Quarterly growth is resuming



Source: CEIC and World Bank staff projections.

Figure 2.7. Consumer price inflation may pick up from a low base



Source: CEIC and World Bank staff projections.

Consumption growth is expected to pick up only slowly. Private consumption will benefit through income, wealth and confidence effects from the gradual improvement in the outlook. Low inflationary pressure for urban consumers and higher commodity prices of palm oil and rubber for rural net-producing households are likely to help.¹¹ The slow pace of the pick-up reflects uncertainties surrounding the outlook, which increase the propensity to save for precautionary reasons. Public consumption will get under some pressure as the Budget 2010 implies a cut in current expenditures by some 14 percent.

The recovery in fixed investment is likely to be protracted. Improvements in export orders, larger domestic sales and low lending rates will all help, but the recovery is weakened by two key factors. First, in spite of recent improvements, capacity utilization remains well below pre-crisis levels, discouraging private investment demand. Second, even though business confidence has recently improved, investors remain in wait-and-see mode due to the uncertainties surrounding the outlook. Following a significant increase in 2009, public investment will also be affected by the government's consolidation efforts, as Budget 2010 forecasts a contraction in net development expenditure by 4.5 percent.

While the government's fiscal consolidation objectives will dampen public consumption and investment growth during the course of 2010, the fiscal stimulus packages introduced earlier are likely to lend further support to the recovery in the early part of 2010. As noted earlier, as of end-October 2009, 66 percent of stimulus expenditures were spent for the first package, whereas this was so far 30 percent for the second package (Figure 1.20). The stimulus also needs time to work its way through the economy and multiply into greater income and growth. The impact lags of fiscal policy are well known. Additional stimulus is therefore expected to be in the pipeline, at least for the beginning of 2010.

The turn-around in the inventory cycle will be a major factor in boosting year-on-year growth. After gross exports collapsed in October 2008, imports fell at a much faster rate than exports for the several months that followed. The large inventory correction earlier this year was the result. Since April 2009, imports have been outpacing exports as firms began importing more materials to meet rising export orders. The deceleration of destocking is likely continue and eventually turn into an acceleration of restocking. At the same time stock levels are likely to stay at low levels until the uncertainty is resolved.

The gradual nature of the recovery is consistent with the perceptions of manufacturing firms that, while conditions have started to improve, the crisis will continue to weigh on the near-term outlook (Table 2.3). Survey data suggests that firms have seen improvements on all fronts over the first half of 2009, including with respect to sales and production, capital, general company performance, labor and financing conditions. Firms however remained concerned for the second half of 2009 about sales for exports, new orders, sales prices, profits and capital expenditures.

¹¹ World Bank forecasts as of October 2009 suggest that palm oil and rubber prices may rise in 2010 by about 1.5 and 6.5 percent respectively. Even then, they will remain some 70 and 33 percent below their 2008 peak levels.

Table 2.3. Manufacturing Firms Believe the Worst is Over

Percent of respondents considering global economic and financial crisis has negative impact on factor

	2009Q1	2009Q2	2009H2		2009Q1	2009Q2	2009H2
<u>Sales and production</u>				<u>Capital</u>			
Sales for export	81	53	42	New capital investment	61	42	39
Sales for domestic	76	40	39	Capital expenditure	65	46	44
Production volume	79	49	39	<u>Labor</u>			
New orders	79	51	45	Employment	52	34	27
Average sales prices	62	51	50	Wage costs	48	31	29
<u>Finance</u>				Nonwage costs	57	35	31
Access to short-term credit	37	34	35	<u>Performance</u>			
Access to long-term credit	39	30	33	Liquidity/cash flow	60	48	46
Cost of credit	37	29	31	Profit	76	51	52
Credit terms	43	28	31	Average profit decline	45	50	37

Source: Federation of Malaysian Manufacturers (2009a and 2009b).

Notes: For 2009Q1 and Q2, qoq improvement in Feb and Jun 2009. For 2009H2, anticipation in Jun 2009.

BOX 3. COMPARISONS BETWEEN THE CURRENT CRISIS AND THE ASIAN FINANCIAL CRISIS

In examining the prospects and drivers of an eventual recovery, it is useful to compare the current crisis episode with the Asian financial crisis. This Box focuses on the differential impact of the two crises on expenditure and activity components (Figure 2.8 and Figure 2.9). To facilitate comparisons between respective pre- and post-crisis episodes, the data for both crises is indexed to 100 at the time that quarterly GDP reached its peak around the respective crises.

The findings are as follows:

- Expenditure data suggests that the boom-bust cycle in overall GDP is less pronounced this time around, and that the recovery also started much earlier. Output rose less quickly before the crisis, but fell more slowly afterwards. This pattern is also observed in the development of private consumption, which proved much more resilient in the recent episode. Gross fixed capital formation also shows a key difference, taking a much stronger hit during the Asia crisis after rising more rapidly in the preceding quarters.
- A notable feature of the current crisis episode, however, was the role of inventory adjustment and the trade balance. Inventory destocking played a much more important role this time around. This is consistent with the increased sensitivity of modern inventory management to changes in demand (as noted earlier in Box 2 on supply chain management). Second, a sharp trade balance improvement occurred relative to trend in the first quarter of 2009 (reflecting the cutback in imported goods), but this faded somewhat in the second quarter. Overall, however, the trade balance improvement so far has been much less pronounced compared with the turnaround in the late 1990s, as back then demand from developed economies did not fall and currency depreciation helped boost price competitiveness.
- Activity data suggests that the marked downward adjustment in construction during the Asian crisis has not been a particular feature of the current downturn. Manufacturing, however, fell deeply during the current episode, not too dissimilar from the Asian crisis. But the recovery of manufacturing started earlier this time around. The services sector showed remarkable resilience compared to the Asia crisis, which is consistent with private consumption being more robust.

These observations suggest that the ongoing recovery process is likely to remain in place, unless there is a realization of downside risks to the external outlook. The balance sheets of households and firms appear in a better position now to support the recovery, maintaining the relative robustness of private consumption and investment compared with a decade ago. The disproportionate role of external demand in the current crisis implies that the speed and strength of the outlook will remain primarily dependent on the future strength of global recovery.

Figure 2.8. Compared with 1997/98, this crisis showed different expenditure patterns



Source: Haver and World Bank staff calculations.
 Note: GDP 2000 prices series, sa; current crisis t=0 at 2008Q3, Asian crisis t=0 at 1997Q4, index=100 at t=0

Figure 2.9. The impact on sectoral activity was also different from 1997/98



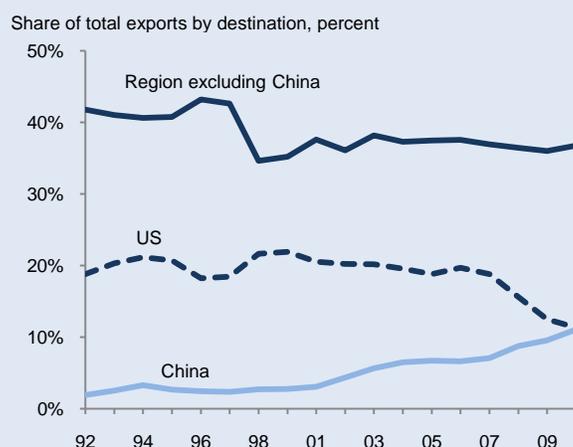
Source: CEIC and World Bank staff calculations.
 Notes: GDP 2000 prices series, sa; current crisis t=0 at 2008Q3, Asian crisis t=0 at 1997Q4, index=100 at t=0.

BOX 4. MALAYSIA'S INTRAREGIONAL TRADE AND US IMPORT DEMAND

A key question concerns the ability for East Asia to sustain rapid growth even when the rest of the world continues to grow slowly. This question obviously has many aspects to it and these have in recent times taken various guises. For example, when the US subprime crisis first hit and East Asia continued to grow at healthy rates, commentators suggested that regional demand in East Asia had decoupled and become self-sustaining. Soon after, when East Asia's economy registered large drops in the demand for their exports from the very economies they had decoupled from, the recoupling hypothesis became in vogue again. This Box focuses on the interdependence between Malaysia's exports with US import demand, which will shed some light on the decoupling versus recoupling issue.

Malaysia's export numbers suggest decreasing importance of direct trade with the United States (Figure 2.10). The share of US-bound exports in total exports has fallen about 10 percentage points since the Asian Crisis, and this decline started well before the recent crisis. Over the same period, the share of Intra-regional trade with China, Hong Kong SAR, Indonesia, Philippines, Singapore, South Korea, Taiwan (China), Thailand, Vietnam, however, has expanded somewhat. Shifts in the structure of intraregional trade point to an increasing share of exports to China, which is somewhat offset by a decreasing share to Hong Kong SAR, Singapore and Taiwan (China).

Figure 2.10. China is overtaking the US as an export destination



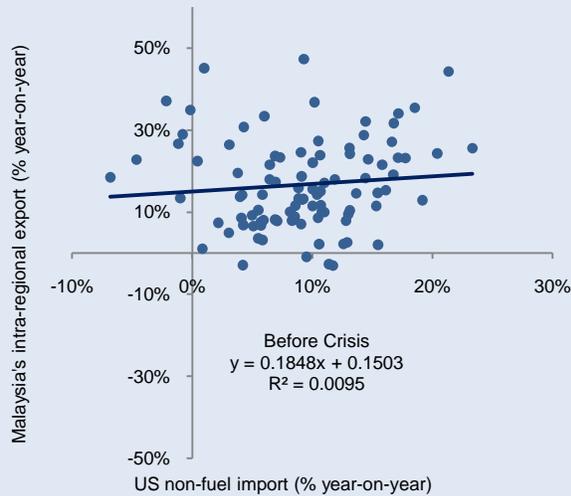
Source: CEIC and World Bank staff calculations
 Note: Region: Hong Kong SAR, Indonesia, Korea, Philippines, Singapore, Thailand, Taiwan (China), Vietnam; 2009 is for H1.

In spite of lesser direct linkages, intra-regional trade linkages seem to have become more closely associated with US demand. As shown in the figures below, the link between Malaysia's intra-regional exports and US non-fuel imports has become much more pronounced after the Asian financial crisis, which suggests that indirect trade has become more dependent with US demand. This is consistent with the ongoing fragmentation of production networks across borders, with a large part of intra-regional trade comprising of parts and components for end-user products destined to the US.

The evolution of three-year rolling correlations between intra-regional exports and US non-fuel imports provides some further interesting insights (Figure 2.11-Figure 2.13). First, there is a marked difference between the period before and after the Asian financial crisis. Before the crisis, the three-year rolling correlation (between growth rates) was 14 percent; after the crisis, it was 51 percent. Second, within the post-Asian financial crisis period, several patterns can be observed: the correlation reached a high during the period 2001-2004, fell to a lower level 2005-2007, and experienced more recently a further fall followed by a V-shaped recovery. These more recent developments suggest that, while direct trade has lost some of its relative importance, indirect trade continues to be closely associated with US demand.

Figure 2.11. Weaker linkages between US import demand and regional exports before the Asia crisis

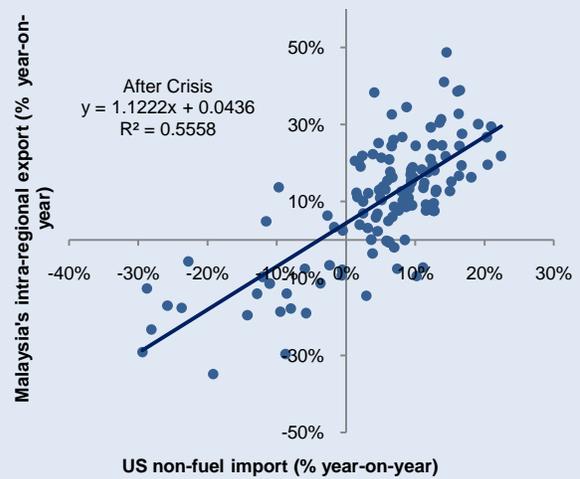
Comparison yoy growth US nonfuel imports and intraregional exports



Source: CEIC and World Bank staff calculations.

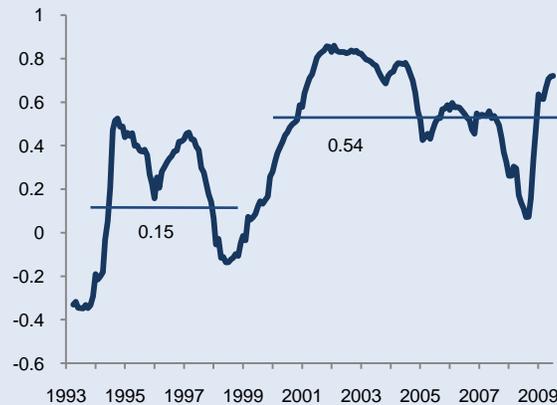
Figure 2.12. ...but much stronger linkages after the Asia crisis

Comparison yoy growth US nonfuel imports and intraregional exports



Source: CEIC and World Bank staff calculations.

