

67944

# MALAYSIA ECONOMIC MONITOR

Modern Jobs

April 2012

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THE WORLD BANK



# **MALAYSIA ECONOMIC MONITOR**

## **APRIL 2012**

### **MODERN JOBS**

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#### **Acknowledgements**

This report was prepared by Frederico Gil Sander (task team leader) and Marek Hanusch, with contributions from and in collaboration with Ximena del Carpio, Rajeswari Karupiah, David Margolis, Mohamed-Ali Marouani, David Robalino, Akhmad Rizal Shidiq, Aleksandra Posarak, Mark Dorfman, Luisa Fernandes, Alex Usher, Victor Levine, Intan Nadia Jalil, Antonio Postigo and Miki Matsuura, under the overall guidance of Annette Dixon, Mathew Verghis and Xiaoqing Yu. Contributions from the Economics Department of Bank Negara Malaysia are gratefully acknowledged. The team wishes to thank Reena Badiani, Bryce Quillin, Philip Schellekens and Sudhir Shetty for helpful comments, suggestions and guidance.

The team also thanks Sofia Busch, Anna Elicano and Trinn Suwannapha for assistance in external relations and web production, Indra Irnawan for designing the cover, and Noppakwan Inthapan, Angkanee Luangpenthong and Piathida Poonprasit for handling the processing of the document and providing extensive support. Cover photos by Tristan Savatier (surveyor), Ali Badri Abdul Karim (oil engineers), Hafiz Itam (pharmaceutical worker), Yeow Chin Liang (Indian sundry shop), and Terenze Lim/Malaysian Solar Resources Sdn. Bhd. (solar worker).

The Malaysia Economic Monitor further benefited from fruitful discussions, extensive comments, and information from the Economic Planning Unit, Bank Negara Malaysia, Department of Statistics, Ministry of Finance, Performance Management and Delivery Unit (PEMANDU), Ministry of Human Resources, Ministry of Trade and Industry (MITI) and numerous other Government ministries and agencies. We are indebted to the Economic Planning Unit for their collaboration with the World Bank and in particular their assistance in the launch of this report.

We also thank representatives from Japan External Trade Organization, the Federation of Malaysian Manufacturers, the American Malaysian Chamber of Commerce, and academics from the Institute of Strategic and International Studies, Singapore Management University, and analysts at several financial and rating institutions for helpful discussions.

The findings, interpretations, and conclusions expressed herein do not necessarily reflect the views of the World Bank's Executive Directors, or the governments they represent. The report is based on information current as of March, 2012.

## ABBREVIATIONS

AEC	ASEAN Economic Community
AFAS	ASEAN Framework Agreement on Services
ALR	Average Lending Rate
ASEAN	Association of Southeast Asian Nations
BIS	Bank for International Settlements
BNM	Bank Negara Malaysia
CA	Current Account
CAGR	Compound Annual Growth Rate
CCI	Communications and Content Infrastructure
CPI	Consumer Price Index
CSR	Corporate Social Responsibility
DECPG	Development Economics Department, Economic Prospects Group (World Bank)
DOS	Department of Statistics (Malaysia)
E&E	Electronic and Electrical
E&O	Errors and Omissions
EA	Employment Act
EPF	Employee Provident Fund
EPP	Entry Point Project
EPU	Economic Planning Unit
ETP	Economic Transformation Programme
EU	European Union
FA	Financial Account
FDI	Foreign Direct Investment
FTA	Free Trade Agreement
FWA	Fair Work Act
G&S	Goods and Services
GATS	General Agreement on Trade in Services
GDP	Gross Domestic Product
GFCF	Gross Fixed Capital Formation
GLC	Government-Linked Company
GNI	Gross National Income
GST	Goods and Services Tax
GTP	Government Transformation Programme
HIS	Household Income Survey
HSC	Higher School Certificate
IC	Industrial Court
ICT	Information and Communication Technology
IFS	International Financial Statistics
ILO	International Labor Organization
IMF	International Monetary Fund
IRS	Interest Rate Swap
JACTIM	Japanese Chamber of Trade and Industry
JETRO	Japan External Trade Organization
JKM	Jabatan Kebajikan Masyarakat (Social Welfare Department)
JPJ	Jabatan Pengangkutan Jalan (Road Transport Department)
KARISMA	1Malaysia Rakyat's Welfare Programme
KR1M	Kedai Rakyat 1Malaysia
KWAN	Kumpulan Wang Amanah Negara (National Heritage Fund)
LFS	Labor Force Survey

LIH	Low Income Households
LNG	Liquefied Natural Gas
LRT	Light Rail Transit
MCE	Malaysian Certificate of Education
MEM	Malaysia Economic Monitor
MOF	Ministry of Finance (Malaysia)
MRT	Mass Rapid Transit
NDTS	National Dual Training System
NEM	New Economic Model
NFPE	Non-Financial Public Enterprise
NKEA	National Key Economic Area
NKRA	National Key Results Area
NOSS	National Occupational Skills Standards
NTEP	National Talent Enhancement Programme
O&G	Oil and Gas
OECD	Organization for Economic Cooperation and Development
OPR	Overnight Policy Rate
PDRM	Polis Diraja Malaysia (Royal Malaysian Police)
PEMANDU	Performance Management and Delivery Unit
PICS	Productivity and Investment Climate Survey
PISA	Program for International Student Assessment
PITA	Petroleum Income Tax Act
PMR	Penilaian Menengah Rendah (Lower Secondary Assessment)
PPI	Producer Price Index
RHS	Right Hand Side
RM	Malaysian ringgit
SA	Seasonally Adjusted
SME	Small and Medium Sized Enterprise
SOCISO	Social Security Office
SPM	Sijil Pelajaran Malaysia (Certificate of Education Malaysia)
SPR	Sijil Pelajaran Rendah (Certificate of Primary Education)
SRI	Strategic Reform Initiative
SRR	Statutory Reserve Ratio
STPM	Sijil Tinggi Persekolahan Malaysia (Malaysian Higher School Certificate)
TERAJU	Unit Peneraju Agenda Bumiputera
TI	Transparency International
TIMSS	Trends in International Mathematics and Science Study
TUKAR	Transformasi Kedai Runcit (project for transformation of grocery stores)
TVET	Technical and Vocational Education and Training
UISA	Unemployment Insurance and Savings Account
UN	United Nations
UNESCO	United Nations Educational Scientific and Cultural Organization
UPSR	Ujian Penilaian Sekolah Rendah (Primary School Evaluation Test)
UPSRA	Ujian Penilaian Sekolah Rendah Agama (Primary School Assessment Test)
US	United States
USD	United States Dollar
WARP	Weighted Average Realized Price
WB	World Bank
WDI	World Development Indicators
WDR	World Development Report
WEF	World Economic Forum

# TABLE OF CONTENTS

<b>Executive Summary .....</b>	<b>1</b>
<b>The Malaysian Economy in Pictures.....</b>	<b>3</b>
<b>Modern Jobs in Pictures .....</b>	<b>4</b>
<b>1. Recent Economic Developments .....</b>	<b>5</b>
Economic growth surprised on the upside .....	5
The global economy slowed in 2011 .....	6
Exports continued on a two-speed mode.....	6
Consumption was the main driver of growth.....	8
Resource-intensive industries and services performed well.....	9
Unemployment reached a new low, but wage growth has been modest .....	10
Inflation eased in the fourth quarter .....	11
Fiscal and monetary policies still accommodative .....	12
Expenditures grow rapidly, but higher revenues boost overall fiscal performance .....	12
Monetary policy remained on hold and supportive of growth .....	13
Robust credit growth continued despite new prudential measures .....	13
Commodity exports supported Malaysia's external position .....	15
High-frequency indicators for early 2012 have been mixed .....	17
<b>2. Economic outlook .....</b>	<b>18</b>
Near-term outlook points to continued but modestly slower growth in 2012 .....	18
Global outlook cautiously improving.....	18
The Malaysian economy is likely to grow cautiously as well .....	20
Inflation to stabilize near current levels .....	23
The current account balance is likely to narrow slightly .....	23
Fiscal consolidation proceeds while monetary policy remains watchful .....	24
Risks to the outlook center on the global environment .....	25
The medium-term outlook hinges on the implementation of structural reforms.....	27
The Government Transformation Programme continues to show progress .....	28
The ETP has performed better on investments than structural reforms .....	30
Economic transformation must boost productivity to prevent 'Dutch Disease' .....	35
<b>3. Modern jobs .....</b>	<b>40</b>
Modern jobs: higher wages, secure workers, competitive firms .....	40
What is the current landscape of Malaysia's labor markets? .....	42
How to create higher wage jobs? .....	51
Boosting the quality of skills in the labor force is crucial.....	51
A well-implemented minimum wage can help.....	59
Leveraging foreign skills – at all ends of the spectrum .....	62
Flexible and inclusive jobs, secure workers .....	65
Labor regulations can be modernized .....	67
Social safety nets protect workers.....	72
Modern social insurance also replaces informality as a shock-absorber .....	75
Implications of a higher wage structure .....	76
Conclusions.....	80
<b>References.....</b>	<b>82</b>

## BOXES

Box 1. Exposure of Malaysia's exports to advanced economies .....	7
Box 2. The potential impact of a slowdown in China on commodity prices .....	19
Box 3. Will Malaysia still benefit from higher oil prices? .....	25
Box 4. Liberalization of services sectors in context of broader trade liberalization in Malaysia .....	33
Box 5. Changes to the National Heritage Fund (KWAN) in 2012 .....	39
Box 6. The World Development Report 2013 on Jobs .....	41
Box 7. Denmark's <i>flexicurity</i> : increasing contestability, the gentler way .....	66
Box 8. Australian Fair Work Act 2009 .....	71
Box 9. The institutional foundations of skill formation in four advanced economies .....	72
Box 10. Unemployment Insurance and Savings Account .....	74
Box 11. Results from a JETRO survey on challenges experienced by Japanese firms in Malaysia .....	78

## FIGURES

Figure 1. Growth picked up in the second half of 2011 .....	5
Figure 2. Year-on-year growth was relatively stable .....	5
Figure 3. Growth in 2011 exceeded expectations... ..	5
Figure 4. ... thanks largely to higher public consumption .....	5
Figure 5. The recovery in advanced economies lost momentum in 2011 .....	6
Figure 6. But commodity prices remained firm .....	6
Figure 7. Exports to the US and the EU declined, while China's market share increased .....	7
Figure 8. Events in Europe affect Malaysia both directly and indirectly through supply chains.....	8
Figure 9. Correlation between non-commodity exports to Asia and exports to US/EU remains high .....	8
Figure 10. Public consumption and fixed investment boosted GDP in the second half of 2011 .....	9
Figure 11. Resource-intensive industries spear-head production .....	10
Figure 12. Domestic-oriented sectors, driven by services, have registered robust growth.....	10
Figure 13. Resource-intensive industries experienced consistent wage growth.....	10
Figure 14. Wages appear to increase in anticipation of job vacancies.....	10
Figure 15. CPI inflation in Malaysia is low among regional peers, but PPI is among the highest.....	11
Figure 16. Supply factors were the main drivers of inflation but demand factors also played a role .....	11
Figure 17. Federal Government debt levels came down in 2011 and remained below 55 percent .....	12
Figure 18. Despite higher subsidy and personnel expenditures the deficit was lower in 2011 .....	12
Figure 19. Real interest rates are low, supporting growth .....	13
Figure 20. BNM bills and bonds become more important instruments for sterilization since 2008.....	13
Figure 21. Housing loans continued to expand robustly while working capital loans picked up.....	14
Figure 22. Approvals of car loans declined for most of the second half .....	14
Figure 23. The current account has been consistently in surplus.....	15
Figure 24. ... driven increasingly by commodity-related exports.....	15
Figure 25. Foreign direct investment fell and portfolio investment flow partly reversed in late 2011 .....	16
Figure 26. Foreign direct investment is concentrated on the manufacturing and distributive sectors .....	16
Figure 27. Malaysia's real effective exchange rate appreciated in line with Thailand and Indonesia .....	16
Figure 28. Net forward position declined much more than official reserves.....	16
Figure 29. Industrial production declined in January .....	17
Figure 30. Demand indicators have been mixed .....	17
Figure 31. Business confidence shows tentative signs of improvement .....	19
Figure 32. The deceleration of growth in China has been concentrated on investment .....	19
Figure 33. Chinese demand is one of the main contributors to rising oil prices .....	20
Figure 34. A considerable amount of Malaysian exports to China are commodities .....	20
Figure 35. Car sales have decelerated further into 2012 along with car production.....	21
Figure 36. Income growth for households dependent on agriculture is likely to moderate on stable or lower prices .....	21
Figure 37. Forecasts for 2012 growth have been deteriorating since August 2011 ... ..	22
Figure 38. ... as expectations about manufacturing and investment worsened.....	22
Figure 39. Inflation expectations declined in October as the global environment deteriorated .....	23
Figure 40. Inflation is expected to decelerate from 2011, but is likely to remain above the pre-crisis average .....	23
Figure 41. The current account is expected to remain in surplus, albeit a slowly narrowing one .....	24
Figure 42. Despite higher expenditures, the federal balance is expected to come in line with the budget .....	24
Figure 43. Fuel subsidies paid by the Malaysian Government have increased since 2000 .....	26
Figure 44. Oil production exceeds consumption but the gap is narrowing .....	26
Figure 45. The net price differential between Tapis and Brent oil increased since January 2011 .....	26

