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Malaysia's Experience during the Crisis: Lessons Learnt and Challenges

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1. Introduction

Malaysia has experienced in recent years two major economic upheavals: the 2008/09 global crisis and the 1998 Asian financial crisis. They are quite different however, when we look at their respective cause, impact and response. The 2008/09 crisis came from the developed countries (US and EU), the impact was transmitted through the real sector and recovery was achieved by a large fiscal stimulus to boost the domestic economy. The 1998 crisis started in East Asia and it affected the financial sector which then resulted in a severe contraction of the domestic economy. Malaysia's response to the 1998 crisis was unconventional at that time – it imposed capital controls, pegged the ringgit and expanded the domestic economy by lowering interest rates and introducing fiscal stimulus programs.

Malaysia had successfully recovered came both crises. The first was much more painful while the second less so. The successful recovery showed that Malaysia has some resilience and the measures worked. However, it is important to compare the two experiences because of the different context and response measures. In a way, the 1998 crisis prepared Malaysia for future upheavals – it is more cautious on financial globalization, particularly short-term capital flows and has strengthened significantly its financial sector. Malaysia's experience can also be put in the broader regional perspective for the 2008/09 crisis: the other Asian countries also recovered quickly due to the massive fiscal stimulus injection, the expansion of Chinese and regional demand, and the good health of the regional countries' financial sector. Moreover, East Asian countries did not face a balance of payment problem and in fact have a strong trade surplus.

Notwithstanding the rapid recovery from both crises, Malaysia has short-term and long-term challenges if it is to achieve its target of developed country status by 2020. Since 2000, growth has been moderate, private investment has been low and per capita income growth has been minimal. This has led to many characterizing Malaysia as a country caught in a middle income trap. In the immediate term, reducing fiscal deficit, rationalizing subsidies and managing inflationary pressure are the priority tasks for the Government.

The Malaysian government launched the New Economic Model (NEM) in 2010, and it has three goals: transforming to a high income country, attaining inclusive growth and ensuring that growth is sustainable. The target date is 2020. The NEM also recognizes that it has to find a balance between an export-oriented strategy with extensive links to the global economy, and the push to expand the domestic economy.

This paper analyses the impact of the 2008/09 global crisis and Malaysia's responses. It also summaries the sources of Malaysia's resilience in managing crisis and draws out lessons by comparing the experiences of both the 2008/09 and 1998 crises. The paper concludes by discussing both immediate and longer term issues that Malaysia needs to settle if it is to regain its high growth path.

2. Impact of the 2008/09 crisis on Malaysia

i. GDP and sectoral components

The global financial crisis of 2008-2009 while its epicenter lay in the United States, brought enormous consequences for the world economy. The crash in global aggregate demand negatively impacted a number of sectors and markets in the Malaysian economy. The overall GDP growth rate of Malaysia fell 0.1% in the last quarter of 2008, and entered a recession following a decline in GDP by 6.2%, 3.9% and 1.2% in the first three quarters of 2009 (Table 1).

While the impact on the real economy for the developed countries came later, the inverse was true for Malaysia, and the real sector was the first point of impact. The contraction in export demand – particularly in manufacturing – as the developed markets were gripped by recession caused a steep drop in Malaysia's highly export-dependent manufacturing sector. The intra-GDP changes show the biggest contraction in manufacturing with growth declining by 8.9% in the fourth quarter of 2008, 17.9% in the first quarter of 2009 and 14.5% in the second quarter. Overall, exports fell by 10.6% in the fourth quarter of 2008 and 15.5% in the first quarter of 2009, partly due to the high import content (intermediate goods) of the goods exported. Although the trade balance, which is measured by deducting imports from exports and dividing the balance with the total of exports and imports, improved to 15.6% in the first quarter of 2009 from 12.1% in the fourth quarter of 2008, the combined decline in trade has already led to a severe recession in manufacturing. The largest manufacturing industry, i.e. electrical machinery, recorded the highest reduction among the real sectors because of its high dependence on exports. Plunging exports had already brought down electronics production by -4.1% and 27.8% in the last two quarters of 2008 (Table 2).

Investment and consumption

Aggregate private investment indicators largely show a fall beginning from the end of 2008. Indicators such as investment in capital goods, machinery for industry and transport equipment, import of intermediate goods and manufacturing project approvals all pointed towards a decline in investment activities.