Figure 2.13. Linkages have increased but not steadily
 (three-year rolling correlations of US nonfuel imports and intraregional exports)

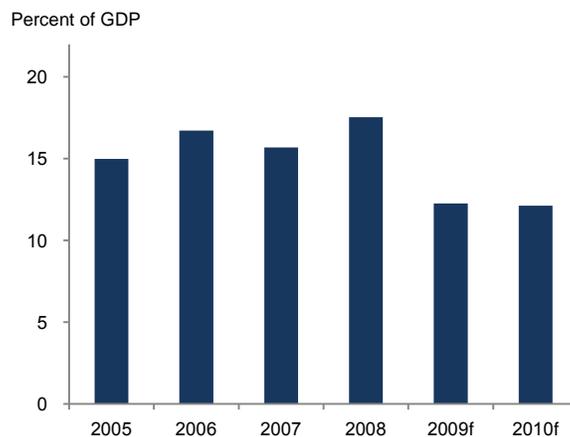


Source: CEIC and World Bank staff calculations.

The Current Account Surplus Will Likely Narrow

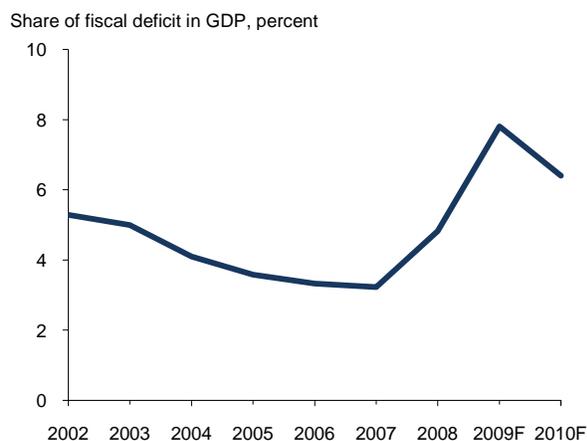
The current account surplus, which stood at a historical high of 17.5 percent of GDP in 2008, is likely to narrow (Figure 2.14). Export growth will gradually pick up, as it did in recent months, but offsetting this will be a rather synchronized increase in imports. This reflects the fact that a large chunk of imports serve as intermediate inputs into the production of exportables. This also reflects the gradual pickup in private consumption which may provide an impulse—even if it is initially a small one—to import demand.

Figure 2.14. The current account surplus remains comfortably high



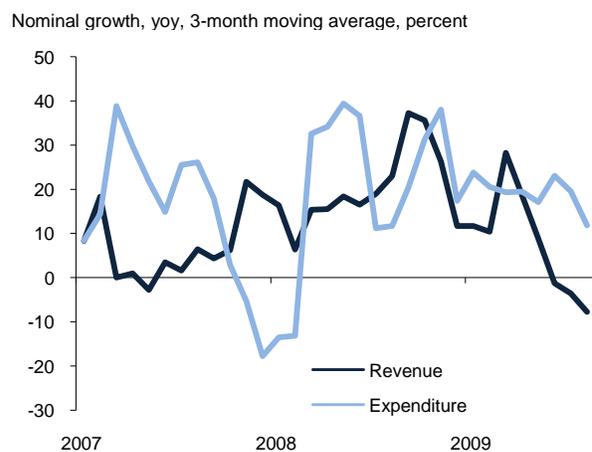
Source: CEIC and World Bank staff projections.

Figure 2.15. Fiscal consolidation next year is expected to curb the fiscal deficit curbed in 2010



Source: CEIC and World Bank staff projections.

Figure 2.16. The collapse in government revenue drove the expansion of the fiscal deficit



Source: CEIC and World Bank staff calculations.

Fiscal Consolidation Efforts Are Expected to Curb the Headline Deficit

As a result of the downturn and the fiscal response to it, the fiscal deficit is projected to initially increase from 4.8 to 7.8 percent of GDP in 2009, and then improve to 6.4 percent in 2010 (Figure 2.15).

- Previous efforts of fiscal consolidation provided Malaysia with some latitude for deficit spending, although the food and fuel crisis reduced the available fiscal space. The central government deficit saw a progressive decline from 5.3 percent in 2002 to 3.2 percent in 2007, but experienced a sudden increase in 2008. The shortfall between revenue and expenditure widened sharply, with expenditure growth outpacing revenue growth due to an upsurge in fuel and food subsidy outlays. The savings that followed a subsidy reform in the middle of 2008 were insufficient to stem the tide and the deficit turned out at 4.8 percent of GDP.
- The deterioration of the fiscal balance to an anticipated deficit of 7.8 percent in 2009 is apparent in the revenue shortfall accumulated so far (Figure 2.16) and comes on the back of weak overall economic conditions and the two fiscal stimulus packages that are being implemented.
- Turning to 2010, the fiscal balance is expected to improve to a deficit of 6.4 percent of GDP. A rebound in nominal GDP, reduced operating expenditure, and smaller fiscal injections allocated for 2010 will contribute to the process of consolidation. The government's objectives, laid out in Budget 2010, are to reduce fuel subsidies, cut discretionary spending and improve government efficiency. Government revenue growth, particularly of corporate income and petroleum-related tax revenues, will be sluggish due to a sharp drop in business activities and subdued international crude oil prices this year.
- The federal debt level is forecast by the World Bank to increase from 41.5 percent of GDP to 51.7 and 55.3 percent in 2009 and 2010, respectively. This assumes that the 2009 and 2010 deficits will be financed through additional debt.

Output Is Expected to Gradually Recover to Potential

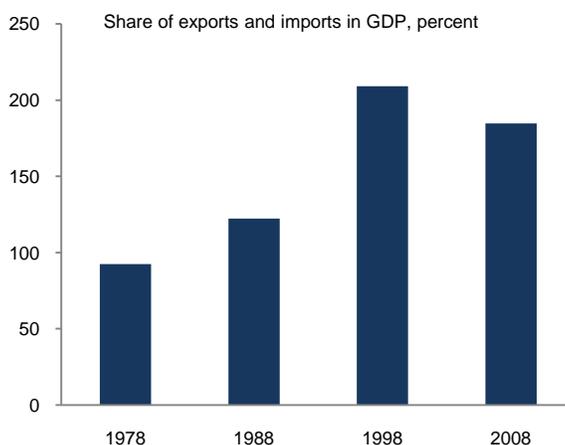
Growth rates in 2011 and 2012 are estimated at 5.6 and 5.9 percent respectively, when the economy is expected to converge back to its potential growth rates. The medium-term recovery is mainly led by domestic demand especially private consumption. Stronger labor markets, moderate inflation, and more favorable commodity prices are contributing factors. Private consumption also benefits from the recovery of external demand. Real exports of goods and services are expected to steadily expand over the years. The post-crisis potential for export growth is expected to be lower given the need to rebuild savings in advanced economies.

Import growth will likely outpace export growth to reflect higher imports of consumer and intermediate goods, more robust domestic consumption, and higher world commodity prices. The current account surplus is expected to fall to slightly over 11 percent of GDP during 2011-2012. The turnaround in private investment, however, may be weaker than that in private consumption, reflecting intensified global competition for FDI as well as binding constraints on investment activities (which as an upside risk may be addressed during the forecast period) Public consumption and investment are also expected to expand more slowly than historical rates as the government consolidates public finances.

DOWNSIDE RISKS OVERSHADOW THE OUTLOOK

The near-term outlook is still fraught with a number of downside risks, but the balance of these risks is improving. The strong reliance on external markets implies that the main downside risk to the outlook is the strength of the global recovery (Figure 2.17). Recent improvements in advanced economies as well as the rebound in the East Asia region increasingly point towards a sustained recovery. This in turn has tilted the balance of risks to Malaysia's favor.

Figure 2.17. The share of trade to GDP has increased markedly over the last few decades



Source: CEIC and World Bank staff calculations.

The key near-term downside risk to the global recovery is that recent improvements do not represent the beginnings of a sustained recovery but merely reflect a transitory rebound due to restocking and the life support extended by stimulus packages in advanced economies.

- With inventory adjustments having played an important role in the down-cycle, they are naturally expected to contribute to the up-cycle. But the question is whether the restocking process is occurring too early and may be reversed if expectations fail to materialize. Exports to Singapore, the largest export partner, and China, the third largest partner, have clearly picked up but their rising demand may be driven by stimulus packages. The Chinese stimulus package—as mentioned earlier—mattered, but so did the stimulus packages in advanced economies. The U.S. White House Council of Economic Advisors reported that US fiscal stimulus added 3-4 percentage points to growth, suggesting that the economy would have barely grown without government support.
- Fiscal stimulus packages as well as public interventions in private firms in advanced economies have shored up confidence and led to a significant increase in public involvement in the economy. Once the stimulating impact of these measures wears out, the question will be whether private demand can pick up the growth momentum. Meanwhile, corporate insolvencies, low capacity utilization, weak corporate and household balance sheets, restrictive lending conditions, and rising unemployment continue to plague the advanced economies that were at the center of the crisis. These factors pose obvious challenges to financial institutions, real sector companies, and their employees, creating the potential for the resumption of downward spirals which may stop the recovery in its tracks.

Malaysia's economy is still highly dependent on the production and export of commodities. Lower than anticipated prices for its natural resources would put pressure on the export receipts and income. Lower oil and gas prices would also affect Malaysia's revenue base and put further pressure on the fiscal deficit.

In addition to these external risks, Malaysia faces the internal challenge of managing its public finances. A premature exit from fiscal stimulus may backfire if external demand has not solidly rebounded. Equally important, a delay of fiscal consolidation may lead to concerns about fiscal and debt sustainability and provoke (further) rating downgrades. The lack of additional fiscal space may prove a binding constraint if the recovery fails to materialize and additional support is needed, which presents a downside risk. The Malaysian authorities have announced that the withdrawal of fiscal stimulus will take place once the economy is on a firmer footing.

As growth recovers and inflationary pressures reappear, policies will need to be tightened to reflect changes in the balance of risks and to address concerns about fiscal sustainability. The limits of what fiscal policy could accomplish in stimulating domestic demand will be reached more quickly unless investors are reassured that exit strategies will be put in place to unwind the stimulus when recovery sets in more firmly. Anchoring expectations about medium-term fiscal consolidation will therefore by itself help the recovery process. The consolidation efforts programmed in Budget 2010 have been helpful in laying out the government's broad strategy.

The downside risks to the medium-term outlook arise from the lingering effects of the current recession and the undiminished need for the rebalancing of the global economy. Post-crisis potential growth in high-income economies may be lower due to consumer deleveraging, slower capital accumulation, higher unemployment, and lower productivity growth.¹² Labor markets may remain a drag on growth and will need more time to recover. Financial and corporate restructuring needs to be worked out and savings need to be rebuilt. Import demand from industrial economies may therefore be dampened.

As a result, the growth of the Malaysian economy may be slower as traditional export-oriented manufacturing activities are constrained by the softening of demand mainly from the US and perhaps from China too whose own exports will be high. Some shrinking therefore of the manufacturing sector may occur, with services taking part of the slack. Such pressure on manufacturing could trigger less productivity growth and less R&D, patenting and innovation.

Domestic demand growth may help offset the down reduced external demand, but given the relatively small size of the domestic market, this will need to be accompanied with further efforts to embrace globalization and expand and diversify the sectors for tradable goods and services. But here too challenges arise: competition for market share in a slower-growth equilibrium is expected to intensify, backward integration by China into components may undermine export prospects, and domestic rebalancing in China may result in fewer imports from Malaysia. These downside risks call for a strategic response, which is the subject of the next part of this report.

¹² The recent World Economic Outlook of the IMF suggests that lower demand and high spare capacity will hold back fixed investments for some time. Lower collateral values due to asset price corrections and tight credit conditions may limit capital accumulation. Temporary unemployment could turn into structural unemployment because workers lost skills. Lower research and development spending and obsolete human and physical capital may reduce production efficiency (IMF, 2009b).

3. REPOSITIONING FOR GROWTH

The overriding medium-term challenge is for the Malaysian economy to join the select group of high-income countries. Malaysia has experienced solid growth over the last decades, but has relied on an economic model predominantly based on capital accumulation, although private investment rates never recovered from their 20 percentage point fall after the Asian 1997/98 crisis and are now at 10 percent of GDP among the lowest in the region.

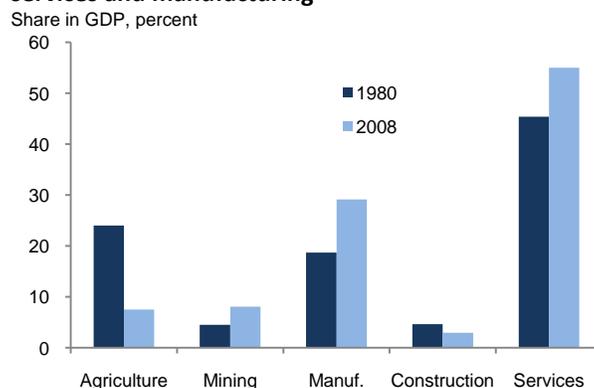
For Malaysia to climb the next step up the income ladder, it needs to prioritize on improving the investment climate to raise investment rates and focus on productivity growth. Against this backdrop, the authorities are developing a ‘New Economic Model,’ which will be squarely centered on boosting productivity. Promising reforms have already been announced in the areas of services and FDI, which will help revitalize private investment.

What will it take to join the league of high-income countries? Moving up the income ladder is a difficult challenge—one which only a few countries have successfully met in the post-war period. Malaysia will need to address a number of weaknesses. An integrated strategy requires sustained efforts in four interrelated areas: specializing the economy further; improving the skill base of the work force; making growth more inclusive; and bolstering public finances.

WHY A NEW ECONOMIC MODEL FOR MALAYSIA?