Figure 46. A third of ETP projects are operational.....	30
Figure 47. Services increasingly constitute the backbone of the Malaysian economy.....	33
Figure 48. Services are more protected in Malaysia compared to high-income OECD economies.....	33
Figure 49. The commodity balance has increased as a percent of GDP .....	35
Figure 50. The real effective exchange rate has appreciated in line with other currencies in the region.....	35
Figure 51. Manufacturing output also moved in line with regional peers in the 2000s.....	36
Figure 52. The nominal exchange rate was similarly stable.....	36
Figure 53. An increase in the commodity balance was followed by an increase in FDI from Malaysian companies abroad .....	36
Figure 54. Reserves counteracted volatile flows .....	36
Figure 55. Only half of expenditures are financed through non-oil revenues.....	37
Figure 56. Inflation in Malaysia is low compared to regional peers .....	38
Figure 57. Malaysia's population is young.....	42
Figure 58. ... and relatively well educated .....	42
Figure 59. Employment grew less than the working-age population in the 2000s.....	44
Figure 60. ...but unemployment was stable as participation declined... ..	44
Figure 61. ...because both young men.....	44
Figure 62. ...and women.....	44
Figure 63. ... pursued further studies rather than join the labor force.....	44
Figure 64. Women's labor force participation is low relative to other Asian and OECD economies .....	46
Figure 65. Labor force participation of women peaks before marriage and declines steadily thereafter .....	46
Figure 66. Employment shares in services increased.....	46
Figure 67. ... with significant gains in finance jobs. ....	46
Figure 68. Most jobs created since 2001 have been skilled... ..	47
Figure 69. ... but the largest share of existing jobs is still relatively low-skilled.....	47
Figure 70. Wage growth lagged productivity in manufacturing... ..	48
Figure 71. ... but grew faster in services .....	48
Figure 72. Malaysia's greatest absolute advantage remains 'cost competitiveness' .....	49
Figure 73. Malaysia's indicators on labor costs are closer to lower-income countries.....	49
Figure 74. The number of registered foreign workers quintupled between 1999 and 2008 but fell since.....	50
Figure 75. Most foreign workers in Malaysia have low skill levels .....	50
Figure 76. High redundancy costs are perceived as reducing Malaysia's overall competitiveness.....	50
Figure 77. Informality appears in line with Malaysia's income level.....	50
Figure 78. Wages are linked to productivity by region.....	52
Figure 79. Across different types of jobs, compensation is linked to productivity .....	52
Figure 80. The share of university graduates in the labor force increased rapidly in the past decade... ..	53
Figure 81. ... but remains below that of advanced economies and even some regional peers.....	53
Figure 82. Enrollment ratios need to rise further for Malaysia to catch up.....	54
Figure 83. Boosting the quality of education, especially basic education, remains a key challenge.....	54
Figure 84. There has been an increase in demand for tasks complementary with technology .....	56
Figure 85. While returns to routine tasks (such as basic auto mechanics) have stagnated.....	56
Figure 86. Firms generally identify non-routine and other soft skills as a key constraint .....	57
Figure 87. Applicants' lack of skills leads to job vacancies .....	57
Figure 88. English proficiency is less of a concern in manufacturing... ..	59
Figure 89. ...whereas firms in business support services require more of that skill.....	59
Figure 90. Median wages in petrochemicals are the highest of the resource intensive sectors.....	60
Figure 91. Wages in services are generally higher than in manufacturing and agriculture .....	60
Figure 92. Labor-intensive, low-skill sectors would be more highly affected by the minimum wage .....	61
Figure 93. There is significant geographic variation in the concentration of low income earners .....	61
Figure 94. Following rapid increase, the share of migrants in the labor force has stabilized .....	62
Figure 95. The low share of non-citizens among the unemployed reflects strong demand .....	62
Figure 96. In total employment, few foreign workers have high-skill jobs .....	63
Figure 97. Secondary educated Malaysian workers rose rapidly, unlike migrants.....	63
Figure 98. In total employment, increasingly fewer foreign workers have high-skill jobs .....	64
Figure 99. Secondary-educated Malaysian workers rose rapidly, unlike migrants .....	64
Figure 100. Migrant wages are generally lower, except for highly-educated migrants.....	64
Figure 101. Migrant wages are lower across occupations, except for the high-skill ones.....	64
Figure 102. Migrant and Malaysian Workers, by Sector of Employment .....	65
Figure 103. Malaysia ranks low in the region in terms of labor market flexibility .....	67
Figure 104. While improvements were made in some areas, labor dismissal regulations consistently lower the overall labor regulation ranking.....	68



Figure 105. The statutory notice period in Malaysia is higher than in most Asian countries for workers with long tenure .....	69
Figure 106. Termination benefits also become relatively high for workers with longer tenure, exceeding levels in the OECD .....	69
Figure 107. Social security coverage around the world (percent labor force) .....	73
Figure 108. Social security coverage around the world (percent labor force) .....	75
Figure 109. Informal workers earn less than formal-sector workers.....	76
Figure 110. ...especially in Manufacturing.....	76
Figure 111. ...but also in services .....	76
Figure 112. Prices rise with income .....	78

## TABLES

Table 1. GDP growth is expected to slow.....	22
Table 2. ... mainly due to slower growth in government consumption.....	22
Table 3. Many of the 2011 targets for the GTP have been achieved .....	29
Table 4. Progress on SRIs has been incremental.....	31
Table 5. The non-oil primary deficit has grown substantially .....	37
Table 6. This has been helped by subsidies and price controls .....	38
Table 7. Traditional vs. Modern .....	41
Table 8. Working Age Population as of 2009 .....	43
Table 9. Labor Force as of 2009 .....	45
Table 10. Compensation, Hours, and Distribution.....	48
Table 11. Degree recipients receive wages 5.5 times higher than those with no formal education .....	52
Table 12. Wages increase with education levels, but the largest rewards come from tertiary education.....	52
Table 13. Distribution of Bachelor's-level Graduates by Income Band, at 18 and 30 months after the end of classes (graduating classes of 2006 and 2007) .....	53
Table 14. School autonomy at lower secondary – TALIS 23-country study .....	55
Table 15. Non-routine skills will be increasingly demanded as routine skills are automated.....	56
Table 16. Employment Status of 2006 and 2007 Graduates at the end 2008, By Institution Type and Level .....	57
Table 17. Graduate Unemployment Rates 18-30 Months after End of Classes by Discipline, Level and Type of Institution .....	58
Table 18. Cross-country comparison of regulations regarding fixed-term contracts .....	70
Table 19. Cross-country comparison of regulations regarding work hours.....	70
Table 20. Reasons for Japanese firms to invest in Malaysia.....	79
Table 21. Challenges Japanese firms face in securing high quality labor .....	79
Table 22. Top Six Challenges Japanese Firms Face in Asian Countries .....	80



## EXECUTIVE SUMMARY

### ECONOMIC DEVELOPMENTS AND OUTLOOK

**The Malaysian economy grew robustly in 2011, outperforming forecasts.** Growth was driven by domestic demand. Public consumption picked up more than expected toward the end of the year and fixed investment was also buoyant on higher investments by public and private companies. Private consumption spending remained strong, sustained by solid consumer credit, civil service bonus payments, and firm commodity prices benefiting smallholders. Inventories were a drag on growth as post-financial crisis restocking was completed.

**Exports and manufacturing production remain in a two-speed mode.** Production and export growth was sustained in petroleum, palm oil and rubber based products (though crude oil exports suffered from ongoing production bottlenecks afflicting the mining sector). Meanwhile, electrical and electronics (E&E) production and shipments continued to face headwinds from weak global demand and supply disruptions in Thailand and Japan. Although commodity-related exports have gained share in Malaysia's trade basket, most exports are still "non-commodities" and remain highly vulnerable to developments in advanced economies.

**Unemployment held steady at low levels but real wages made only modest gains.** Job creation was healthy, accommodating new workers and a higher participation rate. The two-speed pattern of growth in manufacturing was reflected in real wages, with higher wage growth in resource-intensive manufacturing industries as compared to E&E.

**Inflation started to decline**, with stabilizing food prices and falling transport costs. A decline in producer price inflation confirms that price pressures are easing.

**Higher-than-forecast revenue collection reined in the deficit of the federal government.** Healthy revenue collection was predicated on higher oil prices but there were notable increases in non-oil revenues. Operating expenditures outgrew revenue but were partly offset by lower development expenditures as post-crisis fiscal stimulus was unwound. As a result, the deficit and public debt levels were better than expected.

**The gradual return of monetary policy to pre-crisis settings was put on hold in the second half of the year.** With earlier rate hikes only partially offsetting previous rate cuts, the policy interest rate remained supportive of growth and credit growth was healthy. The authorities turned to prudential measures to ensure sustainable credit expansion, especially to lower income households.

**The current account remained in surplus on strong commodity-related receipts.** Capital flows were volatile, with large inflows earlier in 2011 partly reversed in September and October. Reserves were relatively stable and, overall, the ringgit appreciated slightly in 2011.

**The Malaysian economy is expected to post continued but slower growth in 2012.** Investment is likely to expand further while private consumption is projected to remain resilient overall. However, government consumption is bound to moderate, while inventories will be a drag. Net exports subtract from growth as strong domestic demand combined with moderate exports lead to faster growth in imports, especially of capital and consumer goods. Overall, GDP growth is expected to come at 4.6 percent in 2012 and, assuming a continuation of the global recovery, 5.1 percent in 2013.

**Downside risks have eased but persist.** Given Malaysia's export orientation, ongoing risks to the global recovery constitute risks for Malaysian growth. Further increases in oil prices are generally beneficial, but bring challenges as well.

**There is momentum to the reform agenda, but implementation could be accelerated.** The government's transformation programs registered notable progress, but the challenge now is to go beyond quick wins and accelerate the implementation of more difficult—but critical—structural reforms that lie at the core of transforming the economy into a high-income one. Implementation can be assisted by increasing the coordination of related reform efforts (such as safety nets and education), building capacity within the civil service to lead reforms, and working towards consensus in key areas such as educational reform, subsidy rationalization and broadening the tax base.

## MODERN JOBS

**The transformation to a high-income nation involves creating modern jobs.** Jobs lie at the core of a strategy to achieve Malaysia's objective of becoming a high-income economy that benefits all Malaysians. In this regard, Malaysia needs to create more modern jobs and modernize its labor markets.

**Modern jobs are higher productivity jobs that command higher wages.** Modern jobs need not be in futuristic sectors but they involve more complex, non-routine tasks and require more and more diverse types of skills. They can be found in all sectors in the economy, but increasingly will be service-based. Modern firms in a high-income economy derive their competitiveness not from low wages but the productivity of their workers and are willing to pay for talent accordingly.

**Modern labor markets protect workers rather than jobs.** Flexibility for firms and workers to allocate resources more efficiently boosts productivity growth. But added flexibility should be balanced with security for workers through well-designed social safety nets that facilitate job transition and provide protection in downturns. Greater flexibility also helps draw talent from all segments of society—especially women.

**Some recent trends in Malaysian labor markets are encouraging.** Unemployment has been low, more young people are deferring entry into the labor markets to acquire higher education, more high-skill jobs are being created, and more women have entered either labor markets or higher education. Labor markets are already flexible in many areas, and reform efforts are ongoing.

**But further efforts are needed as much of the stock of jobs remains low-skilled and pays relatively low wages.** Wage growth has been muted and Malaysia is still seen as a 'low-cost' country. The low-cost production model has been supported by inflows of low-skilled foreign workers. Despite improvements, women's labor force participation remains low by international standards, leaving a large pool of talent untapped. Finally, high redundancy costs weigh on the competitiveness of Malaysia's labor markets.

**Pulling wages higher through more and better skills and higher productivity should be the focus of policy.** Increasing wages through productivity gains requires creating and retaining more, better and new types of skills. Despite recent improvements, the quantity and

quality of skills in Malaysia's labor force remain below high-income peers. Targeting underserved areas and groups for scaling up enrollments and quality improvements can lead to the quickest gains. The types of skills supplied to labor markets also need to adapt to the demands of modern jobs and match the needs of firms. Measures to boost the supply of relevant skills can help create demand for skills, but are not sufficient. Rather, structural reforms are needed to facilitate industrial upgrading that creates sustained demand for high-skilled, high wage jobs.

**A well-implemented minimum wage can be helpful but is no panacea.** A minimum wage can correct distortions in labor markets, potentially raising wages for some workers and attracting more Malaysians to the labor force. However, a minimum wage is not the most effective policy to address poverty or inequality concerns, nor is it the best tool to compel firms to move up the value-chain.

**With regard to foreign workers,** the focus should be on attracting more highly-skilled migrants and addressing the underlying factors that lead firms to display a high demand for low-skilled labor.

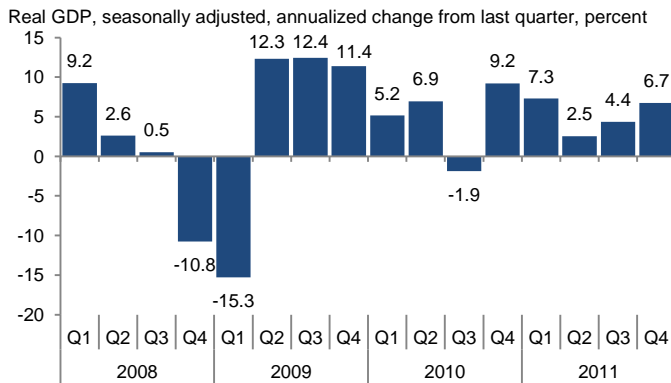
**A better balance between job flexibility and worker protection can be achieved.** Although modern in many respects, Malaysia's labor markets retain a 'traditional' structure of high levels of job protection (through high retrenchment costs) and limited protection for workers who may find themselves out of a job or in the informal economy. Here the priority would be to develop unemployment insurance within the broader context of a modern social safety net, and in parallel create more flexibility in labor markets by reviewing current dismissal regulations.