The crisis has also brought implications for investment flows, both inward and outward. Inward foreign investment had risen steadily over the period 2003-2007 but, because outward investment from Malaysia has risen faster than investment inflows since 2003, Malaysia has experienced a negative net foreign investment over the period 2006-2007. FDI inflows into Malaysia started falling from the third quarter of 2008 until the second quarter of 2009 (Table 3). The prime sources of contraction were North America, Central and South America, and Northeast Asia. Inflows from the United States fell from RM1,100 million in the first quarter of 2007 to RM445 million in the first quarter of 2009. In light of a decline of FDI inflows from traditional sources, the Government has sought to seek inflows from other nontraditional sources. The negative net FDI are to a significant extent the result of increased outflows of capital from Malaysia (Table 4). The slowdown trend in net FDI following the crisis is unavoidable and can only be reversed through inflows from non-traditional sources into resource-based industries as well as through upgrading the high-tech infrastructure in the country to attract FDI in high value-added activities, given the growing cost differentials between Malaysia and late-comer countries, such as China and Vietnam.

Final consumption expenditure fell gradually over the whole of 2008, but contracted in the first quarter of 2009 before recovering by 0.6% in the second quarter. While public consumption slowed down to 2.1% growth, private consumption fell by - 0.7% in the first quarter of 2009 (Table 5). A slowdown rather than an absolute contraction in public consumption has been due to the execution of government expenditure already committed through the Ninth Malaysia Plan.

ii. Commodity Prices

The crisis also triggered a slump in commodity prices from their high in the first quarter of 2009 (Table 6). As a result, income of key sectors in the Malaysian economy – palm oil and petroleum – has been affected. Prices of crude palm oil for local delivery and exports dropped sharply from the first quarter of 2008 until the fourth quarter of 2008, but have risen steeply over the first and second quarters of 2009. Crude oil prices fell from the second quarter of 2008 until the first quarter of 2009 before going up in the second quarter of 2009. Export prices of oil show a slightly different pattern, with prices falling from the third quarter of 2008 and rising in the second quarter of 2009. Prices of liquefied natural gas (LNG) fell from the fourth quarter of 2008 until the second quarter of 2009.

The sharp recovery in palm oil prices, driven primarily by the revival in GDP growth in China and India, augurs well for the Malaysian economy. However, despite recovery in the last two

quarters, oil and gas price trends provide the opposite effect. In addition, the growing deficit in net exports of gas suggests that the natural resource may soon be exhausted. Given the importance of oil and gas in the subsidy of several government projects, it is likely to have a severe bearing on government finance in the medium to long-term. In addition to a need to rethink the subsidies on gas given to independent power suppliers, it is also important that the Government reduces its dependence on oil and gas, both of which are non-renewable commodities.

iii. Trade

Malaysia experienced a contraction in exports and imports from the fourth quarter of 2008 (Table 7). The trade balance improved marginally in the first quarter of 2009 but dropped again in the second quarter. It shows a continuous decline in aggregate demand from external effects, which is the main channel through which the global financial crisis has penetrated the Malaysian economy. Exports of electronics, which is Malaysia's major export, faced a severe contraction over both quarters of 2009 (Table 8). Wood products, petroleum products, toys and sporting goods, and chemicals also experienced a sharp fall in exports in the first two quarters of 2009. Given the significance of electronics to manufacturing employment, this decline is serious.

As the epicenter of the crisis, the contraction in exports from the United States is the most severe. The magnitude of contraction increases each quarter beginning from the third quarter of 2008 (Table 9). Exports to Japan experienced their first contraction in the first quarter of 2009 and continued into the second quarter. Exports to all ASEAN countries fell, except to Brunei in the first two quarters of 2009 and to Vietnam in the second quarter of 2009. The sharper decline in exports to key markets in the first two quarters of 2009 left the Malaysian economy in a precarious situation.

iv. Currency and Financial Markets

The financial sector has, remained strong in Malaysia despite the collapse in exports, a fall in oil prices and a contraction in GDP over the first two quarters of 2009. The capital and currency markets have also remained steady over the first two quarters of 2009. Ringgit only depreciated slightly against the U.S dollar, due to capital outflows in the second and third quarter of 2008. The mild impact on the currency is contributed by the healthy level of international reserves held by the Malaysian treasury.

Liquidity levels in the country remain high with low NPLs, which have given the Government considerable financial stability. The same prudent and conservative regulations on investment banks and finance houses, which were designed to reduce NPLs following the 1997-98 Asian financial crisis, have been retained to good effect. The NPL over total loans ratio was already extremely low prior to the financial crisis (Table 10). Despite a contraction in GDP, the percentage of NPLs in total loans fell from 4.4% in March 2007 to 2.2% in

December 2008, and March and June 2009. This offered the Government the space to pursue expansionary policies to expand domestic demand. Despite the excellent NPL record achieved, the environment for investment has nevertheless continued to deteriorate because of falling aggregate demand.