Over the past few decades, the Malaysian economy has made remarkable progress. It has successfully transformed itself from an economy depending primarily on the production of mineral and agricultural export commodities—palm oil, natural rubber, tropical timber and tin—into one dominated by manufacturing and services (Figure 3.1). The export-led industrialization process attracted massive inflows of FDI, with MNC firms favoring Malaysia for its attractive incentives, geographical location, political stability, reliable infrastructure, and an elastic supply of low-cost labor. The inflow of foreign capital contributed to growth and technological development.

Figure 3.1. The economy was a structural shift to services and manufacturing



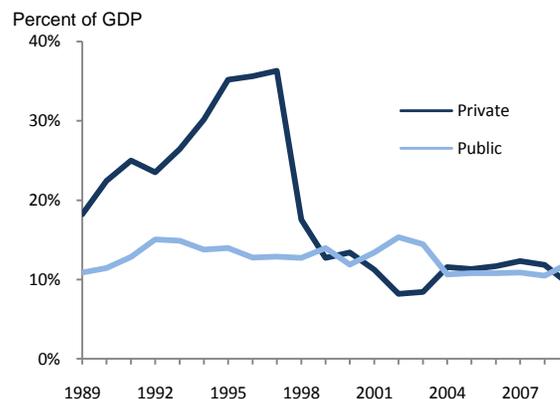
Source: CEIC and World Bank staff calculations.

Private Sector Initiative Has Been Subdued

In spite of these past successes, Malaysia's growth performance has lagged behind that of other regional economies. The economy seems to be caught in a middle-income trap—unable to remain competitive as a high-volume, low-cost producer, yet unable to move up the value chain and achieve rapid growth by breaking into fast growing markets for knowledge- and innovation-based products and services.

The fact that private investment collapsed after the Asian crisis and never recovered epitomizes the need to revitalize private sector initiative (See Box 5 and Figure 3.2). Malaysia's large private surplus on the current account suggests that investors find it more attractive to invest overseas than domestically. This may be for good reasons, as resources compete for the highest return. But with private investment now at a fraction of what it used to be there is a genuine concern that the current low level is an impediment to the goal of becoming a high-income economy.

Figure 3.2. Private investment has remained subdued



Source: CEIC and World Bank staff calculations.

The stagnation of private investment levels, in contrast to the revival seen elsewhere in the region, points to the need to address distortions to the investment environment. It also leads to the question of the role government can play in reducing its involvement in productive activities where it stands in direct competition with the private sector (crowding-out) and in expanding its involvement in areas that complement private sector initiative (crowding-in).

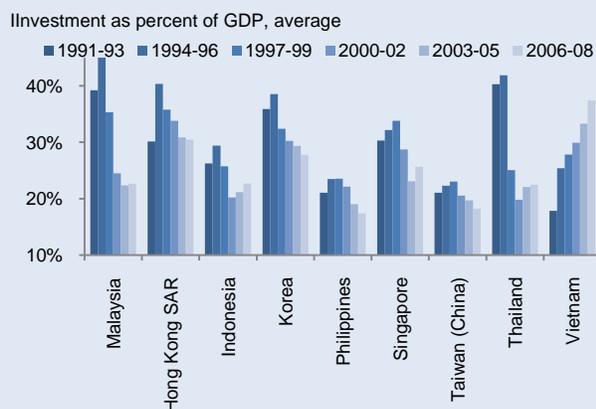
Against this backdrop, Box 6 provides evidence that public infrastructure investment has played an important complementary role to private investment, but that other public investment has in fact crowded out private investment. The recovery of private investment is thus more likely if public investment focuses on improving infrastructure.

However, since the infrastructure deficit has already been much reduced, further crowding-in of private initiative is not guaranteed. To revitalize private investment further public infrastructure investment must increasingly evolve from physical to soft infrastructure. In addition, unleashing the private sector's initiative requires promoting internal competition, making price determination more dependent on market forces, and further improving the investment climate.

BOX 5. INVESTMENT AND SAVINGS IN MALAYSIA

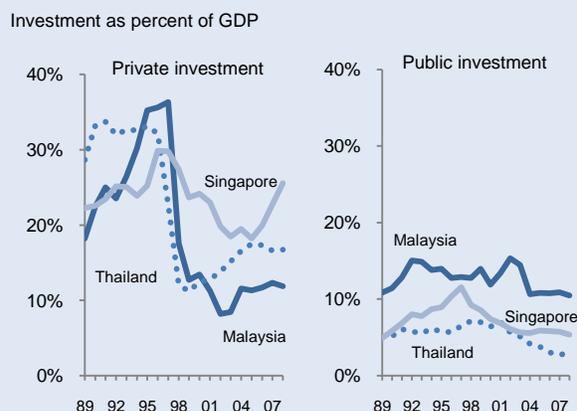
The impact of the current crisis on the overall level of investment in Malaysia has been limited, in contrast to that of the Asian crisis (see also Box 3). Not only did total investment in Malaysia reach the highest levels amongst its regional peers prior to the Asian crisis but also the subsequent fall was the most dramatic and sustained (Figure 3.3). As in Thailand and other crisis economies, this contraction in aggregate investment was driven primarily by a precipitous fall in private investment (Figure 3.4). The absence of a rebound was also particularly marked in Malaysia. The level of private investment to GDP, currently stands at just over 10 percent of GDP, is less than half the private investment rate in Singapore for example. Public investment, remaining broadly stable, did not compensate for the fall in private investment but now accounts for a slightly greater share of aggregate investment. Disaggregating the composition of public investment is made complex by the significant activities of government-linked companies. Overall public sector development expenditures continued to rise relative to GDP through the Asian crisis reaching around 20 percent of GDP in 2003 before falling in 2004 and reaching around 15 percent of GDP in 2008. Over 50 percent of such expenditures are spent by non-financial public enterprises operating across a wide-range of sectors.

Figure 3.3. Investment fell but after the Asian crisis and never recovered



Source: CEIC and World Bank staff calculations.
Note: Investment defined as gross fixed capital formation with data in real terms.

Figure 3.4. ... which was almost entirely due to the collapse in private investment



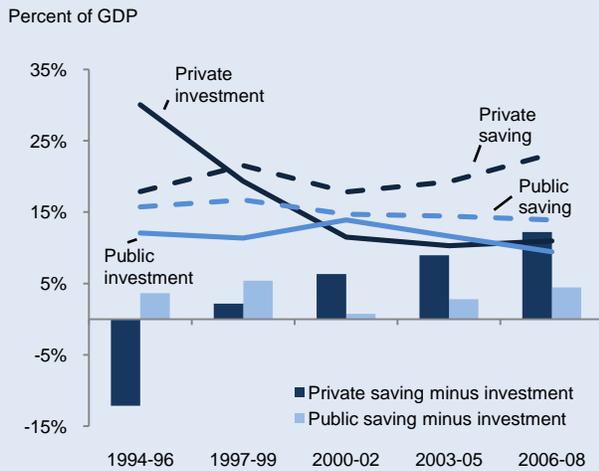
Source: CEIC and World Bank staff calculations.
Note: Investment defined as gross fixed capital formation with data in real terms.

With domestic savings remaining in excess of the investment levels of recent years, the current account surplus has reached almost 18 percent of GDP. This rise in the current account balance reflects primarily the drop in investment rates after the Asian crisis, with aggregate saving rate of the private and public sector broadly stable at around 35 percent of GDP. Both private and public savings-investment balances have been in surplus, with the private surplus of over 10 percent of GDP in 2008 now almost a mirror image of the pre-Asian crisis savings deficit (Figure 3.5). The counterpart of this current account surplus is the accumulation of net foreign assets, i.e. the excess of domestic savings over investment goes to finance investment abroad. In addition to valuation changes, this purchase of international assets, particularly foreign exchange reserves, has contributed to a remarkable turnaround in Malaysia's net foreign asset position (Figure 3.6). From 2002 to 2008, Malaysia moved from net external liabilities of just over 35 percent of GDP to net external assets of just under 20 percent of GDP.

In percentage points terms this reversal has outstripped the large improvements also made in other Asian crisis countries, with Thailand and Indonesia reducing their net foreign liabilities to GDP by just over 30 percentage points over this period.

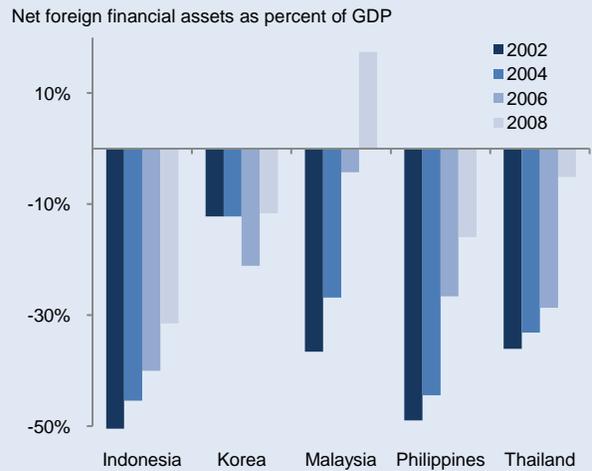
The increased purchase of foreign assets reflects the relative attractiveness of outside opportunities as well as the limited capacity of the economy to generate sufficient investment opportunities to absorb domestic savings. Private investment levels prior to the Asian crisis were boosted by activity in the construction sector, including large-scale infrastructure projects. The reduced private investment rates of recent years may be due to a variety of changes in the economic environment, which have influenced both the opportunity cost and expected return from investment. This includes the investment activities of Malaysia's public sector, and its government-linked companies in particular, which may crowd out private investment. This could be through their reducing the range of profitable investment opportunities available for private firms or through reducing their access to financing.

Figure 3.5. As a result, the savings and investment balance of the private sector dramatically rose



Source: Bank Negara Malaysia, Malaysia Ministry of Finance and World Bank staff calculations.

Figure 3.6. ...which unlike other countries flipped the net foreign asset position into a large surplus



Source: IMF International Financial Statistics, IMF World Economic Outlook and World Bank staff calculations.

The stagnation of private investment levels, in contrast to the revival elsewhere in the region, points to the need to address distortions to the investment environment. The recently completed analysis of the surveys conducted for the World Bank Productivity and Investment Climate Assessment Update for 2007 sheds light on the major constraints on firm activity and investments. Although overall the update found little change in the investment climate relative to 2002, it was found that anti-competitive practices were more of a concern for firms, particularly those in the services sector which is hoped to be a future driver of growth, as well as crime and theft. The constraints that firms indicated were most severe included the shortage of skills (as discussed in more detail in Box 8), the burden of the tax level and regulations, the lack of business support services and the bureaucratic burden on business. All these elements affect the profitability of firms, either through driving up the cost of inputs or reducing the net profits in the case of taxes. The study also provided evidence that innovation and technological capabilities, a key driver of investment, had deteriorated along with a rise in crime and the cost of security.

GUEST CONTRIBUTION FROM KHAZANAH RESEARCH AND INVESTMENT STRATEGY

BOX 6. DETERMINANTS OF PRIVATE INVESTMENT IN MALAYSIA: THE ROLE OF PUBLIC INFRASTRUCTURE

Private investment—once Malaysia’s growth engine from the early 1980s—plummeted during the 1998 Asian financial crisis and has remained depressed ever since. Between 1970 and 1996, private investment accounted for the bulk of total investment. Private Investment has remained at around 10 percent of GDP between 2003 and 2007, down from around 30 percent in 1997. While it is now accepted that private investment rates may never and should not necessarily return to pre-crisis levels, as gross fixed capital formation was mostly sustained through large infrastructure projects, it is clear that a revival in private investment remains key to Malaysia’s future growth prospects. However, given the fact that crises generally leave lasting scars on investment, it is possible that Malaysia’s growth trajectory will further flatten as the result of the 2008/2009 economic crisis. Understanding the policy levers that could help revive high quality investment and growth is therefore critical.

Several authors have offered explanations as to why investment has remained depressed in Malaysia. Guimaraes and Unteroberdoerster (2006) suggested that prolonged overinvestment before the Asian crisis or a shift in investor perception following this crisis may be the culprit. The role of public investment as a determinant of private investment in Malaysia has captured the attention of researchers, given the rather strong presence of government in the economy. However, results have been inconsistent. While Ang (2008) finds that public investment complements private investment (crowding-in), later research (Ang, 2009) suggests that public investment has in fact no effect on private sector investment. Ang then concludes that the ongoing pump-priming efforts by the Malaysian government to revive total investment may be ineffective in stimulating private investment. A common characteristic is that previous studies have not disaggregated public investment into its different components and, particularly, into public infrastructure and other public investments.