**Modern jobs meet women's work-life balance needs through greater flexibility and supportive social policies.** Firms should be encouraged to adopt more flexible working arrangements and the provision of child and elderly care can be enhanced. Greater availability of modern jobs, which command higher wages and entail performing fewer manual tasks, is also likely to attract more women to the labor force.

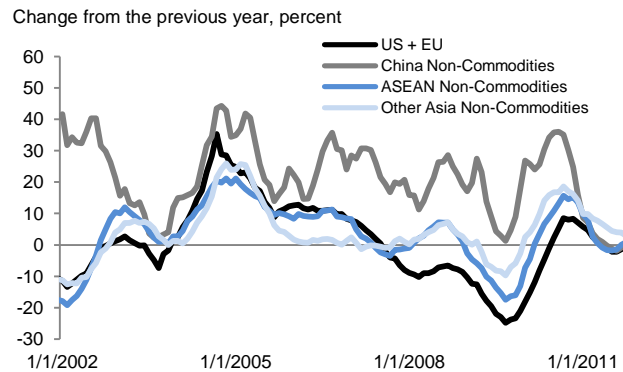
**Higher productivity in a more efficient labor market can enhance competitiveness while raising living standards.** The key to modernizing Malaysia's labor markets is to ensure that unit labor costs—wages adjusted for productivity and other employment-related costs—remain competitive by making sure that both sides of the equation increase in tandem.

# THE MALAYSIAN ECONOMY IN PICTURES

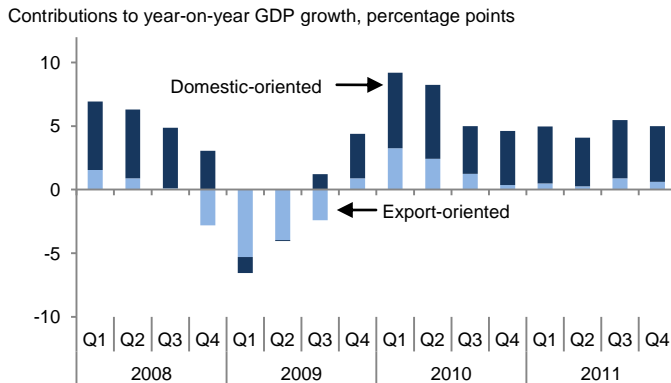
## GDP growth accelerated



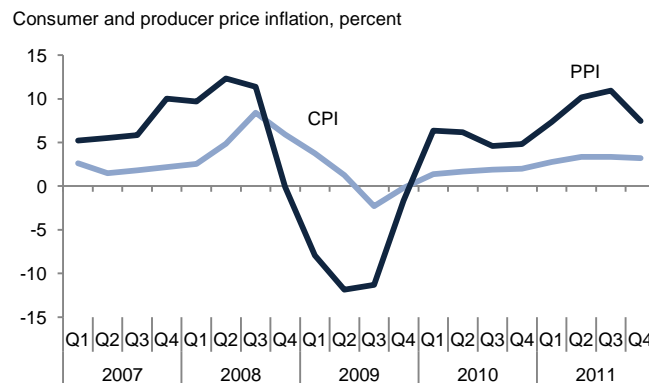
## Non-commodity exports are synchronized



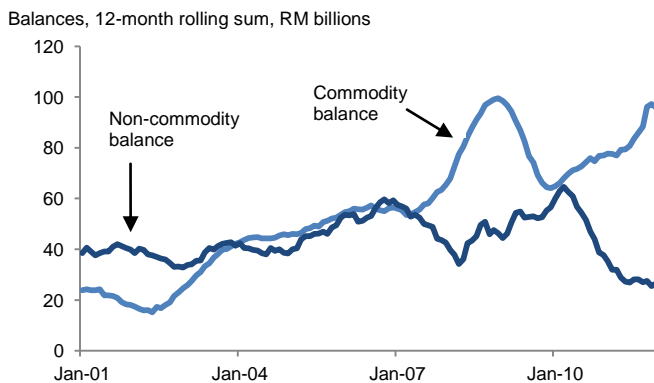
## Domestic-oriented sectors drove growth



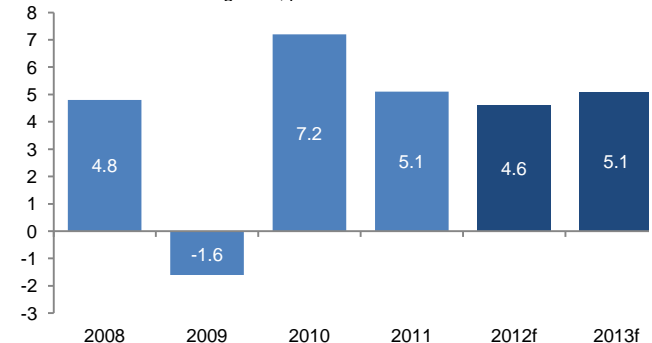
## Inflationary pressures eased



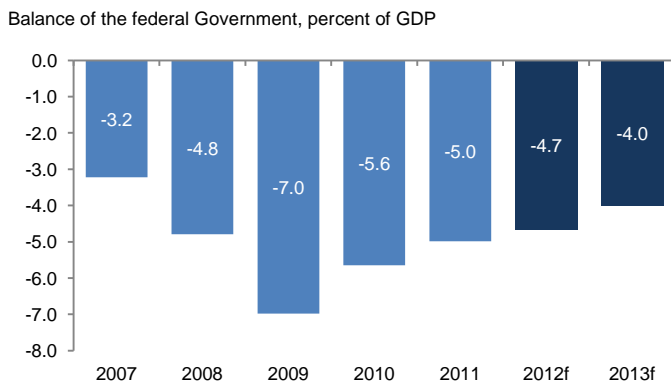
## Commodity-related exports increasingly drive the current account



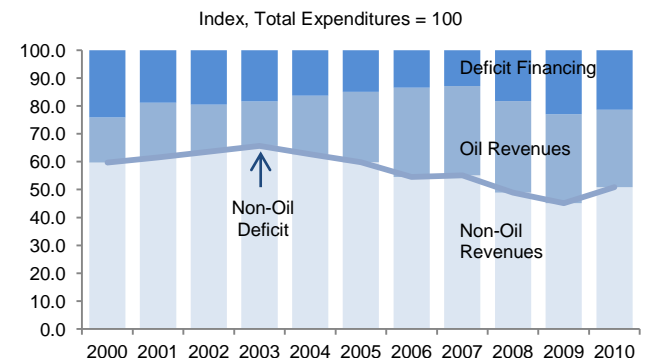
## GDP growth solid but likely to moderate in 2012



## The federal budget deficit is expected to improve

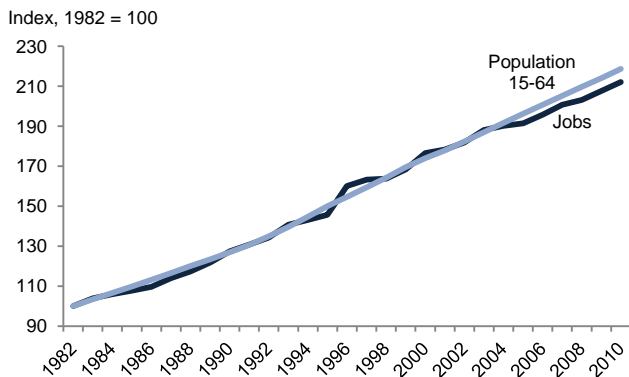


## The share of expenditures financed by oil is up

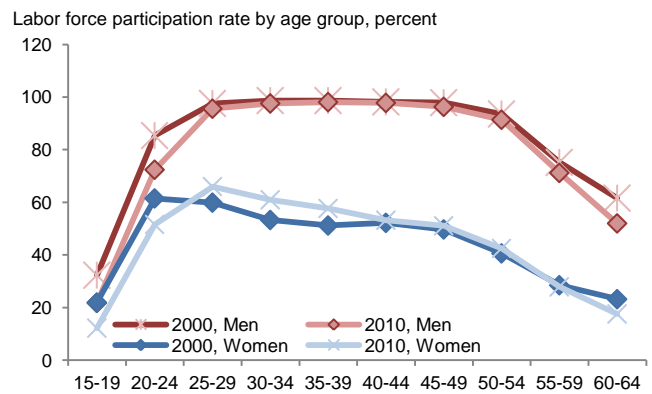


# MODERN JOBS IN PICTURES

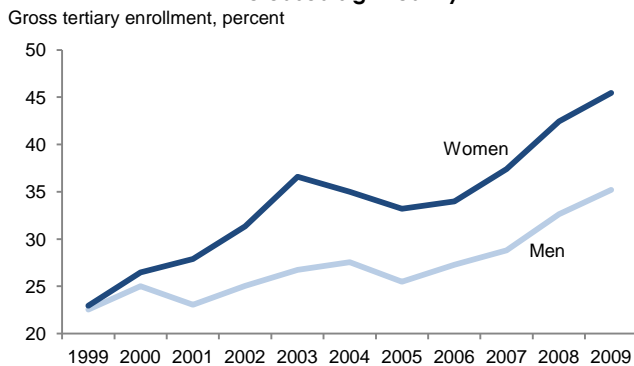
**The working age population grew faster than employment**



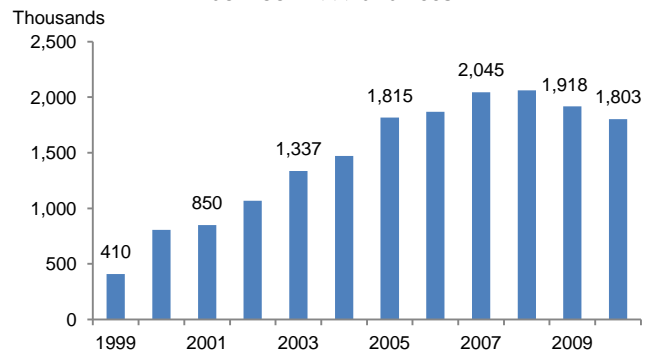
**Fewer young men and women joined the labor force**



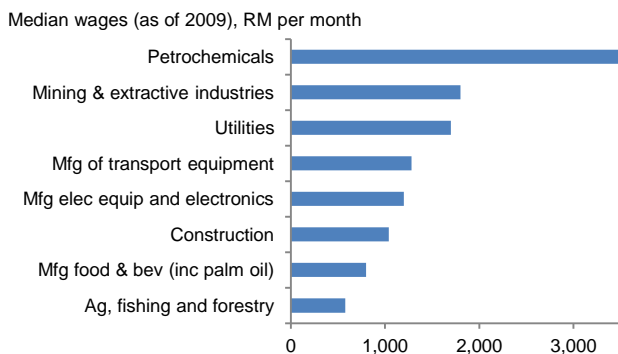
**The share of young men and women in tertiary education has increased significantly**



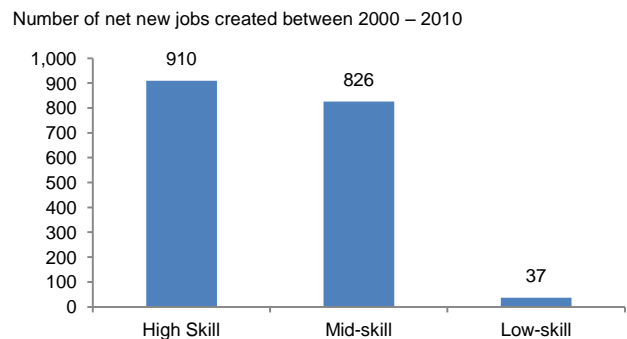
**The number of registered foreign workers jumped five-fold between 1999 and 2008**



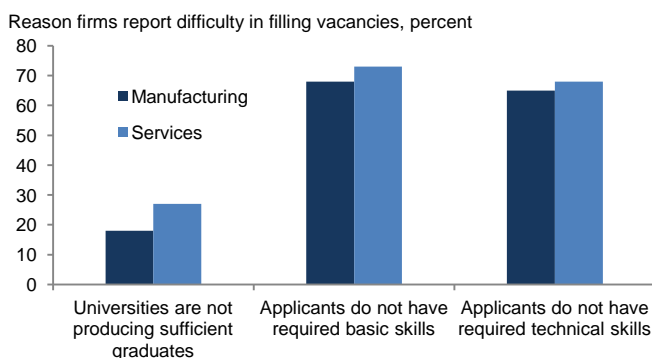
**Wage levels are low in many industries**



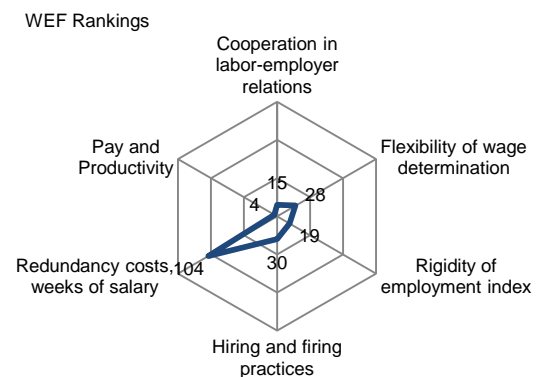
**Most new jobs created in the past decade are high- and mid-skill**



**Skills mismatches remain a challenge**



**Malaysian labor markets are generally competitive, except for redundancy costs**



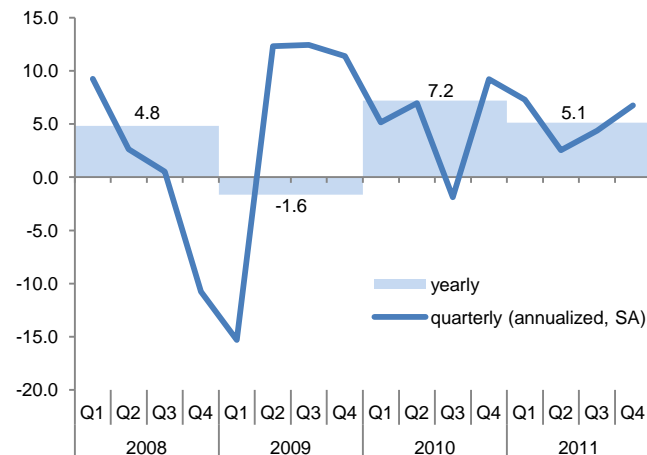
# 1. RECENT ECONOMIC DEVELOPMENTS

## Economic growth surprised on the upside

**Malaysia's economy expanded a robust 5.1 percent in 2011, exceeding forecasts.** Real Gross Domestic Product (GDP) expanded by 4.4 and 6.7 percent in the third and fourth quarters of 2011 on a sequential (quarter-on-quarter, seasonally-adjusted annualized) basis, taking growth for the year to 5.1 percent (Figure 1). On a year-on-year basis, growth was fairly stable (Figure 2). Growth in the first two quarters was revised up largely on account of higher Government consumption. GDP growth exceeded the World Bank's earlier estimate of 4.3 percent, as well as the consensus forecast of 4.7 percent (Figure 3). The difference between the actual outcome and the World Bank's forecast can be largely explained by the Government stepping up consumption spending (Figure 4). Although year-on-year growth in 2011 was lower than in 2010, growth was less volatile, and average sequential growth (reflecting the momentum of the economy) accelerated from 4.8 percent in 2010 to 5.2 percent in 2011.