Despite the ending of capital controls, regulations by the Finance Ministry have ensured that the contraction in aggregate demand arising from a collapse in exports did not trigger a bearish run on the stock market. Bursa Malaysia has also remained fairly steady in 2009. The index fell in the months of January- March 2008, May-October 2008 and March 2009 (Figure 1). After falling from October 2008 until April 2009, the index has grown strongly from May 2009. News of the Malaysian economy entering a recession following a second-quarter dip in GDP did not dampen the stock market very much.

v. Retrenchments and Income

With diminishing exports and GDP, layoffs and pay cuts took place (Table 11). As a result, unemployment rate rose to 3.7% in 2009 after a moderate rise from 3.2% in 2007 to 3.3% in 2008 (Table 12). Given the strong exposure to export markets, manufacturing was the worst hit sector. Manufacturing employment over the one-year period fell by 4.8%, wages and salaries by 4.3% and productivity by a large 14.8% (Table 13). Total retrenchments in manufacturing reported for 2008 and 2009 were double those of 2007 (Table 14).

3. Measures to mitigate the negative effects

The initial government reaction to the global crisis was to relax monetary policy. The lowering of the Overnight Policy Rate (OPR) from 3.5% in 2007 to 2% in February 2009 was done only after the full impact of the global crisis began to be felt in Malaysia. By that time, inflationary pressures which took place in the earlier part of 2008 had dissipated with the collapse of oil and other commodity prices. Interest rate reduction was accompanied by a lowering of the Statutory Reserve Requirement (SRR) of 50 basis points to 3.5% to reduce the cost of intermediation.

The Government also introduced a deposit insurance scheme run by Perbadanan Insuran Deposit Malaysia (PIDM), following the footsteps of some other countries in the region that introduced guarantees for bank deposits to allay fears of the collapse of financial institutions and to discourage capital outflows. Malaysia experienced large capital outflows from March until September 2008. As a result, as a pre-emptive measure, a full guarantee of all ringgit and foreign currency deposits in financial institutions was implemented. Regulated by BNM, this guarantee was managed by PIDM and ran until December 2010.

The Government unveiled two stimulus packages; the first one (ESP 1) was RM7 billion (US$1.9 billion) or 1.04% of GDP launched in November 2008, and the second (ESP 2) was RM60 billion (US$16.2 billion) or 9% of GDP in March 2009. ESP 1 was targeted to cover the

year 2009 while ESP 2 was meant for 2009 as well as 2010. ESP 2 became necessary amidst heightened concerns that the economic deterioration was going to be very severe as indicated by estimates from the IMF and World Bank, both of which had downgraded their world GDP forecast many times. Countries such as China and Japan had also anticipated a severe downturn and had introduced much larger stimulus packages.

Nearly 43% of Malaysia's first stimulus package was allocated for infrastructure, such as the upgrading, repair and maintenance of public amenities, including schools, hospitals, roads, dwelling quarters for police and armed forces, and police stations. It also covered the building of low-cost houses, public transport and high-speed broadband infrastructure. ESP 1, funded by savings from a reduction in petrol subsidies, was being directed to ensuring the well-being of citizens, developing quality human capital and strengthening national resilience. While projects relating to the three thrusts above vary in nature, they focus primarily on construction and infrastructure, transport, banking and finance, and education.

The second stimulus package was 8.5 times larger than the first, amounting to 9% of GDP. Almost half (48%) or RM25 billion of the package was directed towards assisting the private sector as bank guarantees for small and medium enterprises. Another 32% was allocated to infrastructure but of this sum, a substantial portion is for maintenance rather than new spending on public facilities. Food, toll and fuel subsidies, support for low-cost housing and for retrenched workers took up 17% of the spending while the remaining 3% went towards reducing unemployment and increasing job and training opportunities. Although RM60 billion was announced for ESP 2, the actual spending in 2009 and 2010 was only a sixth of that sum. RM3 billion has been allocated for tax incentives and RM10 billion for strategic investments by the national sovereign wealth fund.

ESP 2 is focused on four main areas: reducing unemployment and increasing employment opportunities, easing the burden of citizens, assisting the private sector in facing the crisis, and building capacity for the future. The four thrusts overlap and their implementation involves several ministries and/or agencies in most of the identified projects.

The focus of the first thrust is to curb the ripple effect of increasing unemployment, by means of training and creating employment opportunities. Accordingly, the Government announced that it was working jointly with the private sector to create 100,000 training and employment opportunities for retrenched workers and unemployed graduates. In addition, there are 50,000 existing vacancies and 13,000 newly created vacancies were to be filled on a contractual basis. Other measures include providing welfare assistance for retrenched workers, creating more job opportunities in the public sector, extending opportunities for graduates to further their education at Masters and PhD levels, and introducing the graduate PROSPER scheme to develop young entrepreneurs.