By disaggregating public investment, this Box builds on and complements these studies. Using a cointegrated autoregressive distributed lag (ARDL) approach, this Box finds that only public investment in infrastructure complements private investment. Other forms of public investment tend to crowd-out private investment. The empirical investigation relies on a reduced form of an extended standard neoclassical investment function:

$$PRI_t = f(GDP_t, COC_t, CREDIT_t, UNC_t, FDI_t, TDEBT_t) \quad (\text{Equation 1})$$

$$PRI_t = f(GDP_t, COC_t, UNC_t, PUB_t, FDI_t) \quad (\text{Equation 2})$$

$$PRI_t = f(GDP_t, COC_t, UNC_t, FDI_t, GI_t, NGI_t) \quad (\text{Equation 3})$$

where PRI is private investment; PUB public investment, GDP output growth, COC the user cost of capital, CREDIT credit availability to the private sector, UNC macroeconomic uncertainty, FDI FDI, TDEBT the total national debt, GI public infrastructure investment and NGI other public investment. The basic neoclassical model is extended following Ang (2008) to capture the effects of credit availability to the private sector, macroeconomic uncertainty, FDI and total debt as in Equation (1). The reduced form of this model (Equation 2) is derived from dropping credit availability to the private sector and total debt, the two variables that are not significant from the model. In Equation (3), total public investment is

Table 3.1. The long-run and short-run results of the private investment equation

A. The long-run relationship			
	Equation 1	Equation 2	Equation 3
	Coefficient	Coefficient	Coefficient
Constant	-14.147 (0.003)***	-8.178 (0.000)***	-17.821 (0.002)***
GDP	2.449 (0.001)***	1.229 (0.000)***	2.095 (0.000)***
COC	-0.019 (0.100)*	-0.005 (0.512)	-0.010 (0.559)
CREDIT	-0.130 (0.637)	-	-
UNC	-0.131 (0.099)*	-0.058 (0.088)*	0.033 (0.434)
PUB	-	0.293 (0.013)**	-
FDI	0.263 (0.020)**	0.157 (0.000)***	0.225 (0.013)**
TDEBT	-0.475 (0.152)	-	-
GI	-	-	0.781 (0.047)**
NGI	-	-	-0.640 (0.050)**
D9798	-0.915 (0.750)	0.021 (0.892)	0.046 (0.876)
D9805	-1.158 (0.004)***	-0.787 (0.000)***	-0.944 (0.0065)***
B. The short-run dynamics			
Intercept	-8.939 (0.000)***	-6.975 (0.000)***	-10.156 (0.000)***
ECT _{t-1}	-0.631 (0.002)***	-0.853 (0.000)***	-0.570 (0.001)***
ΔGDP _{t-1}	1.547 (0.000)***	1.048 (0.000)***	1.194 (0.000)***
ΔCREDIT _t	-0.082 (0.616)	-	-
ΔUNC _t	-0.028 (0.464)	-0.045 (0.167)	0.019 (0.416)
ΔCOC _t	-0.012 (0.153)	-0.004 (0.520)	-0.006 (0.573)
ΔFDI _t	0.166 (0.003)***	0.133 (0.000)***	0.128 (0.004)***
ΔTDEBT _t	-0.299 (0.069)*	-	-
ΔGI _t	-	-	0.073 (0.740)
ΔNGI _t	-	-	-0.364 (0.005)***
D9798	-0.057 (0.743)	0.181 (0.893)	0.026 (0.879)
D9805	-0.732 (0.001)***	-0.671 (0.000)***	-0.537 (0.003)***
Test-statistic			
R-squared	0.793	0.887	0.794
F-statistic	7.669 (0.000)	14.882 (0.000)	7.738 (0.000)

Note: The ***, ** and * indicates 1 percent, 5 percent and 10 percent levels of significance, respectively.

replaced by its components: public infrastructure investment and other public investment. The specification includes two dummy variables to capture the effects of the 1997-98 Asian financial crises and the capital control regime adopted during the period 1998-2005 by the Malaysian government in the aftermath of the crisis.

The regressions are based on yearly data from 1975 to 2006. The Dickey-Fuller (DF) and Augmented Dickey-Fuller (ADF) test indicate that all variables become stationary after taking the first difference. The long-run relationship and short-run dynamics of the private investment models are reported in Table 3.1. The results are instructive. Equation (2) suggests that, on average, public investment has had a positive impact on private investment for the last 30 years (crowding-in). Macroeconomic uncertainty exerts a negative influence, suggesting that increased macroeconomic uncertainty may partly explain why private investment has remained depressed. Capital controls, captured by the dummy variable, also had a negative impact, a result which is born out across all specifications. These findings are broadly in line with the existing literature.

Equation (3) disaggregated public investment into public infrastructure investment and other public investment. While public infrastructure investment exhibits a positive sign—indicating a complementary effect on private investment—the non-infrastructure component of public investment shows a negative sign. Government investment in directly productive activities is therefore found to crowd out private investment.

These findings have two key implications. First, a recovery of private investment in Malaysia is more likely if public investment is focused on improving infrastructure. The recent decision of the Malaysian authorities to step up divestment of some Government Linked Companies directly in competition with the private sector is therefore a step in the right direction. This focus on avoiding the crowding-out of the private sector is re-enforced in Budget 2010. Second, while public investment in infrastructure has been rather successful in crowding in private investment in the past, this is no recipe for success in the future. The infrastructure deficit is already much reduced, leaving lesser scope to impart strong positive spillover effects. In other words, infrastructure investment may provide further complementarity to future private investment demand, but decreasing returns are likely to kick in soon.

How then to revitalize private investment? First, public investment in infrastructure must evolve from physical infrastructure to soft infrastructure, from bricks and mortar to building the knowledge and skills base for the innovation-dependent high-income economy Malaysia is aspiring to. Second, as the country climbs up the income ladder, it must progressively rely on the bets of the private sector. In order to unlock the private sector's potential, the following few elements will be key: (1) promoting greater internal competition; (2) allowing for price determination to be more market-driven; and (3) further improving Malaysia's investment climate which will help accelerate the creation of new firms. Since these suggestions are all reflected as policy priorities in the 2010 Budget, implementation is therefore the key.

Global and Regional Competition Will Likely Intensify

Global and regional developments add to these challenges—as mentioned earlier. The emergence of China and India on the global stage has increased the competitive threat—even though counterbalancing this are the opportunities arising from intra-regional trade creation. And, as the global rebalancing process continues to unfold, export demand from advanced economies may be less buoyant going forward, creating additional export competition. Also, competition for FDI is intensifying, especially with the geographical center of gravity shifting to China.

Given these new challenges, the economic model which has served Malaysia so well over the last thirty years in raising incomes and reducing poverty and moving the country to middle-income status requires reconsideration. The challenge for the new economic model is to reignite growth and transform Malaysia into an innovation- and knowledge-intensive high-income economy. With the economy operating under capacity, making adjustments is easier at this point. Also, the excess capacity worldwide is expected to trigger a global restructuring of capital allocation across countries and industries, thus offering a good time for Malaysia to seize the initiative and support a restructuring consistent with its long-term objectives.

However, climbing up the income ladder from upper-middle to high-income status is a difficult challenge—one which only very few countries have achieved in the post-war period. To meet this challenge and eliminate the many impediments along the way requires strong and consistent leadership over a long period of time. Accomplishing the many changes that are needed will require political consensus. And given that the breathing space is becoming more limited in view of the external challenges, early adjustments will be critical for success.

WHAT ARE THE PATHWAYS TO HIGH INCOME?

The Malaysian authorities have expressed their commitment to reposition the economy for sustained growth. Budget 2010 (Table 3.2) lays the foundation for the new economic model, and also serves as input into the formulation of the Tenth Malaysia Plan—the five-year growth plan, which will go into effect during 2011. As Prime Minister Najib Tun Abdul Razak has recently remarked:

“We are now at a critical juncture, either to remain trapped in a middle-income group or advance to a high-income economy. [...] We were successful in the past in transforming the economy from agriculture to industrial-based. We now have to shift to a new economic model based on innovation, creativity and high-value added activities. Only then, we will be able to remain relevant in a competitive global economy.”¹³

Promising are the series of reforms that have already been announced. Most notable among these is the liberalization of segments of the services sector, where local-equity requirements for investment have been adjusted. Financial sector liberalization measures have also been announced, and additional measures were introduced to facilitate FDI by abolishing Foreign Investment Committee guidelines.

Table 3.2. Key thrusts of Budget 2010

1. The road to a high-income economy	2. Holistic and sustainable development
Increase private investment	Enhance highly skilled human capital
Provide business-friendly environment	Strengthen banking and financial system
Implement privatisation initiatives	Combat corruption
Enhance public-private partnership initiatives	Develop regional corridors
Intensify FDI	Improve effectiveness and efficiency of government administration
Intensify research, development and commercialisation	
Promote sectors	3. The well-being of the people
Leverage on niche areas (tourism, ICT, Halal)	Prevent crime
Advance agriculture	Improve income and quality of life of the Rakyat
Promote construction industry	Strengthen infrastructure in rural and remote areas
Develop green technology	Improve public transport
Promote creative industry	
Strengthen SMEs	

Source: The 2010 Budget Speech, 23 October 2009.

¹³ The 2010 Budget Speech, 23 October 2009, p. 2-3.

Promising as well are recent initiatives specifically designed to track the implementation and impact of reforms. The government has mapped ‘National Key Result Areas’—in the areas of crime, corruption, education, living standards of low-income households, rural infrastructure, and urban public transport—into detailed ‘Key Performance Indicators,’ to which Ministries will be held accountable. This initiative will help assess, monitor and evaluate the progress made. Furthermore, the 10th Malaysia Plan will be executed on a rolling format basis with an annual update every two years to allow for mid-course adjustments and ensure that outcomes are in line with national strategies.

What will it take for Malaysia to join the select group of high-income countries? An integrated strategy requires sustained efforts in four interrelated areas—all of which are being considered under the government’s umbrella of the New Economic Model:

- **Specializing the economy further.** Given limited resources—both public and private—and the need to achieve agglomeration economies, it is important to focus on a few high value-added, innovation-based sectors with strong potential. Improvements to the enabling environment can facilitate this through the building of an internally-competitive and business-friendly economy and the provision of appropriate soft and hard infrastructure to support the knowledge economy. Focused technology, innovation and urbanization policies can nurture niches of growth by building on existing strengths.
- **Improving the skills of the workforce.** Greater specialization will assist in accelerating growth and create demand for skilled labor—and increase social and private returns to education and skills upgrading. To ensure this demand can be satisfied—with skilled labor currently at only 25 percent of the labor force—simultaneous efforts are required to improve the quantity and quality of skilled labor. This requires attention to incentives, competition, and merit-based recruitment in education, as well as curriculum development, better teacher training, and leveraging efforts with the help of the private sector.
- **Making growth more inclusive.** Inclusiveness policies are yet another building block of a competitive, dynamic and flexible economy. They not only help households cope with poverty, but are also essential in promoting entrepreneurship and risk-taking. Effective social insurance programs could help mitigate unemployment risks and ensure adequate pension coverage. Well-targeted social safety nets would protect the needy in times of adversity and reduce fiscal costs.
- **Bolstering public finances.** Fiscal consolidation and reform will help address investor concerns about the rise in the fiscal deficit, broaden the narrow revenue base, lessen the significant role of subsidies in expenditures, and reduce the crowding-out of private initiative. Fiscal rules could be considered to stabilize public finances going forward. Shifts in expenditure patterns from bricks and mortar to initiatives in the areas of specialization, skills and inclusiveness will also help.

Specializing the Economy Further

For Malaysia to join the league of high-income economies against the backdrop of an increasingly competitive external environment, it needs to specialize further on a limited number of products and services, deepen its comparative advantage in them, and also remain alert to other opportunities to develop new niches, climb up the technology ladder and promote further diversification. Developing new niches is most likely to succeed by building on existing strengths as revealed in the comparative advantages of the current mix of products and services. Given limited resources—both public and

private—and the need to achieve agglomeration economies, it is important Malaysia focuses on a few high value-added, innovation-based sectors with strong global growth prospects in which it can become world class.¹⁴ In this regard, the government has identified Islamic finance, Halal industry, tourism, ICT, biotechnology and resource-based industries as areas that will be aggressively promoted.

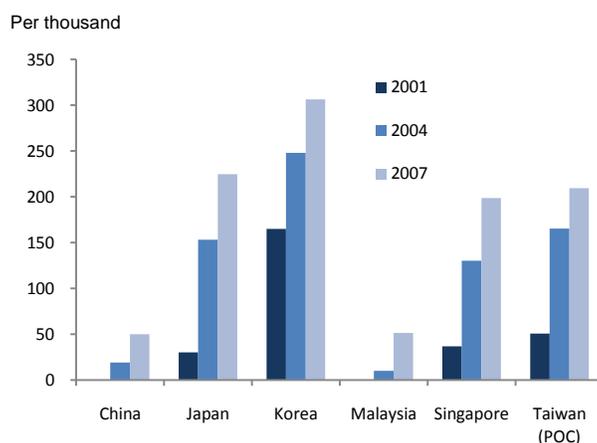
The long-term growth prospects for existing industries hinges on the progress that can be made in moving up the value chain, improving the productivity of existing processes and technologies, and strengthening industry linkages. In order to survive in the global market place, firms will need to move up the value chain from lower-value assembly-type work to higher value-added activities such as localization, design and product innovation on one end of the value chain or marketing and distribution on the other. In addition to adopting such new functions, firms also need to upgrade existing processes and technologies, which will help productivity and competitiveness. Beyond the individual level of the firm, it is also important that industry linkages—both backward and forward—are enhanced so that clusters—both logistical and technological—can be developed. Clustering will help bring about positive externalities and accelerate productivity growth.

To enhance comparative advantages in selected areas, concentrating R&D efforts will be crucial. This is in the spirit of the government's announcement to rationalize all research funds and grants and establish a National Innovation Center. Public resources allocated for research in universities and research labs could be narrowed to few select areas. Policies can also encourage research by SMEs, by providing the necessary infrastructure, assisting them in the acquisition of technology and the customization for commercial purposes, and this is also an area that the government is pursuing. Innovative firms are not built overnight, however, and as Box 7 suggests the innovation capabilities of Malaysian firms are improving only slowly. Malaysia's future dynamism will in large part continue to depend on the productivity and innovativeness of large Malaysian firms operating on a global scale, engaging in R&D and specializing in significant lines of manufacturing.¹⁵

While investment in transport and other energy infrastructure helped in the promotion of traditional industries and services, the emphasis is now shifting to laying the “soft” infrastructure groundwork for a knowledge-based economy – such as the regulatory and institutional framework for new information and mass communication technologies – as well as the hard infrastructure requirements such as communications infrastructure (Figure 3.7). The ongoing efforts in this area—for example the implementation of the High Speed Broadband initiative—will help maximize productivity gains for manufacturing and services activities, stimulate innovation and enhance agglomeration economies and technological spillovers in cities.