**Figure 1. Growth picked up in the second half of 2011**

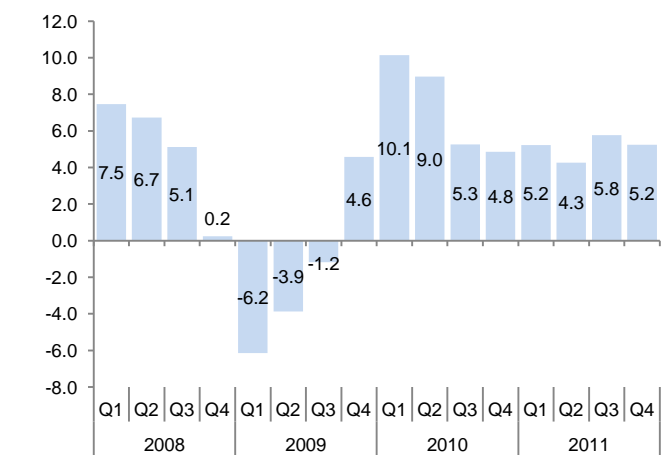
GDP adjusted for inflation and seasonal fluctuations, change from the previous quarter (line), and previous year (bars), percent



Source: Haver and World Bank staff calculations.

**Figure 2. Year-on-year growth was relatively stable**

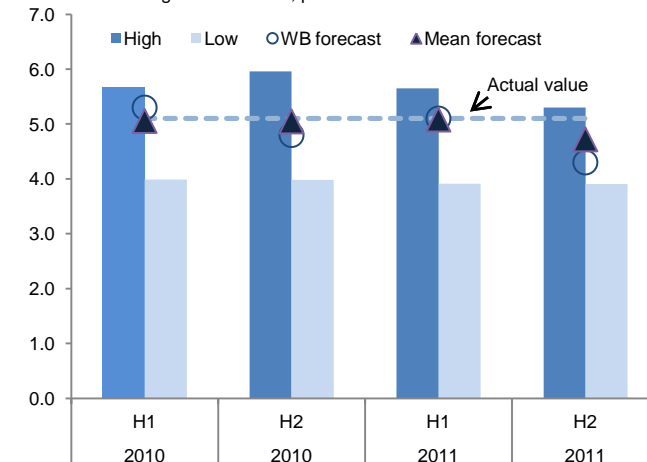
GDP adjusted for inflation, change from previous year, percent



Source: Haver and World Bank staff calculations.

**Figure 3. Growth in 2011 exceeded expectations...**

Forecasts of GDP growth for 2011, percent

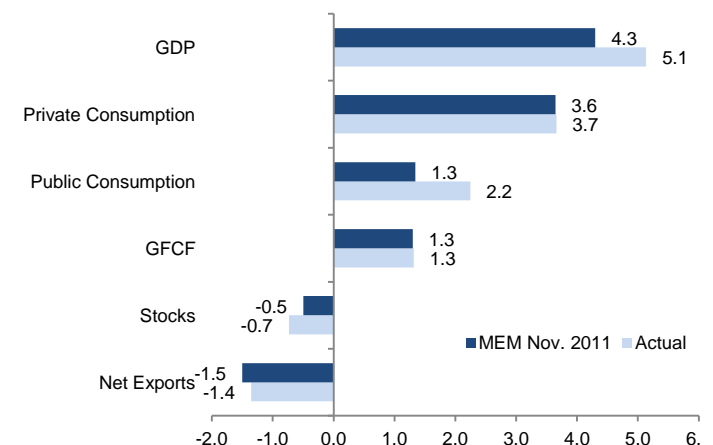


Source: Consensus Economics and World Bank staff calculations.

Note: Values are based on individual forecasts reported by 12 to 16 investment banks. The mean forecast is sensitive to the composition of the sample.

**Figure 4. ... thanks largely to higher public consumption**

Contributions to the year-on-year growth rate, percentage points

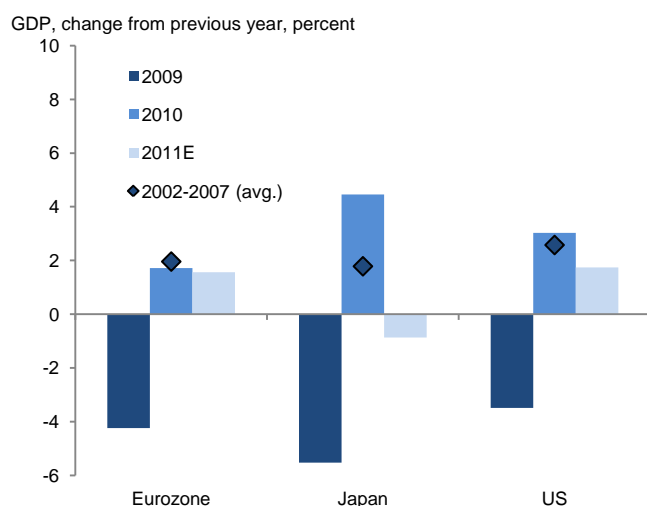


Source: World Bank (2011a) and CEIC.

## The global economy slowed in 2011

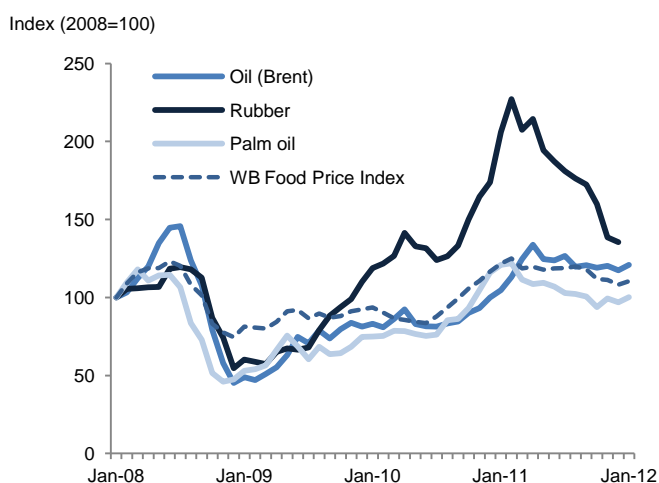
**The recovery of advanced economies lost momentum in 2011, weakening demand for imports from emerging economies.** Optimism in early 2011 was dampened by weak realized economic performance in advanced economies and then by heightened policy risks following the debt ceiling debate in the US and uncertainty surrounding Greek debt restructuring (Figure 5). Member economies of the OECD only grew by 1.7 percent in real terms, compared to 2.9 percent in 2010 and 2.5 percent between 2002 and 2007. Weak economic growth slowed imports from emerging economies, which as a result also experienced a moderation of growth. In the US, real imports grew by 2.1 percent in 2011, down from an average growth from 2.9 percent between 2002 and 2007. In China, nominal imports grew by 29 percent, down from 39 percent in 2010. As a result, although countries in developing East Asia still grew considerably faster than developed economies, both China and Singapore, Malaysia's major trading partners, also experienced a deceleration of growth in 2011.

**Figure 5. The recovery in advanced economies lost momentum in 2011**



Source: World Bank (DECPG).

**Figure 6. But commodity prices remained firm**



Source: World Bank (DECPG).

Note: World Bank (WB) Food Price Index for emerging markets.

### Despite weakness in global demand, renewed tensions in the Middle East halted the decline in commodity prices.

Europe and the US have intensified political pressure on Iran, with the EU recently imposing a ban on Iranian oil imports. In response to a potential further escalation of the conflict, hedging and speculating activities have also increased. The result of these developments has been higher oil prices, despite relatively slack global growth. Other commodities have followed the lead of high oil prices (Figure 6), although partly these increases can be explained by China's steady appetite for commodities. Some of Malaysia's key commodity exports, especially LNG, palm oil and rubber, have benefited from this rally in commodity prices. Food prices have moderated in the second half.

## Exports continued on a two-speed mode

**Exports expanded modestly amid continued divergence between commodities and non-commodities.** Exports of goods and services grew by 8.8 percent in nominal terms (4.5 percent in real terms) in the second half of 2011. Shipments of commodities grew by 26.1 percent, while non-commodities expanded by only 1.7 percent. For the year overall, exports expanded 7.8 percent in nominal terms (3.7 percent in real terms), indicating an acceleration in the second half. However, on a seasonally adjusted basis, exports are yet to return to pre-crisis levels. Shipments of crude oil declined because of ongoing production bottlenecks, but export values increased due to elevated price movements. Meanwhile, exports of palm oil and rubber increased both in volume and value terms. Commodities now represent one-third of Malaysia's exports, up from about 1/6 in 2000. In addition to weak demand from advanced economies, exports of non-commodities were affected by supply chain disruptions first due to the Tohoku earthquake in Japan, then by the flooding in Thailand. Box 1 explores the linkages between two-speed export growth and the shifting in export market shares noting that despite recent shifts in the composition of the export basket and export destinations, Malaysia's exports remain highly dependent global growth.



**One consequence of this two-speed export growth has been faster growth in the domestic value-added of exports.**

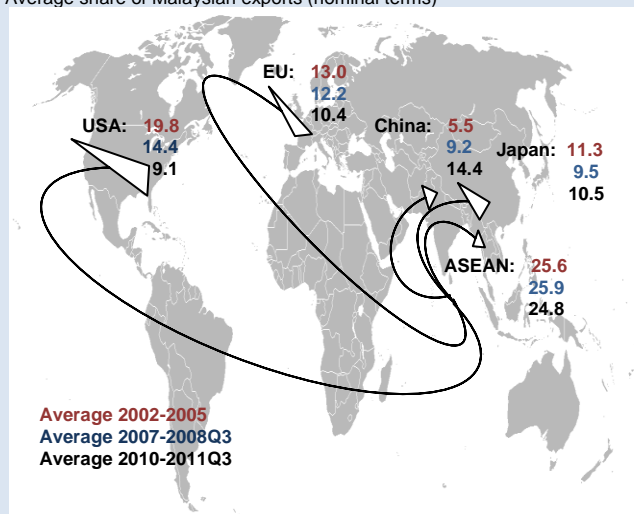
Domestic value-added of Malaysian exports (in nominal terms, estimated as the difference between goods exports and intermediate goods imports) expanded by 13.3 percent in 2011 largely due to the greater share of resource-related goods in the export basket. Notwithstanding the higher domestic value-added of exports, net trade contributed negatively to year-on-year growth due to higher imports of capital goods (up 9.8 percent in nominal terms) and consumer goods (up 19.0 percent), which reflect strong domestic demand. Consumption goods have increased from 5.7 percent of all imports in 2007 to 7.1 percent in 2011.

**Box 1. Exposure of Malaysia's exports to advanced economies**

The share of Malaysian exports going to Asia has increased significantly over the past 10 years at the expense of exports to advanced economies. While the share of the US and Europe in Malaysia's exports has declined from nearly one-third percent between 2002 and 2007 to under 20 percent in 2010 – 2011, China's share has increased from 5.5 percent to 14.4 percent (Figure 7). The decline in trade with advanced economies has been concentrated in office and automatic data processing machines (which include computers and parts), whereas the growth in intra-Asia trade, especially with China, has focused on commodities (especially palm oil, mineral fuels and petrochemicals). This is in line with the two speed pattern of export growth.

**Figure 7. Exports to the US and the EU declined, while China's market share increased**

Average share of Malaysian exports (nominal terms)



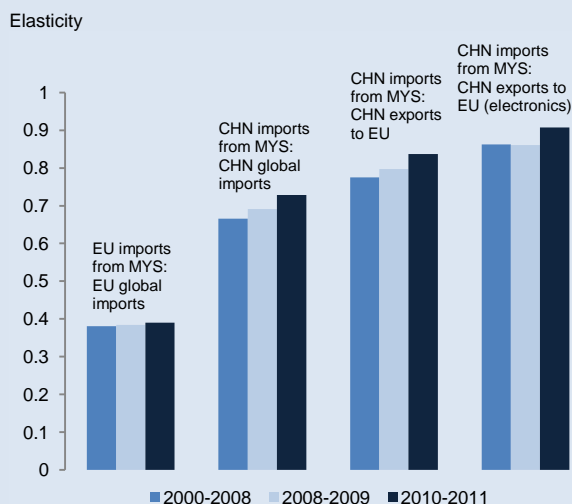
Source: CEIC and World Bank staff calculations.