The second thrust is targeted at low and middle-income earners through efforts to increase household disposable income. These cover subsidies to cancel out increases in the prices of

daily food staples, measures to encourage home ownership, issue of Syariah-compliant Government Savings Bonds, and improvements in public infrastructure. Measures encompassed in the second thrust also aim to improve school facilities, provide micro-credit programmes for farmers and agro-based businesses in rural areas, improve facilities at daycare centres for children and the elderly as well as women's shelters, ensure the welfare of retrenched workers through tax incentives, and provide incentives for banks to defer repayments of housing loans.

The third thrust is focused on the business community. Initiatives include the creation of the Working Capital Guarantee Scheme and the Industry Restructuring Loan Guarantee Scheme. The levy for the Human Resource Development Fund (HRDF) was reduced. A new organisation, Danajamin National Berhad, was established to help private companies access the bond market to finance their activities. In the transport sector, measures include promoting the automotive sector through an auto-scrapping scheme and assisting the aviation industry through a rebate of 50% on landing charges for all airlines. In addition, an accelerated capital allowance was introduced to encourage investment and companies are allowed to carry back their losses to the immediate preceding year, which will postpone income tax payments and improve cash flow. The threshold for the windfall profit levy on palm oil was increased. Tourism was promoted through diversifying tourism products, upgrading infrastructure, improving homestay programmes, and approving work permits for skilled spouses under the Malaysia My Second Home Programme.

The fourth thrust refers to capacity building for the future, and it covers investments, off-budget projects, creative arts, and the effective management of government financial resources. Specific measures on investment include more funds from Khazanah National Berhad for domestic investments, such as telecommunication, technology, tourism, agriculture and life sciences, as well as those in Iskandar Malaysia. Also covered are PFI projects such as those in infrastructure and biotechnology.

Other than the stimulus packages, the Government has also embarked on restructuring the economy and improving its competitiveness. Policy announcements include liberalising 27 services sub-sectors, removing the 30% Bumiputra participation quota in certain businesses and the 25% Bumiputra requirement for listing purposes, and deregulation of the Foreign Investment Committee guidelines. In addition, the Government set up Ekuiti Nasional Berhad as a private equity fund to ensure meaningful and effective participation by Bumiputras.

The government also strengthened the social safety net during the crisis. The allocation for the Malaysia Social Safety Net programme was raised from RM350 million to RM850 million in 2008. An important aspect of this social support is the Federal Welfare Aid given via the Social Welfare Department under the Women, Family and Community Development Ministry. The programme was also revised and a new Social Safety Net Card was introduced in February 2009. The definition of hardcore poor, who are entitled to welfare aid, was revised from a household monthly income of less than RM430 to RM720 in Peninsular

Malaysia, from RM520 to RM830 in Sarawak, and from RM540 to RM960in Sabah. These amounts serve as a guide or as the initial entry point for aid eligibility. Final approval depends on case by case checks by welfare officers who assess factors such as the living condition of the families, the number of children and dependants, age of applicant or head of household, physical disability, and health conditions due to disease or illness.

4. Sources of resilience

Malaysia's response to the crisis has been conditioned by two previous events, namely the recession of 1985-86, which was initiated by a collapse in primary commodities, and the Asian financial crisis of 1997-98, which began as a result of portfolio capital and currency movements. In many ways, the decade leading up to the latest crisis was characterised by efforts to ensure that the economy will be able to withstand strong financial shocks to the system. For an open economy like Malaysia, maintaining a flexible exchange rate and monetary independence in the face of increasingly large capital flows is important. To better manage the surges in capital flows, which have become more prevalent, the range of market-based instruments for monetary policy operations has been increased. Given the rise in intra-regional trade and investment flows, greater importance has also been accorded to stability of the exchange rate against regional currencies. Policymakers have tended to err on the side of caution since the Asian financial crisis, and evidence of this (and the direct consequence) is the large amount of excess savings and international reserves accumulated. While the Government did run continuous budget deficits in the 2000s, these were juxtaposed by inordinately large balance of payments surpluses of up to 15% of GDP.

In the financial sector, following the Asian financial crisis, consistent efforts have been taken to consolidate the banking sector through mergers and acquisitions and increased capitalisation. The overcrowded banking sector which had 58 financial institutions was consolidated into 10 banking groups with larger capital requirements. When the global crisis finally manifested itself in late-2008, the balance sheets of Malaysia's financial institutions were one of the strongest as NPLs only accounted for 2% of overall loans and the loan-deposit ratios were well below 90%. The level of capitalisation of the Malaysian banking system remained high, with a risk-weighted capital ratio of 14.7% at end-December 2009 (end-2008: 12.6%). In the Asian financial crisis large amounts of volatile capital left the country through the combined loss of market confidence and the activities of currency speculators, and Malaysia learnt the lesson to accumulate large foreign reserves. It also took a more cautious approach to financial liberalization and set out guidelines and plans in the Financial Sector Masterplan and Capital Market Masterplan, both introduced in 2001.