¹⁴ Yusuf and Nabeshima (2009) and Anantavasilpa and others (forthcoming).

¹⁵ As Yusuf and Nabeshima (2009) point out, “in the absence of such leadership by [large] technology oriented and internationally successful firms, Malaysia's ambitions with regard to growth and innovation may not be realized... These large firms will need to work in close cooperation with local research, training, financial and other institutions... They will need to upgrade their own human resources and step up efforts to borrow ideas and technologies from others.”

Figure 3.7. Broadband subscription is still low

Source: International Telecommunication Union.

Developing new sources of growth requires further attention to the enabling environment:

- A key requirement is to boost competition within the economy. Increased competition for scarce resources will facilitate the process of moving up the value chain and put pressure on firms to constantly be on the lookout for productivity enhancements. Competition policies that level the playing field will help facilitate the entry of new firms—often the source of more radical product innovations than incumbent firms.
- Malaysia is third-highest in the number of regulations it needs to revise to meet ASEAN’s service sector liberalization requirements. Policies for these subsectors need to be overhauled, allowing for greater ease of entry, trade, and competition. Not only will this immediately have an impact on services sector growth by inserting Malaysia into a rapidly growing dimension of global trade—thereby increasing demand for skilled labor—but it will also lower costs for, and increase competitiveness of skill-intensive, high-technology manufacturing.
- Providing a business friendly environment is a further priority, which will improve the investment climate and position Malaysia to revitalize domestic private investment and also attract FDI.

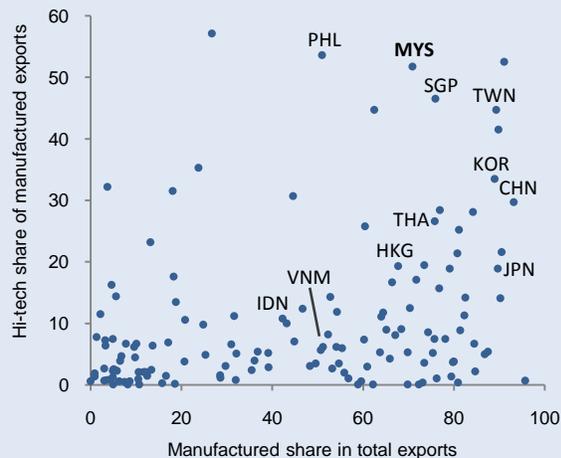
Just as there is the need for focus in R&D, there is also need for focused urban development. For Malaysia to realize the productivity and innovation gains from urbanization and scale economies, it needs to focus its urban development strategies. The drivers of industrial growth of greatest relevance at the current stage of development might not be harnessed if resources are spread too thinly over parts of the country where industrialization is unlikely to take root. Malaysia will be best placed to focus on a few areas and concentrate resources there.¹⁶

¹⁶ The tax incentives the government has recently announced to attract knowledge workers to Iskandar Malaysia will contribute to the concentrated development of a cluster of knowledge-intensive industries.

BOX 7. INNOVATION EFFORTS BY MALAYSIAN MANUFACTURING FIRMS

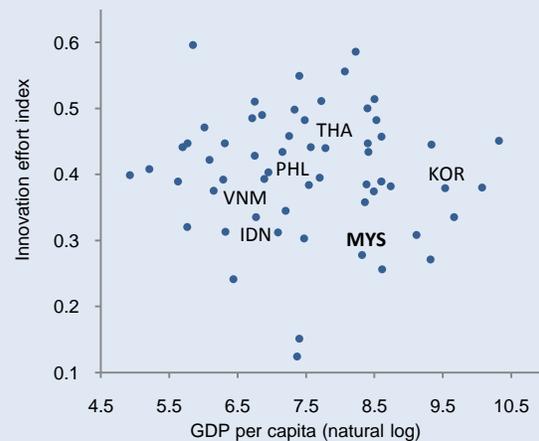
Malaysia ranks 48th out of 145 countries in World Bank's Knowledge Economy Index 2009 and has roughly remained at this position compared to a decade ago. The index captures the ability to generate, adopt and diffuse knowledge, and to create an environment that allows the effective use of knowledge. Comparison with high-income and other East Asian economies suggests that Malaysia lags somewhat in the areas of innovation and education, with other regional economies such as Taiwan (China), Singapore, China, and Vietnam having made improvements registered by the index.

Figure 3.8. Malaysian exports are highly technology-intensive



Source: World Development Indicators and World Bank staff calculations.

Figure 3.9. But innovation efforts by firms are lag those in the region



Source: World Development Indicators and World Bank staff calculations.

While Malaysia is at the top of the world league in terms of its share of high-tech to total exports (Figure 3.8), this does not seem to derive from superior innovation capabilities. Much of country's high-technology exports are based on a lower-skilled assembly of imported parts and components. Malaysia has largely served as a cost-competitive production base for multinational corporations (MNCs) rather than a creator of technological and product innovations. This role does not seem to have contributed to a strengthening of Malaysia's domestic innovation capabilities. The World Bank's investment climate survey for Malaysia in 2007 reveals that less than a quarter of interviewed firms believed they learned new technology from being a MNC supplier.

In comparison with countries at similar levels of development, innovation efforts among Malaysian manufacturing firms appear to be much lower.

- Based on a combination of various World Bank investment climate surveys around the globe, an index is constructed that captures the innovation efforts of firms. The index consists of the simple average of the number of innovative activities that each firm conducted out of possible four activities: (i) developing a major new product line, (ii) upgrading an existing product line, (iii) introducing new technology that has markedly changed the way the main product is made, and (iv) establishing a new joint venture with foreign partner.

Table 3.3. Innovation efforts by firms generally declined between 2002 and 2007

Share of manufacturing firms carrying out selected innovation activities, percent

Innovative activities	All firms			Electronics firms		
	2007	Change from 2002	Number of firms	2007	Change from 2002	Number of firms
Upgraded an existing product line	48.0	- 4.6	477	81.3	0.0	32
Developed a major new product line	26.2	- 3.6	477	46.9	-18.7	32
Upgraded machinery and equipment	60.3	- 2.0	478	84.4	0.0	32
Introduced new technology that has markedly changed the way the main product is made	27.6	- 1.7	478	50.0	+12.5	32
Filed patent/utility or copyright protected materials	11.1	- 3.2	477	9.7	-6.4	31
Subcontracted R&D projects to other organizations	6.1	+ 1.5	461	6.3	+6.3	32
Agreed a new joint venture with foreign partner	5.2	+ 1.0	478	6.3	-9.3	32

Source: World Bank (2005 and 2009b) and World Bank staff calculations.

- Figure 3.9 plots the innovation index against the natural log of real GDP per capita for 59 economies (where the data corresponds to years when an investment climate assessment was made, ranging from 2002 to 2006). On average, Malaysian firms carried out only one out of four activities, well below the outcomes of other countries at similar income levels but also emerging East Asian countries such as Thailand, the Philippines, and Vietnam.

Considering the most recent investment climate survey (2007 data) and comparing this with the earlier survey (2002 data) reveals a number of interesting aspects about the innovation efforts of Malaysian manufacturing firms (Table 3.3):

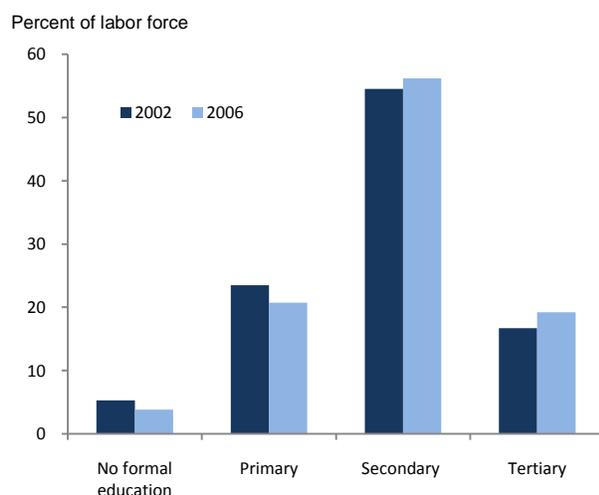
- The 2007 data suggests that less sophisticated activities, such as upgrading existing product lines or machinery and equipment, are conducted more widely. More sophisticated activities such as filing patents—a tangible innovation outcome—are less prevalent. While electronics firms scored much better on all dimensions, innovation efforts were also relatively focused on the less sophisticated activities.
- Comparing firms that participated in both the 2002 and 2007 investment climate survey, innovation efforts slightly deteriorated across most dimensions. There is also no strong evidence that electronics firms spent more efforts on innovation, even though a larger number of firms reported subcontracting R&D projects and introducing new technologies.

Improving the Skills of the Workforce

The above proposals on specialization will assist in accelerating growth and increasing the demand for skilled labor—and raise social and private returns to education and skills upgrading. While Malaysia has a base of talented people, the challenge is to expand the supply of highly-skilled labor.

The level of education attainment of the labor force has improved somewhat in recent years (Figure 3.10). But firms continue to report the inadequacy of the labor force’s skills as the top obstacle in terms of Malaysia’s investment climate (Box 8). The most recent investment climate assessment suggests that firms have become increasingly concerned about IT skills and technical/professional skill followed by English language proficiency and creativity (Table 3.4). Firms’ perceptions of skills shortages appear to relate both to the quality of education and the mismatch between the skills supplied and those demanded by firms.¹⁷

Figure 3.10. The level of educational attainment has improved somewhat



Source: Department of Statistics.

Table 3.4. Skill shortages take on many forms

Share of respondents in investment climate survey

Skill	2002	2007
English language proficiency	47.5	16.5
Professional communication skills	14.0	6.4
Social skills	8.0	2.5
Team working skills	6.6	5.9
Leadership skills	4.4	5.5
Time management skills	3.8	5.0
Adaptability skills	1.9	4.2
Creativity/innovation skills	4.1	10.0
Numerical skills	1.1	1.6
Problem solving skills	1.4	4.0
IT skills	4.1	20.4
Technical/professional skills	3.2	18.0

Source: Yusuf and Nabeshima (2009), based on World Bank (2007, 2009b)

But firms also need to do their part and be willing to pay for the higher wages that better skills deserve. The reluctance by firms to pay higher wages—as evidenced in declining wage premia¹⁸—suggests that production is still based on a low-skilled production model; hence also the need to make progress on fostering further specialization in the economy which, as noted earlier, would stimulate the demand of high-skilled labor. Indeed, in comparison with a number of advanced economies in the region, the share of unskilled and semi-skilled workers is much higher in Malaysia (Figure 3.11). The

¹⁷ Recent interviews of managers of electronics firms in Malaysia corroborate the finding that the education system may not be providing the right skills for the high-growth model. Skill shortages seem to be pervasive, even at the operator level in assembly-type manufacturing sites. Firms require workers who can function within an automated environment. English language skills are important as production processes become more complex and workers need to read process charts and reports for final inspection. Problem-solving skills are also important so operators can introduce first-level corrections and thereby avoid costly interruptions in the flow of production.

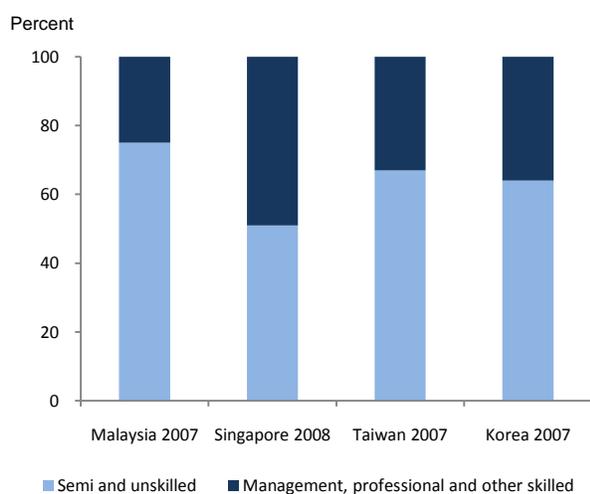
¹⁸ World Bank (2009c).

generally low share of skilled workers applies to most sectors of Malaysia's economy, with the exception of the finance & insurance and government sectors where the proportion of unskilled and semi-skilled workers is less than half.

What then can be done? Public expenditures on education have been consistently high—and in the past this has been a critical factor for increasing the availability of education, enhancing skills, and increasing productivity. The emphasis must now shift to increasing quality, not quantity—and for this the agenda is more complex.

Rural primary school teachers are poorly paid – and this is affecting the quality of teaching and the quality of primary education in rural areas. With teacher quality a key determinant of education outcomes, salaries of primary school teachers need to be sufficiently attractive. Teaching materials need to be adequately available and low teacher-student ratios also contribute to good education outcomes.

Figure 3.11. The share of skilled labor is low



Source: Economic Planning Unit.