The shift in export destinations appears to reflect two important trends. First, it reflects a shift in export products from electronics to commodity-based raw and industrial products. Firms such as Dell have moved from manufacturing to business support services in Malaysia whereas new investments in solar industries have yet to generate substantial export growth. As of 2011, E&E output was 13 percent below its pre-crisis peak in 2006. On the other hand, the production of petrochemicals in 2011 was 22 percent above 2006 levels and may surpass E&E output in 2012.

Second, supply chains have become more fragmented. ASEAN countries, particularly Singapore, Thailand and Indonesia, remain the main export markets for Malaysia, absorbing about 22 percent of its exports largely through transnational supply chains whose final output is ultimately destined to advanced economies. The elasticity of overall Malaysian exports to European import growth has been relatively stable at 0.4 (Figure 8). However, the elasticity of Chinese imports from Malaysia to Chinese exports to Europe is considerably higher and has increased from 0.78 to 0.84 during the economic crisis. The elasticity is even higher when only focusing on electronics where Chinese demand for Malaysian exports is almost perfectly synchronized with European demand. This suggests that the share of intermediate exports to China remains high, forming a key ingredient of Chinese exports to Europe.

Therefore, while trade with advanced economies declined, exports of non-commodities to Asia and exports to the US and EU remains fairly synchronized (Figure 9). Although exports from Malaysia constitute less than one percent of European imports and only 3.5 percent of Chinese imports, Malaysian exports remain highly dependent on demand from both economies and as a result remains vulnerable to a new negative shock in advanced economies.

**Figure 8. Events in Europe affect Malaysia both directly and indirectly through supply chains**



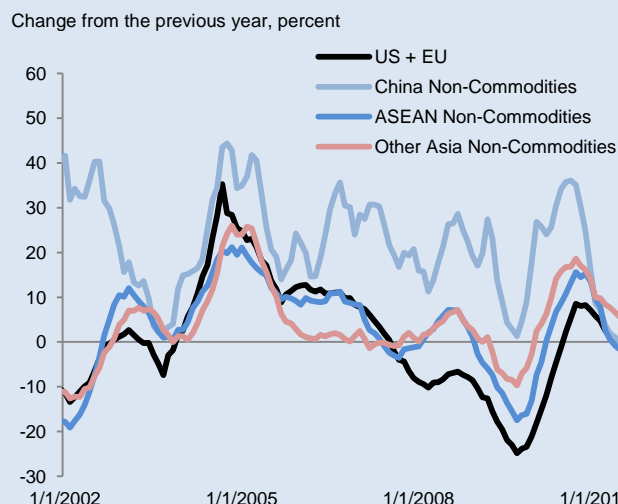
Source: CEIC, Eurostat, and World Bank staff calculations.

Notes: Deflated by CPI of importing country (CPI and PPI where China is the importer). Results based on univariate ordinary least squares regressions. EU refers to the Eurozone.

Notes: a: Dell stopped shipping notebook computers from Penang to the US, Canada and parts of South America in 2009. According to Dell (2006), in 2005, Dell computer accounted for 28 percent of Malaysia's electronic equipment exports and almost 7 percent of its GDP. On the other hand, in November 2011 Dell opened a global business center in Cyberjaya.

b: It should be borne in mind that as the financial crisis of 2008 and 2009 translated to an extent into a trade credit freeze these elasticities are driven not only by demand but also credit conditions. See World Bank (2011c), p. 31.

**Figure 9. Correlation between non-commodity exports to Asia and exports to US/EU remains high**



Source: CEIC and World Bank staff calculations.

## Consumption was the main driver of growth

**Domestic consumption—both public and private—was the main driver of growth in 2011.** Private consumption continued to expand in the final quarter of 2011, posting 7.1 percent year-on-year growth, while public consumption surged 23.6 percent (Figure 10) following higher expenditures on emoluments, supplies and services. The contribution of public consumption to year-on-year growth for the fourth quarter (4.1 percentage points) was the highest since at least 2000. For 2011 as a whole, consumption (both public and private) contributed 5.9 percentage points to GDP growth, of which 3.7 private and 2.2 public. Vigorous growth of household consumption was underpinned by still-accommodative credit conditions, firm prices for Malaysia's main commodities (which boosts incomes of rural households), public transfers such as civil servant bonuses and declining inflation in the fourth quarter.

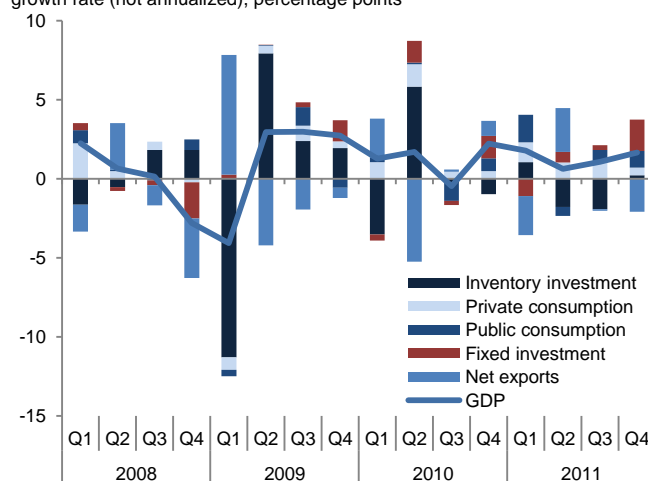
**Fixed investment also expanded robustly on higher investments from the private sector and public enterprises.**

Gross fixed capital formation expanded by 6.0 percent in real terms from 2010 despite a 2.4 percent contraction in public investments. This implies private investments expanded by 14.4 percent, down from 17.7 percent in 2010 (quite respectable given base effects in 2010). Federal Government development expenditures contracted by 12 percent (in nominal terms) during the year following the lapse of the second stimulus package, which had added

an exceptional RM5 billion to the development budget in 2010.<sup>1</sup> Strong capital spending of the non-financial public enterprises (NFPEs) partially offset the decline in development expenditure: net development expenditures of NFPEs surged by 52 percent in 2011. The increase in capital spending by NFPEs was mainly in the mining, transportation, utilities and communication sectors. Mining sector investments by PETRONAS, the national oil company, alone may have accounted for as much as 1/3 of the growth in nominal investments in Malaysia in 2011<sup>2</sup>. Capital spending in the utilities and communication sectors was focused on expanding Malaysia's electricity generation capacity and extending the coverage of High-Speed Broadband services respectively. Fixed investment expanded particularly strongly in the fourth quarter, as development spending became less of a drag and NFPEs accelerated investments.

**Figure 10. Public consumption and fixed investment boosted GDP in the second half of 2011**

GDP adjusted for inflation and seasonal fluctuations, contributions to quarterly growth rate (not annualized), percentage points



Source: Haver and World Bank staff calculations.

**Inventories became a drag on growth as the restocking cycle was completed.** After an extended period of inventory restocking – following the sharp drawing down of inventories during the global financial crisis in 2008 – the contribution of inventories to year-on-year growth turned negative again in the second quarter of 2011 (Figure 10).

## Resource-intensive industries and services performed well

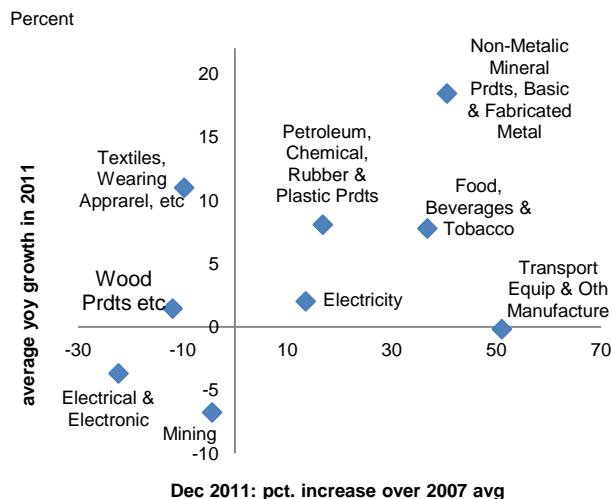
**Commodity-related industries performed well despite external weakness and ongoing bottlenecks in the mining sector.** The manufacturing sector as a whole expanded by 4.5 percent in real terms in 2011 compared to 11.4 percent in 2010.<sup>3</sup> Subdued external demand, particularly from advanced economies, weighed down on the large export-oriented E&E sub-sector. In contrast, companies producing non-metallic mineral products and metals have done particularly well and well exceeded their pre-crisis levels of output (Figure 11). Together with industries that produce petroleum, chemicals (both petrochemicals and oleo-chemicals), rubber, and plastic products, these sectors had the largest contributions to growth in 2011. The mining sector remained a drag due to ongoing operational problems the Kikeh oil field off the coast of Sabah.

<sup>1</sup> Allocation for development expenditures including the second stimulus package declined by 13 percent (from RM56.2 billion to RM49.3 billion) between 2010 and 2011, whereas executed development expenditure declined by 12 percent (from RM52.8 billion to RM46.4 billion) (sources: Economic Report 2009/2010, Economic Report 2010/2011 and EPU).

<sup>2</sup> Based on financial statements available at <http://www.petronas.com.my/investor-relations/Pages/financial-results.aspx>, capital expenditures increased by RM7.8 billion in calendar year 2011. Based on the fiscal year (ended March 31<sup>st</sup>) 2011 breakdown of domestic and foreign capital expenditures (available at the PETRONAS Annual Report, page 33) this represents approximately RM5.2 billion in additional domestic investments in 2011, which compares with nominal gross fixed capital formation growth of RM15.9 billion.

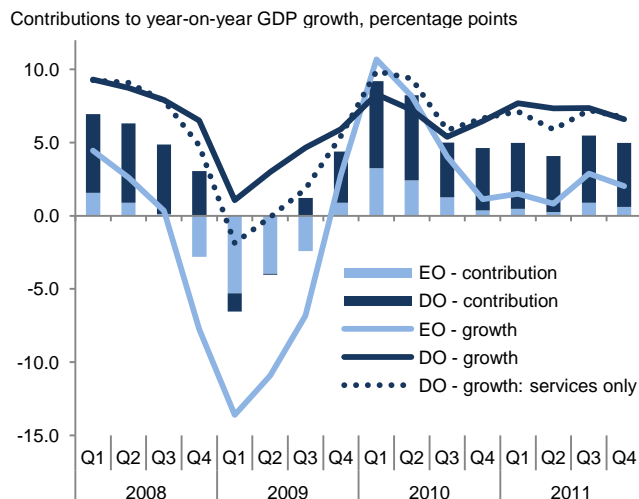
<sup>3</sup> The average sequential growth rate also slowed, though less dramatically since the year-on-year growth rate in 2010 included substantial base effects due to recovery from the global financial crisis.

**Figure 11. Resource-intensive industries spear-head production**



Source: CEIC and World Bank staff calculations.

**Figure 12. Domestic-oriented sectors, driven by services, have registered robust growth**



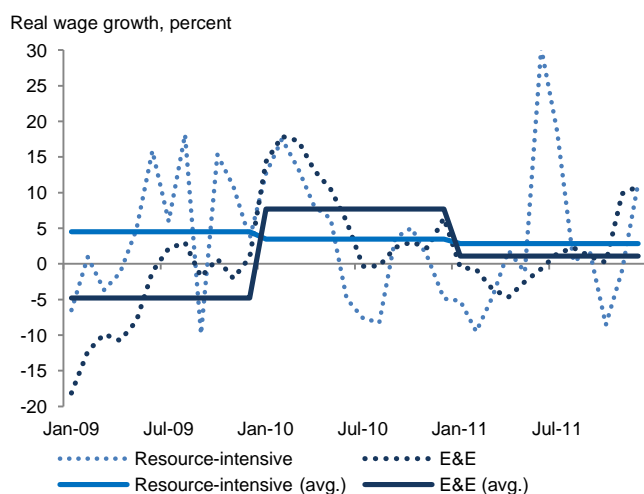
Source: CEIC and World Bank staff calculations.  
Notes: EO stands for 'export oriented' sectors and DO for 'domestic oriented' sectors.

**Sectors more closely linked to domestic demand, especially services, expanded vigorously.** Sectors producing primarily for domestic demand contributed 3.6 percentage points to overall year-on-year real growth in 2011, more than double the 1.5 percentage points contributed by sectors where demand comes primarily from external markets (Figure 12). As a result of strong investment in the fourth quarter, the construction sector expanded by over 6 percent though it remains a small contributor to overall growth. Services sectors contributed the largest share of Malaysia's economic growth in 2011 and will keep playing a key role in Malaysia's economic transformation.