The indebtedness of corporations and households relative to the value of financial assets was falling rather than rising at that time. Exposure to foreign loans was also kept to a minimum. Malaysia was very cautious when approving the use of complex, innovative, yet risky financial instruments such as collateralized debt obligations. The exposure of the

domestic banking system to sub-prime assets was also limited. The prudential measures put in place not only strengthened corporate governance but also insulated Malaysia from over-leverage and over-exposure, which in turn helped to contain the negative effects of the global crisis.

Malaysia was fortunate to have entered the global crisis with a significant proportion of its economic growth contributed by domestic sources, particularly private consumption. Even though domestic demand did not adequately insulate the economy from recessionary effects, it did help blunt the force of the shocks to trade and investment. Private consumption turned out to be highly resilient, dropping the least among demand aggregates. Final consumption contracted by 0.2% over 2008 in the first quarter of 2009, but increased by 0.6% in the second. Imports of consumption goods fell by a mere 4% in the first quarter of 2009, while the food and beverages component actually rose overall by 11%. Other private consumption indicators, such as sales and service taxes, registered large increases in the first quarter of 2009, although these seem to have slumped in the second. In contrast, investment goods imports declined by almost 8% and intermediate goods imports fell by 35%. The crisis was thus felt by corporations and producers much more than households and consumers.

To Malaysia's advantage, the country's capacity and resilience in managing these sizeable and volatile financial flows had been fortified in a number of ways. First, our economic fundamentals have remained healthy and the financial markets were more diversified and developed. This has enhanced the ability of the financial system to absorb capital inflows and outflows, thereby minimising disruptions while ensuring that the capital flows can be effectively intermediated. Second, the managed float regime accorded the necessary flexibility for the ringgit to adjust to changing conditions. Since exiting from the fixed exchange rate regime, the managed float regime has served the economy well by providing a good balance between flexibility and stability. Third, the ability to manage domestic liquidity has also improved significantly, supported by a wider range of instruments to conduct monetary operations and having in place better surveillance and information system. This ability to manage liquidity effectively meant that financial flows have limited impact on financial intermediation and the level of economic activity, including reducing the risk of the build-up of large imbalances in the economy.

Over the years, Bank Negara Malaysia has maintained a pre-emptive approach to monetary policy. Earlier in 2008, inflation was on the rise due to the sharp and significant increase in food and energy prices. The OPR, however, was left unchanged. The assessment of the Bank was that the food and energy price increases were largely supply driven. Raising interest rates under these conditions would have a limited impact in containing inflation. Importantly, it was also assessed that the Asian economies would also be affected by the spillover effects of the crisis, given the strong trade links with the developed economies. In addition, given the high percentage of food and energy in total consumption, higher prices in these categories would be contractionary on growth. While there were considerable uncertainties, the balance of risks was that growth would slow in the twelve-

month period beginning mid 2008. That was the main consideration in the decision to maintain interest rates despite assertions that the Bank should have tightened monetary policy. Subsequently, as the global economy contracted, the Bank's decision to maintain interest rates was not only justified, but also enabled the initial monetary conditions to be appropriately positioned to provide support to the domestic economy.

5. Comparison with the 1997/98 Asian financial crisis

The transmission of the impact of the 2008/09 global crisis on the Malaysian economy was different from the Asian crisis in 1998. This time, the transmission was through the real sector, namely exports, investment flows and prices of exports, unlike the 1998 crisis where the channel was through the financial sector. The real sector was the first point of impact while the financial sector was almost not affected. Although exports suffered a massive collapse in 2008/9, the economic decline was much smaller than in 1998 where exports had increased substantially in ringgit terms (because of the sharp ringgit depreciation). The sharp GDP contraction in 1998 was precipitated by the large capital outflow, large depreciation of the ringgit and the troubled domestic financial and business sectors. The priority was to stabilize the exchange rate and reduce capital outflows, resulting in the introduction of a pegged exchange rate and capital controls. With these measures in place, the domestic situation stabilized and that allowed fiscal stimulus and a relaxed monetary policy to be implemented to boost domestic demand. The situation in 2008/9 was different because Malaysia had sufficient reserves to meet capital outflow, the exchange rate depreciation was mild and the financial and business sectors were strong. As such, the policy response was targeted only for expanding domestic demand through fiscal stimulus and lowering of interest rates.