Table 3.5. Malaysian 13-year olds are outperformed in math and science

Ranking and score	1999			2003			2007		
	Rank	Score	Rank	Score	Rank	Score	Rank	Score	
Math Score 13-year old									
Taiwan (POC)	3	(585)	4	(585)	1	(598)			
Korea	2	(587)	2	(589)	2	(597)			
Singapore	1	(604)	1	(605)	3	(593)			
Hong Kong SAR	4	(582)	3	(586)	4	(572)			
Malaysia	16	(519)	10	(508)	20	(474)			
Science Score 13-year old									
Singapore	2	(568)	1	(578)	1	(567)			
Taiwan (China)	1	(569)	2	(571)	2	(561)			
Korea	5	(549)	3	(558)	4	(553)			
Hong Kong SAR	15	(530)	4	(556)	9	(530)			
Malaysia	22	(492)	20	(510)	21	(471)			

Source: Trends in Intl Mathematics and Science Study.

The quality of secondary education still lags behind the strong performance of economies in the high-income league. The TIMSS scores for math and sciences (Table 3.5) point to much scope for improvement. Introducing greater competition among schools and providing them with more autonomy would also be beneficial for teacher quality and education outcomes at pre-SPM levels.¹⁹ Schools could focus more on addressing the concerns by firms for technical and soft skills, including team-working skills, and students could be exposed to instruction in English at an earlier level. The rise of graduate unemployment in Malaysia at the same time as firms express persistent concerns over skill shortages speaks to weak points in the tertiary education level.²⁰ World Bank (2007) identifies weaknesses in: (1) governance and financing arrangements; (2) quality concerns, including insufficient

¹⁹ The Sijil Pelajaran Malaysia (SPM), or the Malaysian Certificate of Education, is a national examination taken by all fifth form students in Malaysia.

²⁰ There is scope for improving the quality and relevance of the Malaysian universities—as revealed by their relatively poor standing in international and regional rankings. Malaysian universities rank among the top 200 to 300 universities worldwide and among the top 30 to 50 in the East Asia region (Yusuf and Nabeshima, 2009).

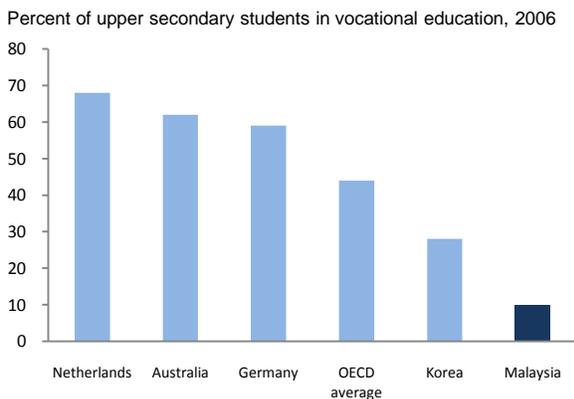
number of faculty with the highest credentials and a disjointed quality assurance system; (3) relevance and graduate unemployment problems; and (4) a disjointed research and innovation system, with weak private sector demand for R&D and weak university-industry linkages.

Improving the quality of public universities requires the introduction of greater meritocracy – in the selection of students, faculty, and leadership. This would entail opening recruitment of the best teaching talent, including from outside Malaysia, and in making the selection of Vice Chancellors subject to a systematic, non-political, meritocratic process. More competition could also be introduced in the allocation of funding for R&D.

Simultaneous efforts at improving the quality of higher education and meeting the rising demand may require additional public funding, but the government can also increasingly rely on private institutions. The private tertiary education system has grown significantly (numbering more than 500) and currently enrolls more students than do the public universities (185,000 compared to 180,000). Private universities can play a useful role in ensuring that the skills supplied meet the market test.

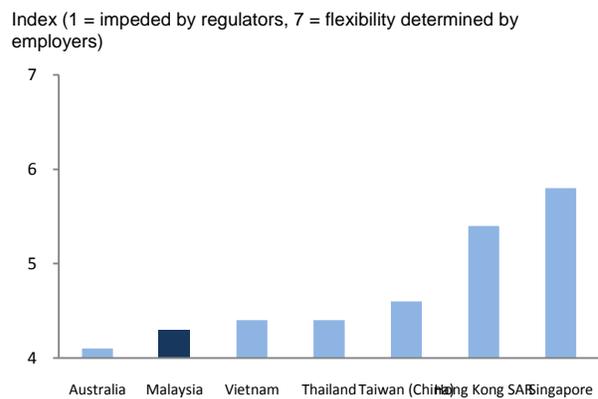
To align the demand and supply of skills, firms can be more actively involved in the development of curricula. Greater use could be made of firm internships to expose graduates to practical experiences. Firm interviews suggest that training in engineering schools is very theoretical and would benefit from greater exposure to lab experience. Attention could be given to making final-year projects more industry-oriented. Firms also expressed the need for developing vocational education (Figure 3.12). Currently only few students take up the vocational track, partly because they perceive vocational education as inferior to university education.

Figure 3.12. Vocational education is not yet widespread



Source: EPU.
Note: Malaysia: 2005.

Figure 3.13. Hiring and firing practices are comparatively rigid



Source: Global Competitiveness Report 2008.

It is important to discard the idea that foreign and Malaysian skilled workers are perfect substitutes. On the contrary, they are strong complements. Knowledge workers interact with one another in ways that lead to exponential benefits and increase the productivity of all (rather like the internet – the more the number of users, the more powerful is the web). Visa and restrictive employment requirements on foreign skilled workers is proving to be a critical and binding constraint preventing many companies from accessing the skills needed to move up the value chain. The government’s recent announcement to

simplify the granting of Permanent Resident Status to high-skilled individuals from abroad as well as their dependent expatriate family members is a helpful step in this direction.

While many reasons may argue in favor of introducing a minimum wage, industrial upgrading is likely not one of them. The introduction of a minimum wage or any other intervention designed to push up the wage rate artificially—such as reducing the influx of foreign workers—needs to be accompanied by productivity improvements, else low-skilled workers as well as the companies themselves run the risk of being priced out of employment or the market. A more natural way to facilitate industrial upgrading is to pull—rather than push—wages up by fostering specialization to invigorate the demand for highly-rewarded skills and by making sure that the required skills are available for when the need arises.

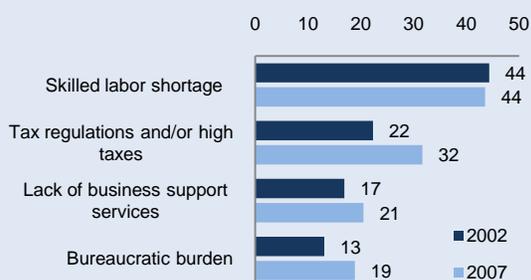
Firm interviews in the electronics sector suggest that rising wage costs also need to be evaluated within the wider context of hiring and firing practices (Figure 3.13). Firms indicated that higher wages, per se, are not the issue, but they need to be able to condition wage increases on prospective productivity improvements. With hiring and firing practices relatively restrictive in Malaysia and the costs of firing relatively large, this incentive mechanism is not working the way it could (Figure 1.37).

BOX 8. SKILL SHORTAGES AND THE PERCEPTIONS BY MANUFACTURING AND SERVICES FIRMS

The Malaysia Investment Climate Assessment Update Report (World Bank, 2009b), based on the perceptions of 1,115 firms in the manufacturing sector and 303 firms in the selected business support services sector that participated in a survey in 2007, shows that firms continue to believe that a shortage of skills is the top obstacle: about 40 percent of participating firms reported this as one of their top three constraints (Figure 3.14 and Figure 3.15).

Figure 3.14. Skill shortages are the main investment climate concern of manufacturing firms

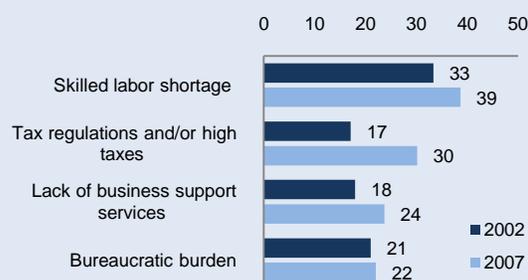
Percent of manufacturing firms indicating problem as one of top three concerns



Source: World Bank (2005 and 2009b).

Figure 3.15. ... and this also holds true for services firms

Percent of services firms indicating problem as one of top three concerns

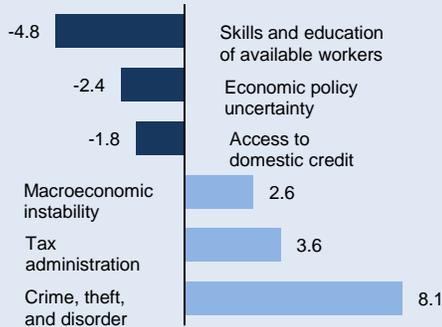


Source: World Bank (2005 and 2009b).

The supply of skills has improved, but not sufficiently. At the macro level, the gap in human capital stock between Malaysia and economies at similar levels of development has narrowed, but the deficit remains large. At the micro level, although the surveys suggest the quality of local professionals and skilled production workers has improved, the supply of skills still falls short of rapidly increasing demand. The incidence and intensity of hard-to-fill vacancies remain high in the manufacturing sector of Malaysia. Over time, firms in manufacturing sector reported an improvement in perception while firms in business support services sector a worsening of concerns (Figure 3.16 and Figure 3.17).

Figure 3.16. Manufacturing firms are concerned about crime, taxes and macro instability

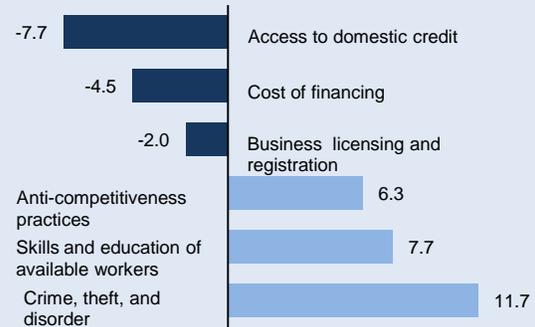
Percentage point change in share of manufacturing firms indicating problem as severe of very severe, 2002-2007



Source: World Bank (2005 and 2009b).

Figure 3.17. Services firms worry about crime, skills, and anti-competitive practices

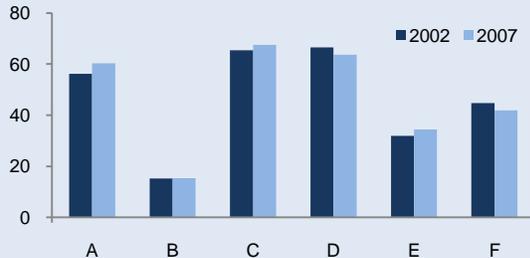
Percentage point change in share of services firms indicating problem as severe of very severe, 2002-2007



Source: World Bank (2005 and 2009b).

Figure 3.18. Manufacturing firms see skill inadequacies as the key reason for vacancies

Percent of manufacturing firms reporting factor is one of top most three cause of vacancies

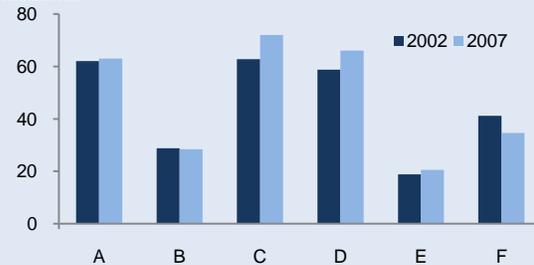


Source: World Bank (2005 and 2009b).

Note: A: wage demands are too high; B: not enough university graduates; C: basic skills inadequate; D: technical skills inadequate; E: no applicants.

Figure 3.19. ... and this is even more the case for services firms

Percent of services firms reporting factor is one of top most three cause of vacancies



Source: World Bank (2005 and 2009b).

Note: A: wage demands are too high; B: not enough university graduates; C: basic skills inadequate; D: technical skills inadequate; E: no applicants.

Lack of skills is a main reason for job vacancies in Malaysia (Figure 3.18 and Figure 3.19). Over 70 percent of firms in the manufacturing and services sectors surveyed in 2002 and 2007 indicate that applicants do not have required basic skills or technical skills as one of the top three most important causes of job vacancies. In 2007, it took Malaysian firms about four weeks to fill a vacancy for a professional or a skilled production worker.

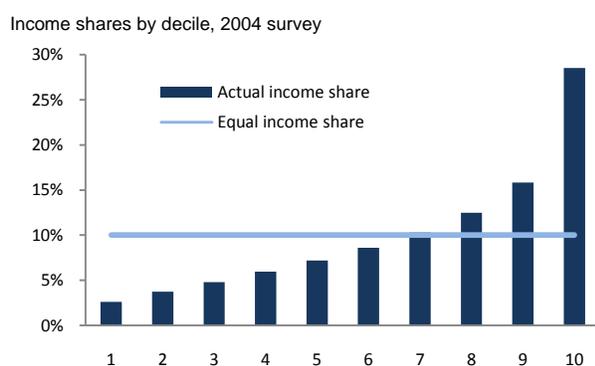
The stagnant real wage level and declining wage premium suggest that, while skills inadequacies are seen as a major obstacle and increasingly so by services firms, the willingness to pay for the scarce factor of education may be limited—and even declining over time. The wage premiums for those who had studied abroad, who received employer-provided training in marketing, IT and management, and who received off-the-job training, are high. The coexistence of high job vacancy rates for skilled work and college graduate unemployment points to imperfections in the labor market and education system.