## Unemployment reached a new low, but wage growth has been modest

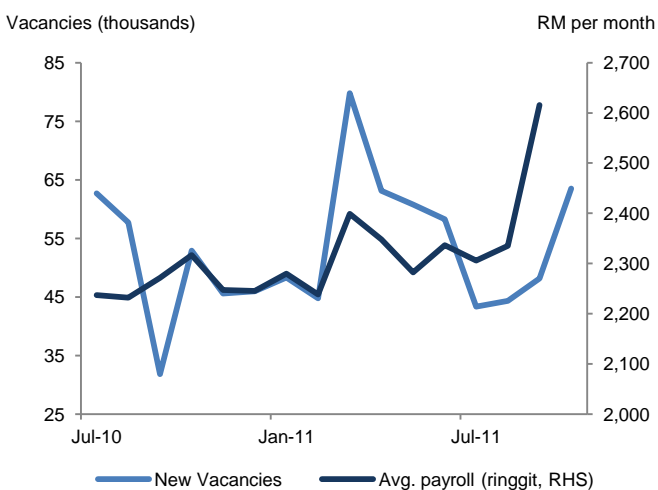
**Unemployment has returned to pre-crisis levels.** Seasonally adjusted unemployment stood at 3.0 percent in the final quarter of 2011 and declined further to 2.8 percent in January. Malaysia created 285 thousand jobs between January 2011 and January 2012 (a growth rate of 2.3 percent), exceeding the growth rate of the working age population in the period (260 thousand) as well as absorbing new entrants into the labor market, which led to an increase in labor force participation by 0.4 percentage points to 65.1 percent in January.

**Figure 13. Resource-intensive industries experienced consistent wage growth**



Source: CEIC and World Bank staff calculations.  
Notes: Seasonal adjustment by World Bank staff.

**Figure 14. Wages appear to increase in anticipation of job vacancies**



Source: CEIC and World Bank staff calculations.  
Note: Vacancies data depicted as 4-month lead.

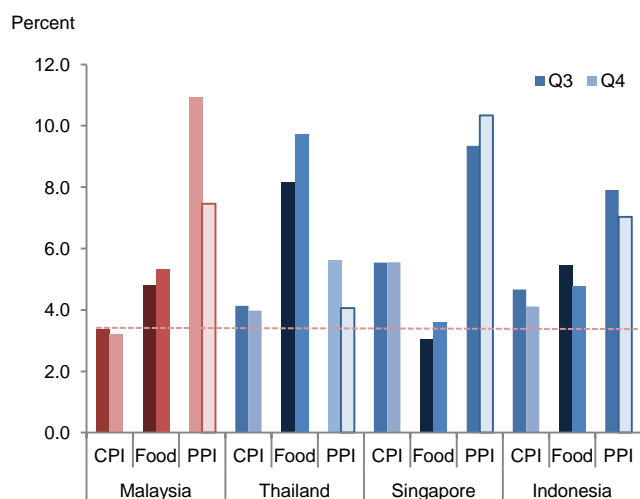
**On the other hand, manufacturing wage growth has been modest.** Manufacturing wages (adjusted for inflation) increased by 0.8 percent in January and 0.6 percent for 2011 on average—below the real output growth of the manufacturing sector. Within manufacturing, wages in resource-intensive industries gained the most, reflecting the good overall performance of the industry. Wages in petroleum, chemicals, plastics and rubber products posted a 4.6 percent gain in real terms in 2011, compared to an increase of just 0.8 percent in E&E.<sup>4</sup> This represents the continuation of a trend, and the gap in wages between resource-intensive petroleum and chemical industries and E&E has increased from -0.2 percent (i.e. E&E wages used to be higher) to 11.2 percent in 2011. In addition, wage growth in resource-intensive industries has been less volatile, expanding even during the crisis period (Figure 13). Wages seem to increase about four months before vacancies increase suggesting that, as labor markets tighten, firms will initially try to create incentives to improve labor productivity and retain workers before opening new vacancies (Figure 14).

## Inflation eased in the fourth quarter

**Inflation started declining in the fourth quarter of 2011 as food prices stabilized and transport inflation declined.**

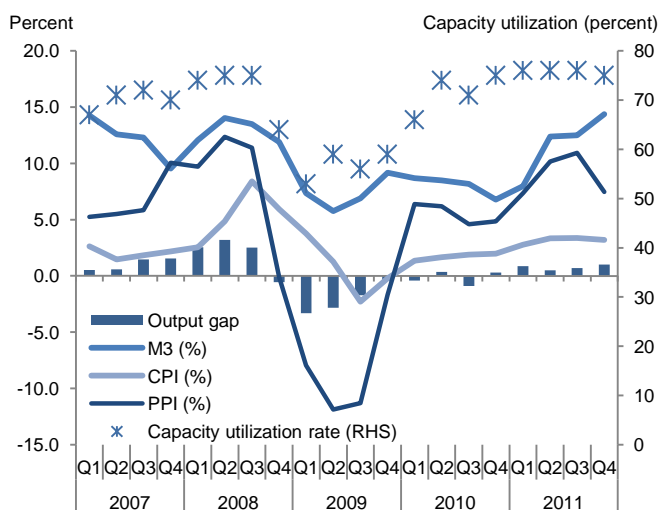
Consumer price inflation averaged 3.2 percent over the year after peaking at 3.4 percent in the third quarter. By December inflation had fallen to 3.0 percent, down from the year-high in June of 3.5 percent. Among its neighbors, Malaysia has experienced the lowest headline inflation rate, likely due to more extensive subsidies on fuel and transportation costs, as food price inflation in Malaysia is comparable to other countries in the region (Figure 15). While consumer price inflation may not reflect underlying inflation pressures due to price controls and subsidies (as evidenced by the higher gap between PPI and CPI in Malaysia compared to other countries; see Figure 15), the downward trend in producer price inflation is suggestive that inflationary pressures have indeed declined steadily since mid-2011. At 6 percent year-on-year it has come down to its lowest value in 2011. The gap between PPI and CPI has also narrowed to 3.2 percentage points, compared to an average of 5.8 percentage points for the year.

**Figure 15. CPI inflation in Malaysia is low among regional peers, but PPI is among the highest**



Source: CEIC, IMF (IFS) and World Bank staff calculations.

**Figure 16. Supply factors were the main drivers of inflation but demand factors also played a role**



Source: Haver and World Bank staff calculations.

Note: Output gap and capacity utilization rates for domestic oriented sectors. Output gap calculated using the Hodrick-Prescott filter to estimate potential GDP.

**Supply factors were the main drivers of inflation.** Rising inflationary trends in early 2011 were underpinned primarily by supply factors, notably higher global commodity prices, as suggested by the predominant role of food and energy prices in driving inflation. In particular, prices of raw food rose faster than those of prepared foods (including

<sup>4</sup> Overall wages expanded by less than both referenced industries due to a contraction in wages in motor vehicles and medical and optical devices.

'food away from home'), suggesting that raw material costs rather than labor costs were driving inflation. Demand factors also appeared to play a role, however, as the output gap was consistently positive in 2011, growth in the monetary base was strong and capacity utilization in domestic industries picked up (Figure 16). Both supply and demand factors subsided in the fourth quarter.

## Fiscal and monetary policies still accommodative

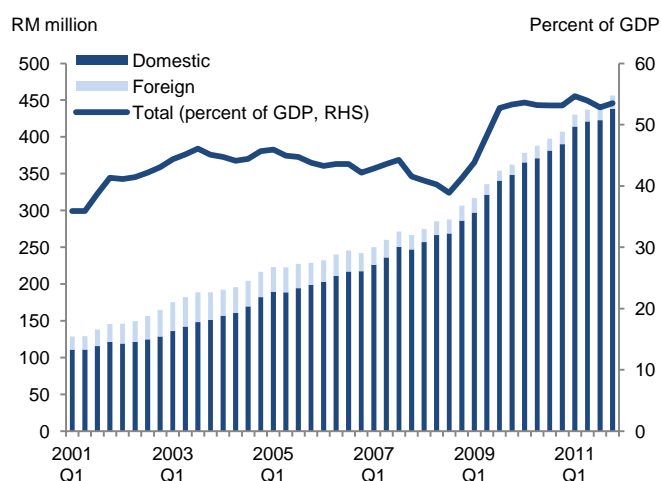
### Expenditures grow rapidly, but higher revenues boost overall fiscal performance

**Fiscal performance was better than expected mainly due to strong revenue collection.** The federal budget deficit for 2011 came in at 5.0 percent of GDP, better than the 5.4 percent projection in the last Malaysia Economic Monitor and the Government's Economic Report 2011/2012. Revenue collections were higher than expected: the Federal Government collected RM185.4 billion in receipts, a 16 percent increase from 2010 and 12 percent above the RM165.8 billion that were budgeted for. Total spending also expanded, coming in at RM229 billion, 12 percent above 2010 levels and 8 percent above the RM212 billion that had been budgeted. As a result of the lower deficit and robust GDP growth, the Federal Government debt declined to 53.5 percent of GDP at end of 2011, below the Government's informal fiscal rule that the federal debt should remain below 55 percent of GDP (Figure 17).

**Revenues expanded as a result of high oil prices and improvements in tax collections.** High commodity prices were the main contributor to higher revenues. Oil-related revenues expanded by 17 percent (year-on-year), with collections of the petroleum income tax up nearly 50 percent from 2010 (Figure 18). But performance of non-oil revenues was also strong, increasing by 15.5 percent (the largest expansion since 2001). Revenue from corporate taxes rose by 29.2 percent compared to 2010 and 6.6 percent more than budgeted. Individual income tax revenue was RM20.2 billion, a 13.5 percent increase from 2010 and 2.5 percent higher than what was budgeted. Some of these gains may be explained by improvements in tax administration such as expanding audit coverage.

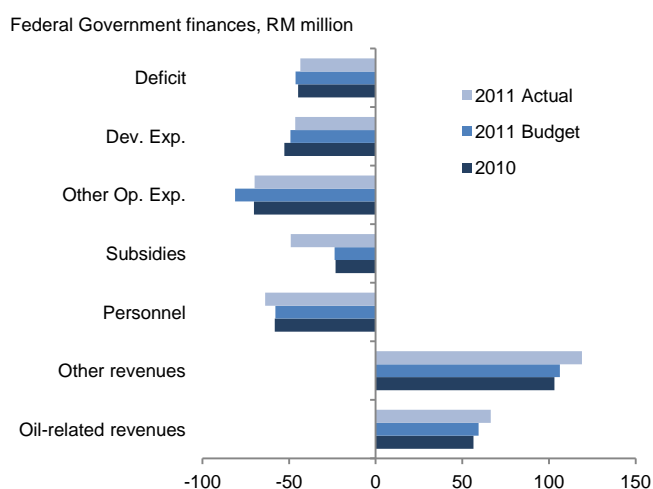
**Operating expenditure increased more than revenues, but this was offset by lower development expenditures.** Operating expenditure (about 80 percent of federal spending), rose by 20.4 percent over 2010 primarily due to higher spending on fuel subsidies and personnel costs. The flipside of high oil revenues are higher fuel subsidies, which were up by 112.1 percent over the year (Figure 18; see also Box 3). Civil service emoluments grew by 7.5 percent, with an upswing in the second half of the year due to bonus payments. Expenditures on pensions and gratuities grew by 17.8 percent. Development expenditures contracted by 12.1 percent, which resulted in overall Federal Government expenditures growing by 13 percent. As operating expenditures grew faster than revenues, the 'fiscal current account balance' (revenues less operating expenditures) contracted 0.7 percentage points to 0.3 percent of GDP.

**Figure 17. Federal Government debt levels came down in 2011 and remained below 55 percent**



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

**Figure 18. Despite higher subsidy and personnel expenditures the deficit was lower in 2011**



Source: CEIC, MoF and World Bank staff calculations.

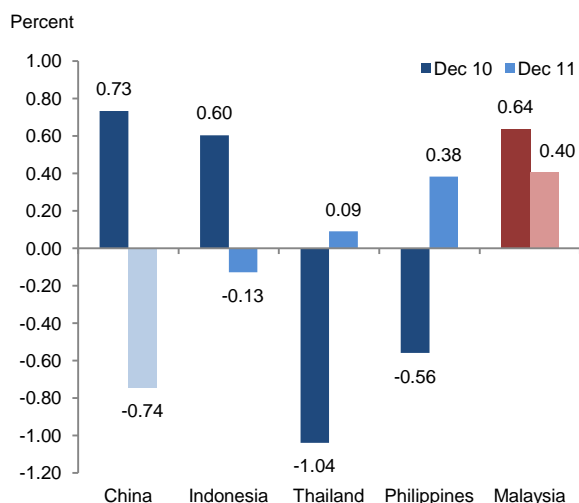
Note: 'Personnel' includes emoluments, pensions & gratuities.



## Monetary policy remained on hold and supportive of growth

**The normalization of monetary policy towards pre-crisis levels was put on hold in the second half of 2011 as inflation stabilized while risks to growth increased.** Following a cumulative increase of 100 basis points since 2010, Bank Negara Malaysia (BNM) kept its overnight policy rate (OPR) unchanged at 3.0 percent in the second half of 2011. This ensured that monetary conditions remained accommodative given the heightened risks to global demand observed since September. At 0.4 percent, the real policy rate remains low in historical perspective, as recent rate increases only partially offset rate cuts totaling 150 basis points since the onset of the global financial crisis and inflation has been higher compared to the pre-crisis period (Figure 19). Although low in absolute terms, real rates remain among the highest in the region and there would be room for further monetary accommodation should a new shock to global demand materialize.

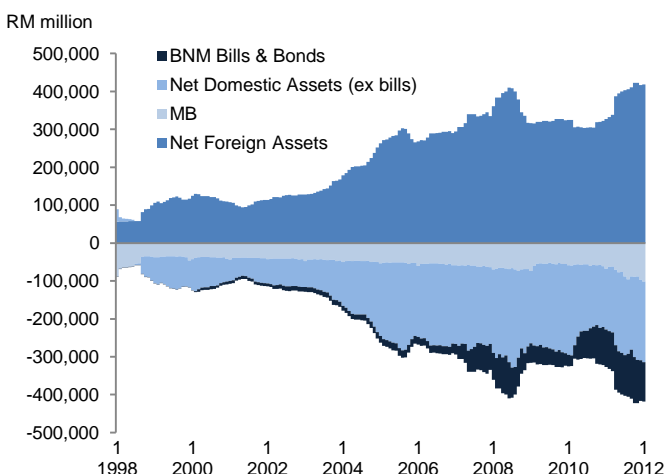
**Figure 19. Real interest rates are low, supporting growth**



Source: CEIC.