The two crises – the 1998 Asian and 2008/9 global – had differing impacts on the Malaysian economy but provided some very useful and pertinent lessons. In the 1998 crisis the external shock had caused severe consequences for the Malaysian financial sector whereas the export sector was only marginally touched and in fact it led the recovery process. On the other hand, in the 2008/9 global crisis, the Malaysian financial sector escaped the spillover effects of the collapse of the developed countries' financial sector especially the major financial institutions. Likewise, the movement of ringgit was very different between the two crises – in 1998, the ringgit depreciated by 45 per cent causing massive damage to the economy, which prompted the imposition of capital control and pegging of the ringgit. In contrast, the movement of the ringgit was mild in the 2008/9 crisis.

There are several lessons from these crises:

- The health of the real sector in the major markets for Malaysia (the developed markets) has an important and immediate impact on Malaysian exports. In this case the issue of

competitiveness and the state of Malaysian export industries are secondary because the collapse in global demand will automatically result in fall in demand for Malaysian exports and will lead to economic slowdown or even a recession.

- Because of Malaysia's heavy dependence on exports, revival from economic slowdown is very much dependent on the external demand, be it regional or global. Recovery by expanding domestic demand may not be as quick because the measures such as public sector infrastructure investment or tax incentives will take time to produce the required results. Recovery is very dependent on exports – in the 1998 and the 2009 crises
- For the financial sector, the state of the domestic sector is critical in determining its ability to withstand global shocks. When the sector is strong and well governed, the impact of external volatility will be manageable.
- Building safeguards is important to reassure domestic and foreign constituencies that the economic fundamentals are strong. In this regard, the sufficiently large international reserves, low short-term external debt and realistic exchange rate are some of the fundamentals that maintain public and investors' confidence.
- It is important to differentiate between external shocks that affect short-term demand for exports and the long-term competitiveness and strength of the external sector. The state of the external sector is determined by the competitiveness of export industries, the strength of the domestic financial sector or the attractiveness of the investment climate. It is difficult to be insulated from global short-term demand shocks but export recovery will be quick once international demand is restored. However, if the external sector is uncompetitive, the medium and long-term growth will be jeopardized because the exports may not be able to be restored to its previous position.
- The public sector financial position was a major factor in stimulating domestic growth to offset declining external demand. With strong surplus or capability to mobilize funds, the public sector had to take a leading role to stimulate the domestic economy when the private sector was weak. However, having the funds alone is insufficient: the public sector must also act quickly to pump prime the economy. In 1998, the Malaysian public sector was in a better financial position than in 2008 but due to political differences, measures to stimulate the economy took longer to implement and thus had caused a sharper contraction.

6. Short run challenges

The two stimulus packages that were undertaken during the recent financial crisis have caused fiscal deficit to balloon. In 2008, the country's fiscal deficit was 4.8% of GDP and this has risen significantly to 7.6% in 2009. The New Economic Model (NEM), proposed by the National Economic Advisory Council (NEAC), has urged that fiscal deficit is should fall to near-balance by 2020. Apart from the stimulus packages, the rising fiscal deficit has been caused by the increasing amount of subsidies for fuel and various price-controlled items. Globally, prices are constantly rising, making subsidies on price-controlled items more costly. The subsidies were meant to support the vulnerable groups but they have benefited a wider

group, including the well off. The large government outlay on subsidies – mostly funded by petroleum proceeds – is not sustainable. The retail price of essential goods and services in Malaysia does not reflect market prices. Price controls and subsidies distort price signals resulting in overconsumption and waste.

The private sector has also becoming ever more reliant on government subsidies which are numerous, complex and expensive to administer. Such support by the public sector to the private sector is not leading to innovation and high levels of private investment. As a result, domestic and foreign investors have a vested interest in maintaining low value added production. Adding to that burden are the numerous tax incentives granted by the government. While tax incentives are necessary measures to encourage private investment, they contribute to foregone tax revenue if used indiscriminately.

Historically, Malaysia's development expenditure has depended greatly on revenue from natural resources. Export duties on tin, palm oil and rubber, for example, substantially financed the early five-year plans. From the mid-1970s, the contribution from oil and gas rose and now accounts for about 40% of total government revenue. The government should reform its revenue sources. With the depleting oil and gas reserves, a more diversified tax base is needed to compensate for an expected future reduction in the share of revenue from these commodities. The tax base should be diversified, among others, by implementing the goods and services tax (GST). Revenue collection should also be strengthened by developing and implementing an effective technology-based revenue collection and management system.

Another major challenge for Malaysia is to revive private investment. The Asian financial crisis of 1998 caused significant outflows of foreign portfolio investment (FPI) and foreign direct investment (FDI) as well as a fall in overall investment. These have not recovered. Aggregate investment levels, expressed as a percentage of GDP continue to decline and private investment has stagnated. The absence of private domestic investment is further evidenced by developments in the external account. In recent years, the balance of payments of Malaysia has seen persistent current account surpluses, reaching almost 18% of GDP in 2008. While this current account surplus has been largely off-set by the accumulation of net foreign assets, there has been an increasing capital account outflow for financing Malaysian investments abroad.