Addressing the distortions which have been persisting in the past years in preventing labor market from sending signals to effectively match supply and demand and improving the general education system to provide workers with skills and potential required by firms are of critical importance.

Making Growth More Inclusive

Efforts to foster specialization and enhance the skill base of the workforce will be critical to sustaining growth and moving the Malaysian economy up the value-chain. However, while economic growth can contribute significantly to poverty reduction, this is not a given. Indeed, many countries have seen rapid growth coincide with large segments of the population being stuck in a situation of low wages, limited access to social services, and little opportunity for social mobility. As a result, economic growth in East Asia and elsewhere has often been associated with rising inequality in terms of income, assets and outcomes such as education and health status. A high level of inequality may conflict with social values, but is also a concern because it can undermine social cohesion and constrain economic progress.

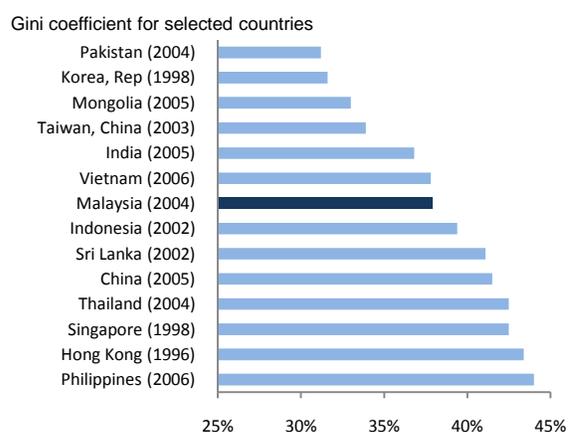
Figure 3.20. The bottom three deciles each account for less than 5 percent of total income



Source: Povcalnet, World Bank.

Note: Data are from a labor force survey (Department of Statistics), and may not be comparable with results from the Household Income Expenditure survey, which show greater income disparities for earlier years.

Figure 3.21. Income inequality is significant, not unlike the rest of the region



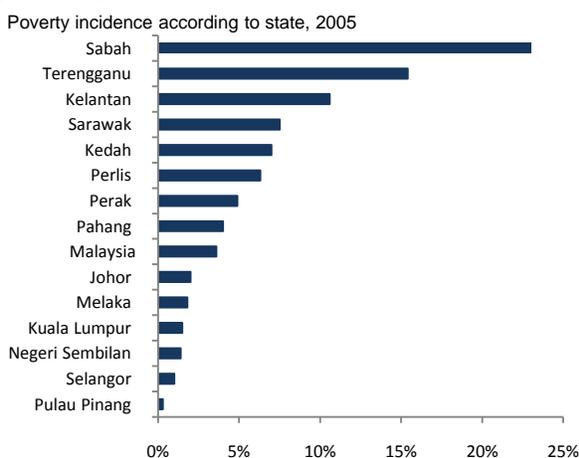
Source: Asian Development Bank (2009).

Malaysia has made significant progress in reducing poverty in recent decades, from a level of around 29 percent in 1990 to 3.6 percent in 2008.²¹ While trends in inequality are not readily available, available data suggest a high level of income inequality. For example, household income data from 2004 suggest that the bottom three deciles of the income distribution each account for less than 5 percent of total income (Figure 3.20). Conversely, the Gini coefficient, which provides a summary measure of inequality in income and consumption, was just under 0.4 in 2004, highlighting the significant level of inequality in the country (Figure 3.21).

There are also significant spatial disparities in income and poverty. Indeed, as can be seen from Figure 3.22, the incidence of poverty varies from nearly 25 percent in Sabah, to poverty rates of less than 3 percent in Johor, Melaka, Kuala Lumpur, Negeri Sembilan, Selangor, and Pulau Pinang. Reflecting these differences, poor households are also concentrated in a few states, with Sabah, Kelantan, Sarawak, and Terengganu accounting for nearly 75 percent of the poor (Figure 3.23).

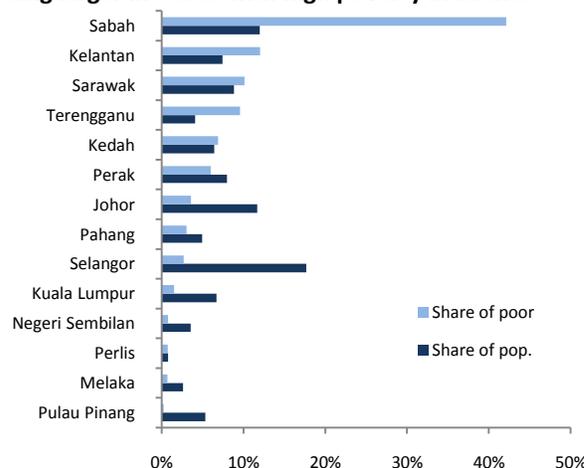
²¹ Based on the national poverty line.

Figure 3.22. Poverty incidence is subject to large spatial disparities...



Source: Ragayah Haji Mat Zin (2007) and World Bank staff calculations.

Figure 3.23. ...which is not due to population shares being larger in states with high poverty incidence



Source: Ragayah Haji Mat Zin (2007) and World Bank staff calculations.

Rising inequality has been a feature of many countries in the region in recent decades, typically because the rich are getting richer faster than the poor (rather than the poor getting poorer). In explaining this trend, a number of factors are likely to be at play, including low productivity growth in agriculture, growth and expansion of opportunities in skill-intensive sectors; and a concentration of economic activity in areas with better infrastructure and trade links (which tend to be better-off to start with). Taken together, these factors contribute to uneven growth across sub-national units (“lagging regions”), across urban and rural areas, and across households with different endowments in human capital.

Yet, the tendency for inequality to increase as economies develop is not inevitable. Looking forward, a key question for the Government of Malaysia is therefore what it can do to help ensure that all Malaysians have an opportunity to participate in the growth process, and, more broadly, that sustained economic progress is shared across the population in ways that are consistent with the country’s values. A full answer to this question would require an in-depth analysis of the growth record, the endowment of infrastructure, human capital, and assets of different parts of the country and groups, and patterns of social exclusion. However, strategies for inclusive growth tend to include a number of common elements, including broad-based investment in human capital; measures to enhance the functioning of credit, land and labor markets; promotion of sectors that provide opportunities for poor households and un-skilled workers; and investment in infrastructure and public goods in “lagging regions”.

Of course, even if conditions for inclusive growth are met, many households will remain vulnerable to poverty or loss of income as a result of shocks or other events. This is where the social protection system—including policies and institutions that protect workers; social insurance programs to cushion the risks associated with unemployment, ill health, disability, and old age; and social safety nets for the most vulnerable groups—comes in. Effective social insurance and safety nets not only help reduce poverty in the short term, but can also reduce the risk that temporary shocks have long-term consequences for households—due to accumulation of debt, sale of productive assets, because children are withdrawn from school, or because households forego essential health services. Moreover, by allowing households to engage in riskier livelihood strategies (with higher potential returns) and reducing the need for precautionary savings, safety nets help underpin a dynamic economy.

The social protection system in Malaysia is well-developed, although with some notable gaps. On the social insurance side, there are provisions for sickness, maternity, disability, and other benefits, although these programs primarily benefit formal sector workers. However, there is no unemployment insurance for workers in Malaysia, except payment of termination benefits required by the labor law. The Employment Provident Fund is the primary mechanism for ensuring old-age security (on a defined-contribution basis). However, the fund only covers around 50 percent of the workforce (almost exclusively the formal sector), hence leaving many uncovered by any formal pension arrangements. Moreover, due to gaps in contribution periods (people may spend part of their working life in the informal sector) and early retirement (55 years), accumulated savings, which are paid in lump sum at retirement, are often inadequate. Access to health care is provided on a universal basis, with financing from general government revenues. Yet, despite the availability of free or near-free services in the public sector, around 40 percent of total health expenditures are financed through out-of-pocket payments. This reflects extensive utilization of private providers, even among the poor, in most cases to gain swifter access to services or due to dissatisfaction with responsiveness in the public sector. Private health insurance is expanding rapidly, but it will also be important to consider other options to promote access to health care and enhance financial protection (e.g. through reforms of public financing and service delivery and/or establishment of supplementary social health insurance).

Turning to social safety nets or social assistance, programs in Malaysia fall into three broad categories: subsidies, incentives or assistance. While social safety net spending is substantial, the major share of this spending is not explicitly targeted on the poor. Some of the larger safety net programs (in terms of expenditure) are self-targeted, meaning that the extent to which households benefit from the program depends on households' behavior or choices. This is the case, for example, with subsidy programs (e.g. diesel and petrol subsidies, and subsidies for rice consumption and production). Because richer households often consume more of these commodities than the poor, these programs tend to disproportionately benefit the better off. Other programs are universal (e.g. un-targeted grants to schools), and yet others, such as many scholarship programs and programs for the disabled, use criteria other than poverty to target benefits.

Programs that are explicitly targeted on the poor include a number of social assistance programs operated by the Ministry of Women, Family and Community, some education sector programs (e.g. supplementary program, tuition aid program, federal scholarships, uniform aid program, and the poor students' trust fund), medical assistance, and other programs operated by the Ministry of Regional and Rural Development and the Ministry of Housing and Local Government. These programs mostly rely on a simple means test, whereby the agencies responsible for the respective programs compare self-reported income to the official income poverty line. This approach to targeting creates a number of problems, including (i) duplication of effort across programs; (ii) risk of inconsistent treatment of households; (iii) incentive to under-report income in order to receive benefits; and (iv) mis-targeting due to the high variability of cash income and the exclusion of non-cash income (e.g. imputed rent for owner-occupied dwellings and own-produced food).

In order to address some of these problems, the government has recently set up a centralized system —e-Kasih—for identification of poor and ultra-poor households and managing a list of actual and potential beneficiaries. While this system represents a step in the right direction, it still has a number of teething problems. For example, although data have been collected from both existing data-bases and new household visits, questions remain about the coverage and accuracy. It is also unclear whether and how the system should capture beneficiaries of safety net programs that are based on criteria other

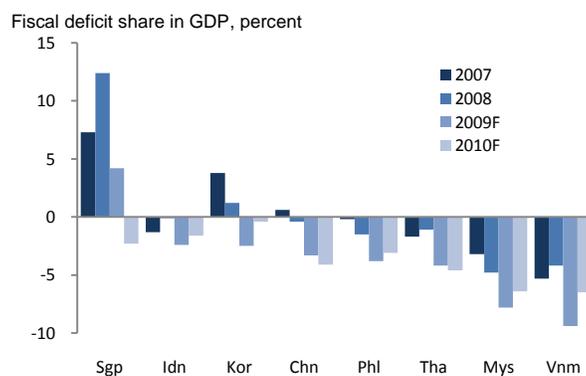
than income. More importantly, perhaps, measures taken to date fail to address some of the more fundamental challenges associated with the current targeting system, in particular the focus on cash income and inability to verify income for many households.

Overall, the social safety net system in Malaysia is weakly targeted and fragmented across government agencies (and levels of government). These problems are not unusual. However, going forward, there is a need to assess the extent to which safety net programs are achieving their intended objectives, as well as broader aspects of program performance (e.g. incentive effects and administrative costs). There is also a need to assess targeting performance. This would include looking at errors of inclusion and exclusion, the direct and indirect costs of targeting, and the potential merits of alternative targeting approaches, such as proxy-means testing or community-based targeting. Assessments along these lines could help inform a strategy for enhancing the coherency and poverty-focus of safety net programs, managing fiscal costs, and ensuring that the social safety net system effectively supports a dynamic and flexible economy.

Bolstering Public Finances

The strengthening of public finances is a further instrument to boost medium-term growth.²² To create sufficient fiscal space to counter future shocks, it is clear that further consolidation efforts will need to take place beyond 2010—which will also bring Malaysia’s deficit in line with the rest of the region (Figure 3.24). Mitigating concerns about fiscal sustainability is the fact that Malaysia’s public sector fiscal balance has been in a better shape relative to federal government (Table 3.6).²³

Figure 3.24. Many countries in the region anticipate fiscal consolidation



Source: CEIC and World Bank staff projections.

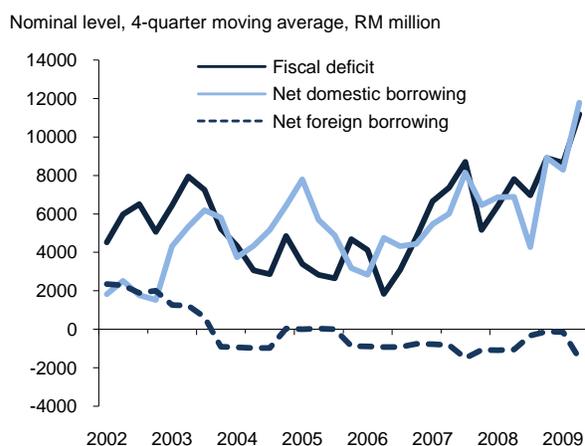
²² See Ministry of Finance (2009).

²³ This is thanks to the net surpluses of Malaysia’s non-financial public enterprises. The year 2008 was an exception though, as their surpluses fell by 8 percent compared to 2007 and their development spending rose by 43 percent. High GDP growth in the past several years has also helped to keep government debt/GDP at lower than 45 percent of GDP, despite the fact that government debt value continued to rise every year. Debt service charges also fell steadily to currently around 8 percent of government revenue, as revenue growth has outpaced debt service charges growth.