Note: Calculated subtracting expected inflation for the following year from the policy rate.

**Figure 20. BNM bills and bonds become more important instruments for sterilization since 2008**



Source: BNM and World Bank staff calculations.

Note: MB stands for Monetary Base or 'M0.'

**Liquidity was ample despite increases in the statutory reserve ratio (SRR) earlier in 2011.** Private sector liquidity, as measured by broad money (M3), expanded by 14.4 percent as of end-December 2011 on account of sizeable capital inflows in the first half of 2011, as well as higher credit extension by the banking system. The expansion in M3 was in part contained by the central bank's sterilization operations and capital outflows in the third quarter. The central bank conducted sterilization operations through a wide range of instruments including direct borrowing, repos and short term central bank bills (Figure 20). This was in addition to the raising of the statutory reserve requirement (SRR) by three times between April and July 2011, from 1.0 percent to 4.0 percent, to provide longer term sterilization of the liquidity.

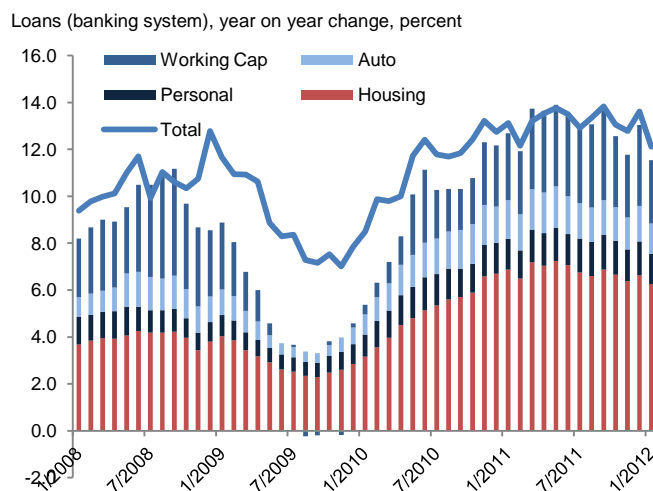
## Robust credit growth continued despite new prudential measures

**Growth of credit to businesses accelerated in 2011 while household credit moderated somewhat.** Net financing raised by the private sector through the banking system and the capital markets expanded at a faster annual pace of 12.5 percent in 2011 compared to 10.9 percent in 2010. Total financing extended through financial institutions and the capital markets to the business sector expanded by 11.5 percent in 2011 compared to 7.7 percent in 2010. Banking system loans to businesses expanded by 13.5 percent (compared to 9.4 percent in 2010) as investment and working capital loans picked up (Figure 21). Business demand for funds from the capital markets was also higher, with new issuances of private debt securities amounting to RM69.6 billion in 2011. Financing via the equity market, however, declined to RM12.6 billion from RM32.1 billion in 2010 as turbulent market conditions took their toll on domestic markets in the second half: net financing to the private sector via capital markets during the

second half of 2011 amounted to RM14.7 billion, a 33.7 percent decline on a year on year basis. The increase in financing to businesses was driven by improved retail sales and higher investment activity in response to strong domestic demand. Outstanding household loans rose by 12.9 percent in 2011, a deceleration from the 13.4 percent recorded in 2010. Loan growth for passenger cars moderated to 6.0 percent in 2011 from 7.3 percent in 2010 (Figure 22). This may reflect the impact of amendments to the Hire Purchase Act in June 2011, but also supply disruptions stemming from the impact of natural disasters in Japan and Thailand.

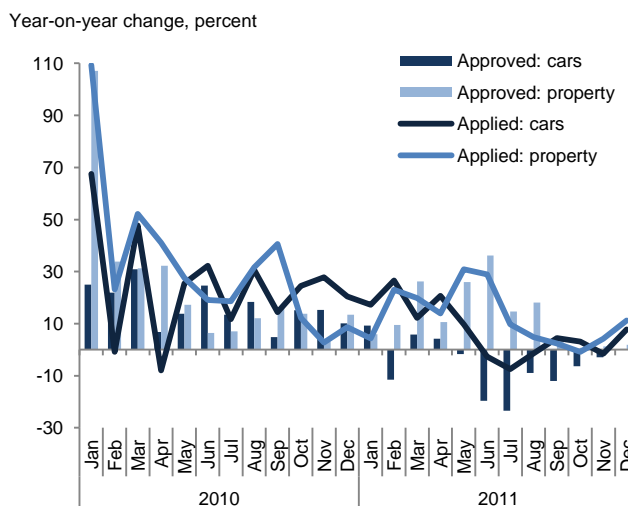
**Prudential measures may have played a part in the moderation of household credit but their impact is more likely to be felt in 2012 and beyond.** Household debt in 2011 stood at 76.6 percent of GDP, over 10 percentage points higher than the 62.7 percent of GDP recorded in 2008. While BNM highlights that overall household balance sheets remained at a prudent level, with a debt-to-financial-assets ratio of 43.5 percent, household debt is not homogeneous across income groups. The ratio of average outstanding debt to median annual income of borrowers earning less than RM3,000 a month is between 4.4-9.6 times annual income, compared to 2.3-3.3 times for those in the upper-middle and high-income groups (those earning above RM4,000). To avoid an unsustainable build-up in debt especially among lower income households, BNM has implemented a number of prudential measures including a reduction of the loan-to-value ratio to 70 percent for third home purchases and above, increased risk weights for housing loans with loan-to-value above 90 percent and personal financing with tenure above 5 years.<sup>5</sup> Further prudential measures were announced in November 2011 which stipulated that income eligibility should be assessed using income net of statutory expenses<sup>6</sup> rather than the previous methodology of gross income. In addition, the loan tenure for passenger cars has been restricted to not more than nine years. Although more data is required to assess the impact of the regulations, a decline in auto sales in January, when the rule started to take effect, has been attributed to the new regulations.

**Figure 21. Housing loans continued to expand robustly while working capital loans picked up**



Source CEIC and World Bank staff calculations.  
Note: Working Cap stands for working capital.

**Figure 22. Approvals of car loans declined for most of the second half**



Source: CEIC.

**Banks remained healthy and well capitalized despite the persistent headwinds from global financial markets.** The domestic banking system has been insulated from the renewed financial turbulence arising from the debt crisis in the euro area. Risk-weighted and core capital ratios, at 15.1 and 13.2 percent respectively, remained comfortably above levels required by national authorities and Basel III, and actually rose from levels seen at the end of the first

<sup>5</sup> The authorities also tried to reduce the proliferation of credit cards. In addition to a RM50 service charge imposed earlier in 2010, in March 2011 Bank Negara increased minimum income requirements and restricted credit cards to two issuers per person for those belonging to the lowest income bracket. The measures have shown some effect, with the number of credit cards decreasing since 2010, albeit at a lower rate in 2011. Meanwhile, the amount of credit lines extended has risen, leaving the effect on consumer borrowing ambiguous at this stage.

<sup>6</sup> Defined as tax payments, provident fund contributions and social security contributions.

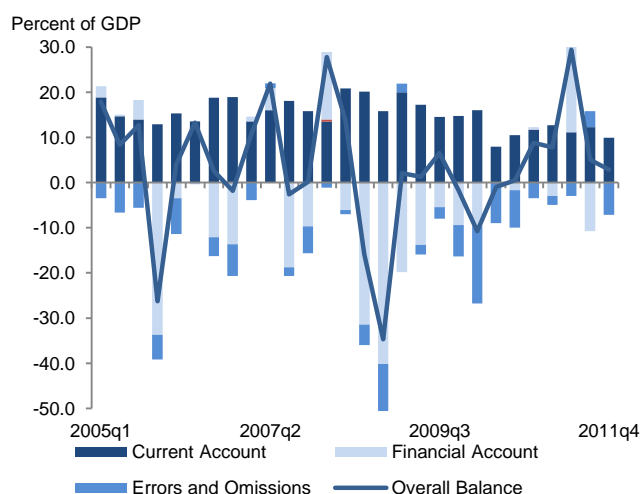


half of 2011. Tier 1 capital comprised 86.8 percent of total capital while capital in excess of the minimum 8 percent regulatory requirement remained high at RM71.4 billion. The ratio of non-performing loans declined to 1.8 percent as of December 2011, an improvement compared to the ratio of 2.3 percent as at end-2010. Although earlier rate hikes were largely passed through to base lending rates, the effect on the average lending rate (ALR) varied between segments. The ALR for passenger car loans actually declined in tandem with the decline in interest rate swap (IRS) rates, while the ALR for business loans rose at a lower rate than that for households.

## Commodity exports supported Malaysia's external position

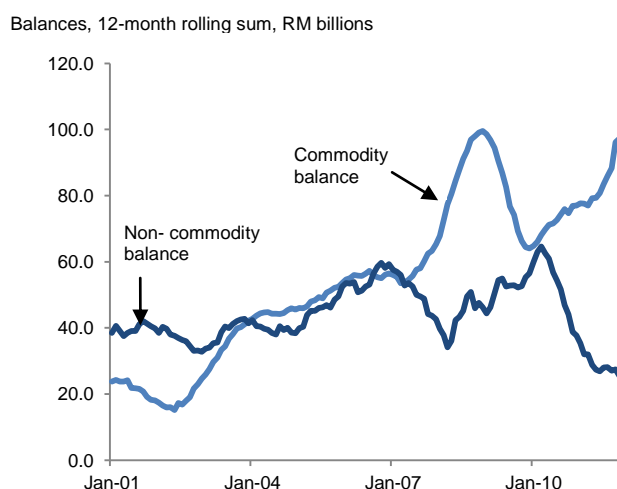
**The current account surplus remained substantial thanks to robust commodity exports.** As Figure 23 shows, the current account has posted fairly steady surpluses around 10 to 12 percent of GDP. However, the composition of the current account has shifted. The two-speed nature of export growth is reflected in a widening gap between the trade balances of commodities and non-commodities (Figure 24). While net commodity exports surged 22 percent in 2011 to RM133.6 billion, the non-commodity balance of goods fell by 37 percent to RM15.9 billion as capital goods imports picked up while manufacturing exports, especially of E&E products, remained sluggish. The overall balance of goods and services expanded by 3.4 percent as services imports expanded faster than exports. Outflows from the income account decelerated while current transfers were stable. As a result, the overall current account posted a surplus of 11.5 percent of GDP, the same level as in 2010.

**Figure 23. The current account has been consistently in surplus...**



Source: CEIC and World Bank staff calculations.

**Figure 24. ... driven increasingly by commodity-related exports**



Source: Haver.

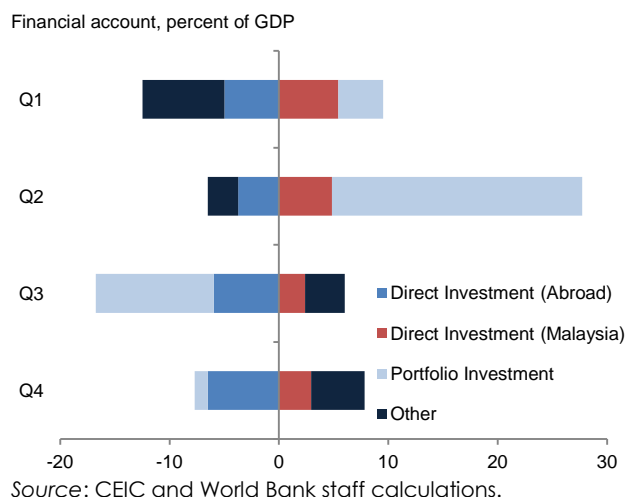
Notes: Commodity-related exports include food, beverages & tobacco; mineral fuels & lubricants; chemicals; animal and vegetable oils and fats. Non-commodities include manufactured goods and miscellaneous categories.

**After a surge in the first half of the year, Foreign Direct Investment (FDI) in Malaysia declined in the second half with retrenching Japanese investment.** Net FDI in Malaysia fell from 5.4 percent of GDP in the first quarter of 2011 to 2.9 percent in the final quarter (Figure 25). The decline was most marked for Japanese investments, which had driven the original surge in late 2010 and early 2011. The drop in FDI could be partly explained by Japanese firms' ramping up of investments in Japan to restore production facilities in response to the Tohoku earthquake and tsunami of March 2011. For the year as a whole, FDI expanded by 12.3 percent. FDI remains concentrated in the distributive trade and manufacturing sectors (Figure 26). FDI by Malaysian companies abroad increased more modestly than in the previous year, but remains larger than FDI by foreign companies in Malaysia.

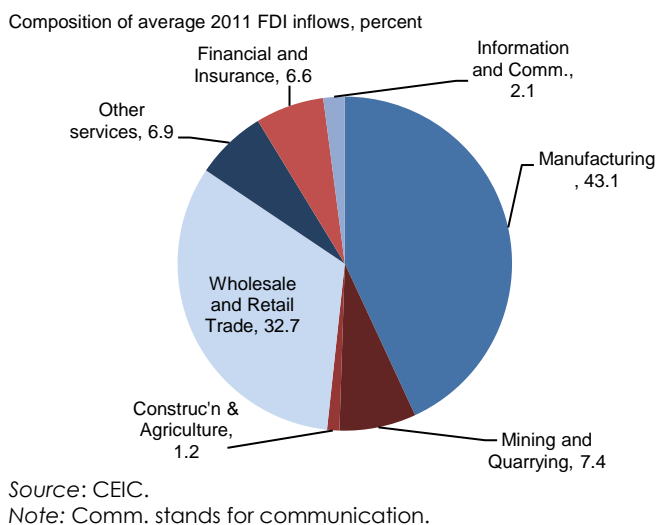
**Portfolio flows contracted sharply in September and October due to fears of a new shock to global financial markets caused by sovereign debt troubles in the Eurozone.** A surge of inflows in the second quarter (when portfolio inflows reached 23 percent of GDP) was partly reversed in the third quarter when the deterioration in the global environment led to outflows equal to 11 percent of GDP. This development was also reflected in the liquidation of

debt holdings by non-resident investors which subsequently led to some upward pressure on Government bond yields. The equity market was also affected by foreign investors selling off their positions, particularly in the third quarter, when the stock market declined by 12.2 percent. Inflows started to return in the fourth quarter, buoyed by optimism surrounding better-than-expected economic performance in the region, including Malaysia.