Although FDI inflows into Malaysia have recovered reasonably well, this rebound has not translated into higher levels of aggregate investment. It has been highlighted that tax incentives, which have been Malaysia's traditional measure to spur private investment, have grown in number, variety and complexity over time. They also lack the ability to phase out low value added industry and services and boost domestic private investment in high value added products and services. The heavy presence of government and government-linked companies (GLC) in some industries has discouraged private investment. In addition, cumbersome and lengthy bureaucratic procedures have affected both the cost of investing,

and the potential returns on investment. The persistent shortage of skills has had an impact on investment as well.

7. Macroeconomic rebalancing and strategies for robust, inclusive and sustainable growth

From 1990 to 1997, the Malaysian economy grew at an average annual rate of 8.1% while from 2000 to 2010 it grew only 5.6%. This performance gave rise to the immediate and widespread comment that Malaysia's growth had lagged and that growth is on a downward trend. The private sector's role is much smaller now - in 1995 private investment expanded annually by 32.8% but in 2007 it was only 12.3%. As a knowledge economy, the services sector is targeted to play a bigger role in economic growth. Unfortunately this transformation is slow. Services contribution to the economy has only increased by 2% from 1997 to 2007 (53.6%). Nevertheless, there is a solid progress made - tourism and the new services industries such as Islamic finance, education, health services, air transport and logistics have become significant contributors to the national economy. Malaysia remains in the mid-level range of competitiveness benchmarking since 2000. Based on the World Economic Forum Growth Competitiveness Index, out of 131 countries, Malaysia's position declined from 29th in 2003 to 31st in 2004, improved to 19th position in 2007 but slipped again to 21st in 2008.

Some argued that Malaysia has not got back to its previous high growth path and is caught in the middle income country trap. Malaysia is facing strong competition at both end of the scale: in the areas of its traditional strength and also in the new fields that can be the source of its future growth.

Malaysia reached middle income country status in mid 1990s. Its economic structure is balanced: a well-developed manufacturing alongside a commercial agriculture sector and a potentially strong services sector. It is also a resource rich country with oil, gas and primary commodities. Yet, Malaysia is still a low-wage, low skill and resource-based economy. In the 1990s Malaysia was narrowing its economic gap with Korea, Taiwan, Hong Kong and Singapore but unfortunately this gap has now become wider. This growing gap is particularly noticeable in per capita income growth rate, technological capability, human capital development and creation of high value-added jobs. Malaysia's annual real per capital income growth rate of 3.6% (in 2000-2007) is lower than Korea's (4.7%) and Singapore's (4.3%).

A key challenge is to secure a sustained high growth rate. The opposing trends of continuing with low-cost, low skill activities and making little progress in transforming into a high productivity economy will only produce low growth in the future. Is Malaysia in danger of not meeting its own target of being a developed country by 2020?

The government has launched the New Economic Model (NEM) in 2010 to propel Malaysia into the ranks of high income countries by 2020. The per capita income is to be doubled from the present US$7,000 to US$15,000 by 2020. The other two goals of the NEM are inclusive and sustainable growth. In order to achieve these goals Malaysia needs to generate sustained high growth. In this regard, the sources of growth, human capital capacity, technology and price system are among the keys factors that need to be addressed.

Unlike the 1998 crisis, this 2008/9 global crisis has called into question Malaysia's outward development strategies because of the gloomy prospects for trade growth as a result of the economic difficulties in its two major markets – the US and EU. Before the Asian financial crisis, Malaysia was very positive about globalization and its close integration with the international economy. However, the recent crisis has demonstrated that a decline in global demand leaves Malaysia vulnerable, given a heavy reliance on global trade. The more cautious approach to financial liberalisation and integration taken after the 1998 Crisis was seen as having saved Malaysia from the potentially devastating damage as suffered by the financial sectors in developed countries.

Improving and refocusing its outward-oriented development strategy can help Malaysia mitigate the impact of future global financial crisis on trade and bring a sustained high growth for Malaysia:

i. Have a balanced export structure. Presently Malaysia's exports come from three major groups – manufacturing, mining and primary commodity. In the past this structure has produced a good counter balance: when one component suffered a slowdown, the other groups grew quite well because they had different consumers and demand cycles.
ii. Accelerate the expansion of services exports. Malaysia has made good progress in promoting services exports – tourism is a major export earner and the Multimedia Super Corridor is focusing on IT and business off-shoring services. Other services exports that have been identified are Islamic finance, health and education services and air passenger transport services.
iii. Upgrade existing exports – both the manufacturing and primary commodity exports should be upgraded to incorporate higher value add and innovation.
iv. Diversify markets. This diversification is important especially in view of the moderate growth prospects and consequently demand for imports from these traditional markets.
v. Continuous improvement of investment climate to attract FDI.