Table 3.6. The federal headline deficit is generally larger than the public sector deficit (except 2008)

Percent	Public sector balance/GDP	Federal govt balance/GDP
2000	0.7	-5.5
2001	-0.3	-5.2
2002	-0.6	-5.3
2003	-4.6	-5.0
2004	3.9	-4.1
2005	1.4	-3.6
2006	-0.3	-3.3
2007	1.5	-3.2
2008	-5.6	-4.8

Source: CEIC and World Bank staff calculations.

Figure 3.25. The fiscal deficit is financed mainly domestically

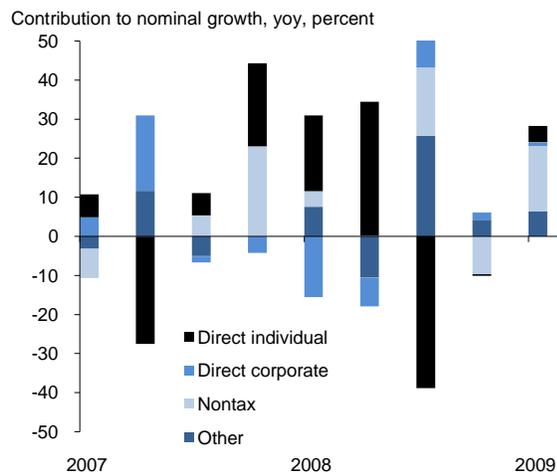
Source: CEIC and World Bank staff calculations.

Most of Malaysia's fiscal imbalance is financed domestically, and therefore the government competes with the private sector for funds (Figure 3.25). External debt accounts for less than 5 percent of government debt. Domestic debt consists of government securities (70 percent), investment issues (14 percent), housing loan fund, and treasury bills. The drop of private investment demand during the crisis allowed government to expand domestic borrowing without much concern about the potential crowding-out of private investment. However, as the economy recovers, large borrowing requirements may dampen the prospects for private investment financing. The government's announcement to gradually reduce its involvement in economic activities where it competes with the private sector is therefore significant.²⁴

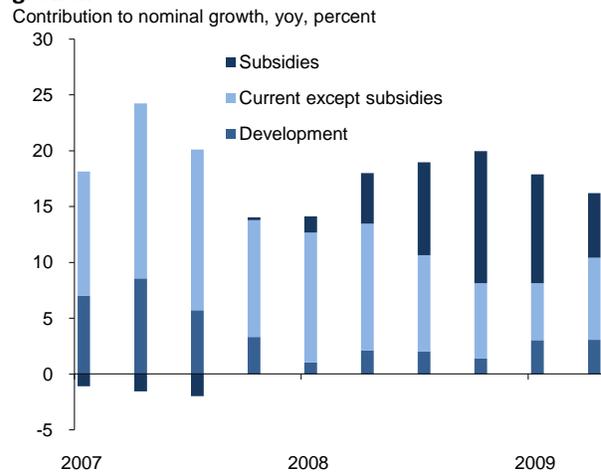
The proliferation of incentives and exemptions that have eroded the tax base has been a cause for concern. World Bank (2006) concludes that Malaysia's tax and incentive structure is overly generous and complex, and may leave room for tax abuse. Measures that are initially designed to be temporary run the risk of becoming easily entrenched. A well-functioning medium-term fiscal framework is instrumental in allowing policy makers to establish a credible strategy for maintaining fiscal sustainability over time. This can be usefully supplemented with comprehensive debt sustainability analysis which takes account of contingent liabilities and other fiscal risks.

The overdependence of the revenue base on oil and gas is a major fiscal risk. Oil-and-gas revenue presently account for about 40 percent of total revenue. With the rise in commodity prices of recent years, oil-and-gas revenue increased from 5.1 percent of GDP in 2004 to 8.6 percent in 2009. Non-oil revenue has been unable to finance operating expenditures since 2004. The large dependence on oil and gas has posed challenges to fiscal management, as the volatility of oil prices introduces a procyclicality into the budget. Also, with proven oil reserves at 4 billion barrels as of early 2009 and production rate in 2008 at 727 thousand barrels a day, expanding the revenue base helps prepare for the day that reserves will be depleted.

²⁴ The government will privatize companies under the Ministry of Finance and other viable government agencies. In addition, public-private partnership initiatives will be enhanced.

Figure 3.26. Government revenue growth moderated

Source: CEIC and World Bank staff calculations.

Figure 3.27. Subsidies drove government expenditure growth

Source: CEIC and World Bank staff calculations.

Budget 2010 proposed to carry forward the tax assessment basis for upstream petroleum companies from preceding-year to current-year assessment, allowing the additional tax burden that this implies to be spread out over a period of five years. As a result of this measure, Petronas, which accounts for 70 percent of Malaysia's oil and gas production, is expected to pay an additional RM4 billion in tax annually over the next five years. The measure is unlikely to reduce the procyclicality of government revenue with respect to the oil and gas business going forward, but will help provide a one-off relief next year when the lagged impact of lower oil prices is anticipated.

Diversifying and widening the revenue base remains an important objective going forward (Figure 3.26). A goods and services tax (GST) is ready to be rolled out in terms of administrative capacity, but the social impact is still being considered. While the timing of the new tax needs to be aligned with the recovery path of the economy, introducing the GST would be an important step to broaden the tax base.²⁵ The government has further announced that it will reintroduce a 5-percent capital gains tax on gains arising from the disposal of real property. A service tax on credit cards has also been proposed.

On the expenditure side, the sizable expenditures on subsidies will be difficult to maintain going forward. Subsidy programs have risen from 5 percent of GDP in 2004 to 16 percent in 2008, with 80 percent of the overall bill being related to fuel. The subsidy bill has strained government finances in recent quarters with subsidies accounting for most of the growth in expenditures (Figure 3.27). Mid-2008 a subsidy reform was introduced, but further efforts will be required to target subsidies better based on means. The government announced the fuel subsidies will be revisited early next year and be more targeted to benefit low-income groups.

²⁵ See also IMF (2009a).

APPENDIX

Appendix Table 1: Economic developments

	2005		2006		2007		2008		2008		2009	
					Q3	Q4	Q1	Q2	Jun	Jul	Aug	Sep
Real GDP (% chg yoy)	5.3	5.8	6.3	4.6	4.8	0.1	-6.2	-3.9	..	..	..	..
Industrial production index (2005=100)	100.0	104.8	107.2	107.8	110.3	101.1	94.6	97.3	97.9	105.1	104.0	..
(% chg yoy)	3.6	4.8	2.3	0.6	1.0	-8.3	-6.5	2.8	-9.5	-8.2	-5.7	..
Unemployment (%)	3.5	3.3	3.2	3.3	3.1	3.1	4.0	3.6	..	..	..	..
CPI (% chg yoy)	3.0	3.6	2.0	5.4	8.4	5.9	3.7	1.3	-1.4	-2.4	-2.4	-2.0
Gov't balance (% GDP) 1/	-3.6	-3.3	-3.2	-4.8	-3.9	-10.3	-4.3	-7.5	..	..	..	..
Domestic public sector debt (% GDP) 1/	38.2	37.9	38.5	39.6	36.4	43.3	51.0	52.0	..	..	..	..
Trade balance (US\$ bn)	26.3	29.5	29.2	45.3	12.4	11.7	9.2	7.5	2.6	2.2	2.7	..
Goods exports (US\$ bn)	140.9	160.6	176.0	209.7	55.5	52.0	33.5	36.4	12.8	13.8	13.6	..
(% chg y-y)	11.3	14.0	9.6	19.1	21.8	6.7	-28.8	-33.2	-28.4	-29.3	-23.0	..
Key export (% chg yoy) 2/	9.9	6.4	-4.2	-3.8	2.6	-17.2	-19.1	-22.8	-16.3	-15.2	-13.1	..
Goods imports (US\$ bn)	114.6	131.1	146.8	164.4	43.1	40.3	24.3	28.9	10.2	11.6	10.9	..
(% chg y-y)	9.0	14.6	12.0	12.0	15.0	0.4	-37.2	-30.9	-26.7	-23.1	-17.9	..
Current account balance (US\$ bn)	20.0	25.5	29.2	38.8	11.5	8.4	8.6	8.1	..	..	..	..
(% GDP)	14.6	16.3	15.7	17.5	19.5	16.7	20.2	17.8	..	..	..	..
FDI (US\$ bn)	0.0	6.1	8.5	7.2	0.3	4.1	2.8	0.9	..	..	..	..
External debt (US\$ bn)	52.2	50.9	55.8	66.4	75.3	66.4	68.3	65.7	..	..	..	..
(% GDP)	37.8	32.5	29.9	29.9	32.9	32.5	40.1	35.9	..	..	..	..
Short-term debt (US\$ bn)	12.4	11.8	16.2	22.4	30.6	22.4	24.3	24.3	..	..	..	..
Debt service ratio (% exports of g&s)	5.4	7.3	2.6	3.1	2.2	3.1	7.8	8.1	..	..	..	..
Gross foreign exchange reserves (US\$ bn)	70.2	82.2	101.5	91.6	109.7	91.6	87.9	91.7	91.7	91.3	93.3	96.2
(months of goods imports)	7.7	7.8	8.4	7.4	8.9	7.6	8.3	9.0	9.0	7.9	8.6	..
Domestic credit (% chg yoy)	8.6	6.3	8.6	12.8	10.5	11.3	11.2	9.3	8.3	8.4	7.3	7.2
ST interest rate (% p.a.) 3/	2.8	3.5	3.5	3.5	3.6	3.5	2.5	2.1	2.1	2.1	2.1	2.1
RM/USD (end-period)	3.79	3.53	3.31	3.46	3.46	3.46	3.65	3.52	3.52	3.52	3.53	3.48
Real effective exchange rate (2000=100) 4/	95.2	99.2	102.6	103.3	104.6	101.4	100.5	100.8	100.0	..	..	..
(% chg yoy)	0.3	4.0	3.4	0.7	0.9	-2.4	-3.9	-0.6	-1.1	..	..	..
Stock market index 5/	900	1096	1445	877	1019	877	873	1075	1075	1175	1174	1202

Source: Bank Negara Malaysia, CEIC and World Bank staff calculations

Notes: 1/ federal government only ; 2/ electronic products ; 3/ one-month interbank rate; 4/ World Bank staff estimate; 5/ KLSE Composite.

Appendix Table 2. Developments and projections: real GDP levels

RM billions

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009f	2010f
Consumption expenditure	192	203	214	231	253	275	292	320	349	352	359
Private	156	161	167	180	198	216	231	255	277	279	287
Public	36	42	47	51	55	58	61	65	72	73	73
Gross fixed investment	90	88	89	91	95	99	107	117	118	111	113
Private	48	40	31	34	49	51	56	62	63	49	52
Public	42	48	58	58	45	48	51	55	55	62	62
Change in stocks	6	-1	5	1	4	-3	0	-4	-8	-21	-3
Domestic demand	288	289	307	324	352	371	399	433	459	442	470
Exports of goods & services	427	398	419	441	512	554	591	617	625	556	582
Imports of goods & services	359	329	349	365	437	476	515	546	556	482	514
Net external demand	68	69	70	76	75	78	76	72	69	74	68
GDP	356	358	378	399	427	449	476	505	528	516	538

Source: Bank Negara Malaysia and World Bank staff calculations and projections.

Appendix Table 3. Developments and projections: real GDP growth and other indicators

	2001	2002	2003	2004	2005	2006	2007	2008	2009f	2010f
Consumption expenditure	5.4	5.5	8.2	9.4	8.5	6.4	9.6	9.0	0.9	2.0
Private	3.0	3.9	8.1	9.8	9.1	6.8	10.4	8.5	0.7	2.9
Public	15.7	11.9	8.6	7.6	6.5	5.0	6.5	10.9	1.4	-1.0
Gross fixed investment	-2.1	0.6	2.8	3.6	5.0	7.5	9.6	0.8	-6.0	2.2
Private	-15.7	-23.3	8.8	46.5	3.3	9.2	11.8	0.8	-22.3	6.3
Public	13.3	20.6	-0.3	-21.5	6.8	5.8	7.1	0.7	12.4	-0.2
Change in stocks	-125.8	-438.4	-80.3	319.5	-176.0	-108.3	-1685.6	89.6	-167.5	87.4
Domestic demand	0.5	6.2	5.3	8.6	5.5	7.7	8.5	6.0	-3.7	6.3
Exports of goods & services	-6.8	5.4	5.1	16.1	8.3	6.6	4.5	1.3	-11.1	4.7
Imports of goods & services	-8.2	6.2	4.5	19.6	8.9	8.1	6.0	1.9	-13.4	6.7
Net external demand	0.5	1.8	8.1	-1.2	4.7	-2.8	-5.9	-3.5	7.0	-8.5
GDP	0.5	5.4	5.8	6.8	5.3	5.8	6.2	4.6	-2.3	-4.1
CPI inflation (%)	1.4	1.8	1.1	1.5	3.0	3.6	2.0	5.4	-0.1	1.5
Unemployment rate (%)	3.5	3.5	3.6	3.6	3.6	3.3	3.3	3.3	...	...
Fiscal balance/GDP (%)	-5.2	-5.3	-5.0	-4.1	-3.6	-3.3	-3.2	-4.8	-7.8	-6.4
Current account balance/GDP (%)	7.9	8.0	12.1	12.1	15.0	16.7	15.7	17.5	12.3	12.1

Source: Bank Negara Malaysia and World Bank staff calculations and projections.

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