Notwithstanding the importance of outward orientation, it is imperative that Malaysia undergoes a macroeconomic rebalancing that expands domestic demand while at the same time improves its global competitiveness and links. Switching to domestic demand can only be a long-term strategy because Malaysia has to increase its domestic market and purchasing power first before that strategy can be effective.

The future prospects of the Malaysian economy will hinge on its own internal conditions. Strong macroeconomic fundamentals such as low national and foreign debts, sound fiscal position, low inflation and unemployment, current account surplus, high international competitiveness, capability for R&D and technological development and availability of skilled workers are overall key fundamental factors for growth. Enhancing human capital is certainly a move in the right direction but this effort must go beyond education and has to be linked with the labour market policy and demand for labour. If the supply of human capital is not matched with industries' needs, there will be unemployment (a trend that has already emerged) and under employment.

Technology and innovation are fundamental catalysts for an economy moving up the value chain because they create high value added. Many measures to acquire and develop technological capability and capacity have been introduced, but success is still limited. The culture of innovation is essential if competitiveness is to be sharpened. Malaysia needs to combine technology-driven and market-driven innovation approaches to be ahead of other countries, lead in strategic technologies and quickly capture market shares in growth products and services. For this, we should continue to invest in technology-driven innovation by supporting research in basic sciences as well as in R&D works. At the same time, Malaysia should also acquire technologies and improve them to meet market demand.

The price system is mired in subsidies, price controls, licensing requirements and quotas and it needs to be revised to reflect the market signals. Price controls and subsidies began with the noble aim of supporting production and investment to promote domestic output and to alleviate the impact of price increases on the poor but they have allocated resources inefficiently and affected Malaysia's competitiveness.

It is also important to pursue an inclusive growth agenda. Malaysia has achieved significant improvements with regard to poverty reduction. The incidence of absolute poverty has been cut from about 50% in 1970 to almost 20% by 1987. All ethnic groups recorded progress in poverty reduction. Even with the slower growth following the Asian financial crisis, the incidence of poverty continued to decline, reaching 3.6% in 2007. Relative poverty, however, rather than absolute poverty, is the challenge for Malaysia. Relative poverty in 2008 was 19%, slightly higher than 15 years before. Recent data shows a growing gap between the rich and the poor. While overall income disparity lessened as measured by the Gini coefficient, going from 0.459 in 1997 to 0.441 in 2007, the disparity seem to have increased over the past decade for certain groups. The disparity among the urban group remains high with no improvements in the last decade. Moreover, the results of household income surveys suggest that only the top 20% of Malaysian income earners enjoy income growth, particularly since 1990. On the other hand, average incomes of the bottom 40% have grown the slowest, reaching RM1,222 in 2008.

To address the poverty and inequality issues that inhibit the achievement of inclusive growth, human capital development efforts should be intensified. Massive investments have been made in education and training, but a more targeted approach should be pursued. Education and training are essential factors that improve the job prospects of the poor and those in the rural areas. Disparity in the availability of quality education between rural and urban areas remains. Therefore, access to quality training and skilling courses, especially in rural areas and marginalized urban centers should be increased. The training system must produce the skills that meet the needs of industry. More technical and vocational schools should be built to cater for the non-academically inclined students. Training and skills development is key to expanding the talent base as it allows workers to undergo a continuous improvement, particularly those that may be displaced from low value added jobs in the course of the economic transformation.

The social safety net for the poor and the vulnerable must also be strengthened. Despite the various measures implemented during the global financial crisis, several weaknesses remain. Subsidies for food, fuel, and other products comprise about 60 percent of social protection spending in Malaysia in 2010. Yet these subsidies benefit the well-off more than they benefit the poor, because of the non-targeted nature. Workers are not protected, or at best are poorly protected, from the risks associated with unemployment, illnesses, disability and old age. Unemployment insurance is absent, and health insurance programmes for the poor have a narrow reach. 35 percent of the employed are outside the pension system. A stronger social safety net would provide support to cushion the impact of an adverse economic situation. Ideally, this would have effective targeting mechanisms and a clear and consistent focus on the needy.

Growth should also be sustainable in the long term, so that expansion of the wealth of the current generation is not achieved at the expense of future generation. The NEM emphasizes that natural resources should be preserved and a green economy policy be developed. Current trends in energy intensity and carbon emission are not yet in line with the sustainable growth aspiration. Policies to encourage cost-based pricing of environmental resources to improve the efficiency of usage of fuels and water and the provision of incentives to promote “green” innovation and conservation of biodiversity should be introduced.