**Figure 25. Foreign direct investment fell and portfolio investment flow partly reversed in late 2011**

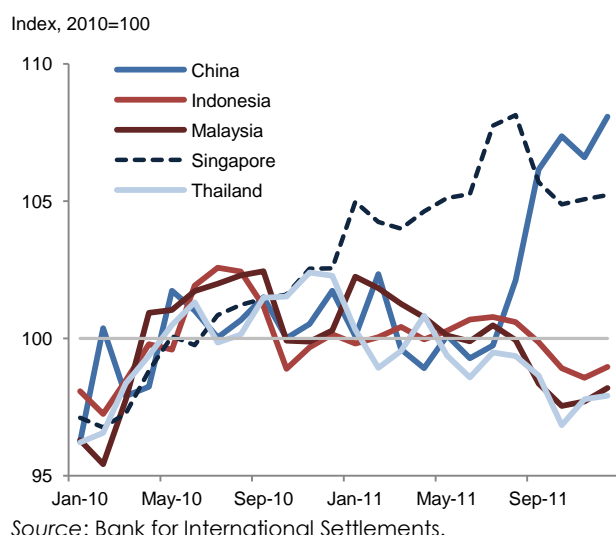


**Figure 26. Foreign direct investment is concentrated on the manufacturing and distributive sectors**

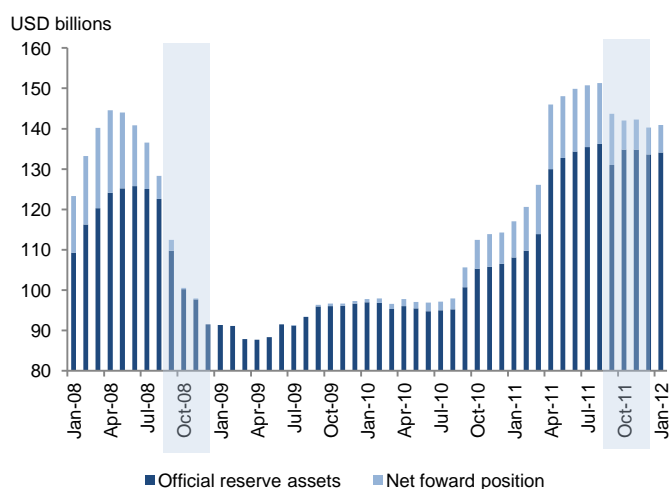


**The ringgit resumed a modest appreciation trend following a decline in September and October.** Capital outflows in September and October led to a depreciation of the nominal and real exchange rates. The real effective exchange rate depreciated by 4.6 percent in October from its high in January (Figure 27), but by December it had regained 0.7 percent. As has been generally the case in recent times, this pattern was similar to that followed by other currencies in the ASEAN region.

**Figure 27. Malaysia's real effective exchange rate appreciated in line with Thailand and Indonesia**



**Figure 28. Net forward position declined much more than official reserves**



**External reserves remained relatively stable.** While BNM accumulated reserves rapidly during the surge of capital inflows in the first half of 2011, reserves declined more modestly in third quarter when investors withdrew. Net international reserves declined from a peak of USD 136.3 billion in August 2011 to USD 131 billion in September 2011 (for comparison, capital outflows in the third quarter were over USD 7 billion). External reserves remained stable in the following months, amounting to USD 134.1 billion as of end-January 2012. This level of reserves is sufficient to

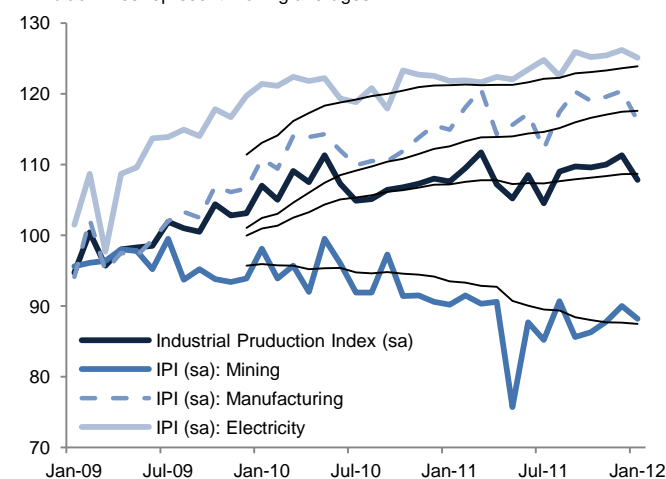
finance 9.6 months of retained imports and is 4.1 times the short-term external debt. Notwithstanding such developments, the reduction of net foreign exchange forward position of the central bank was greater than that of the official reserves during the period of heightened uncertainty (Figure 28). This suggests that during times of external liquidity stresses, such as the second half of 2011, the central bank may have unwound its long foreign exchange forward position to inject foreign exchange liquidity into the system. A similar trend was also evident during the height of global financial crisis in 2008.

## High-frequency indicators for early 2012 have been mixed

**Recent indicators for the Malaysian economy are mixed.** Although production levels remain stable and generally above the twelve-month moving average, industrial production declined in January across all sectors, possibly due to the Chinese New Year holidays. Except for mining production, which has been on a declining trend since 2009, recent momentum in manufacturing production appears modestly positive (Figure 29). Demand-side indicators appear to be slowly improving but are also mixed. Exports and imports also declined in January but appear to remain on a generally upward trend (Figure 30). Sales of manufactured goods continued to expand, although auto sales declined, possibly already reflecting the new guidelines on lending practices recently introduced by Bank Negara. Consumer confidence declined in Q4, but the decline in average consumer sentiment in 2011 compared to 2010 was not correlated with weaker consumption growth.

**Figure 29. Industrial production declined in January**

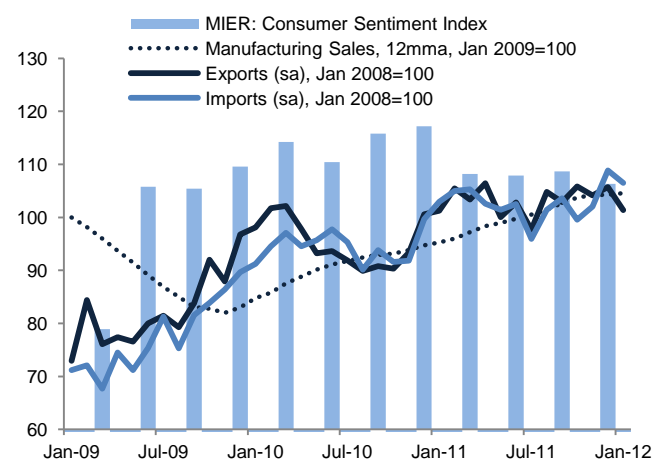
Industrial Production Index, seasonally adjusted  
Thin black lines represent moving averages



Source: CEIC and World Bank Staff calculations.

**Figure 30. Demand indicators have been mixed**

Indices



Source: CEIC and World Bank staff calculations.

## 2. ECONOMIC OUTLOOK

### Near-term outlook points to continued but modestly slower growth in 2012

**With global demand still subpar and some domestic drivers unlikely to post the same performance as 2011, Malaysia's highly open economy is expected to slow modestly in 2012.** Although the outlook for advanced economies has improved somewhat, prospects for global demand remain subdued as advanced economies continue on the lengthy path of repairing public and private balance sheets. Reconstruction from the Tohoku earthquake in Japan and the reestablishment of production following the Thai floods offer some upside risks, but external demand is expected to remain below 2008 levels. Domestic demand is expected to continue to support growth in 2012 and the outlook for fixed investment in particular is somewhat more favorable than in 2011. However, three factors are likely to reduce the contribution of domestic demand to growth. First, public consumption, while still expected to remain robust in 2012, cannot be expected to continue growing at the 17 percent pace of 2011. Second, private consumption faces both headwinds and tailwinds: on the one hand, wages may increase with the introduction of the minimum wage, inflation is trending down, and Government transfers are likely to support consumption. On the other hand, stricter rules on credit and stable commodity prices and output (especially in palm oil) may dampen growth. Finally, inventory accumulation is likely to contribute more negatively to growth in 2012 since the restocking cycle is expected to have been completed in 2011.

### Global outlook cautiously improving

**Growth in advanced economies is likely to remain subpar in 2012 but the probability of further deterioration in global prospects has declined.** Excessive optimism in early 2011 gave way to excessive pessimism late in the year. The combination of disappointing performance of major economies in 2011 and heightened risks of both a disruptive sovereign default in Europe and greater fiscal drag in the US led many observers to mark down growth forecasts for 2012 even as the data coming out was best described as mixed. Considering the steady improvements in labor markets and strong business confidence (Figure 31), growth in the US in 2012 is likely to be an improvement over 2011, even if still below pre-crisis levels. Fears of a disruptive event in Europe remain, with a mild recession as the baseline scenario (the European Commission forecasts a 0.3 percent contraction for the Eurozone).<sup>7</sup> Nevertheless, business confidence has picked up since December 2011 and Greece's debt restructuring appears to have proceeded without causing major disruptions. Japan is likely to post relatively robust growth, reflecting the recovery and reconstruction from last year's Tohoku earthquake.

**Growth in China is expected to slow, but the slowdown will be focused on investment with consumption expected to continue to grow robustly.** According to the IMF's World Economic Outlook (January 2012), Chinese growth is expected to come at 8.2 percent in 2012. This is down from 9.2 percent in 2011 and 10.4 percent in 2010. However, this slowdown mostly reflects a cyclical deceleration in fixed capital formation, especially through a moderation of real estate investments (Figure 32). Domestic consumption growth is expected to grow above 9 percent. The composition of China's slowdown has important implications for emerging markets (see Box 2). Growth in ASEAN is also expected to remain robust, with Thailand rebounding strongly from devastating floods and Indonesia continuing to post a solid expansion in 2012.

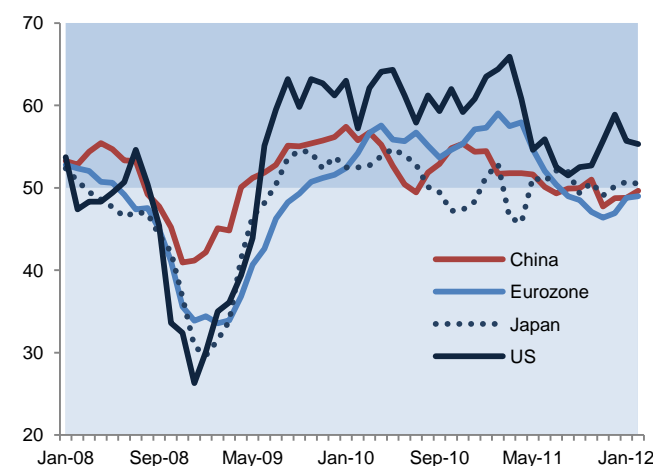
**Low interest rates in advanced economies increase the risk of a renewed surge of capital flows to emerging economies.** Central banks in Europe and the US continue to provide exceptional support to mitigate risks to the recovery. The US Fed for example recently vowed to keep interest rates at zero percent until 2014. In an environment of uncertainty, investors still prefer relatively safe Government bonds in advanced economies to riskier assets in emerging markets. However, if the global economic environment remains on an improving trend, risks exist of renewed surges in capital inflows into emerging markets, such as those Malaysia experienced in the second quarter of 2011.

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<sup>7</sup> Source: [http://ec.europa.eu/economy\\_finance/articles/eu\\_economic\\_situation/pdf/2012-02-23-interim-forecast\\_en.pdf](http://ec.europa.eu/economy_finance/articles/eu_economic_situation/pdf/2012-02-23-interim-forecast_en.pdf).

**Figure 31. Business confidence shows tentative signs of improvement**

Seasonally-adjusted Purchaser's Managers Index

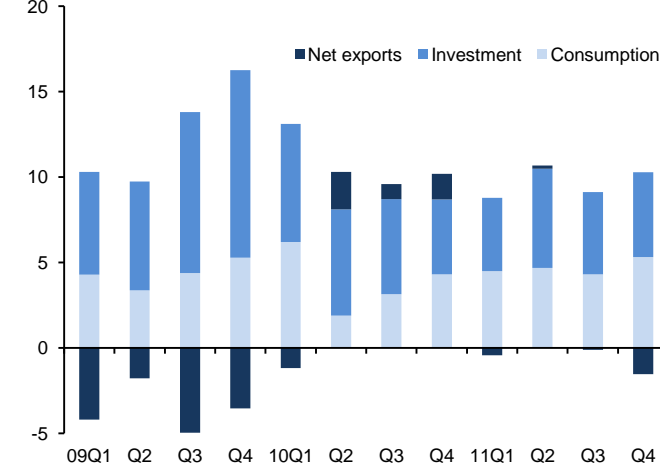


Source: Haver.

Note: Scores above 50 reflect business optimism.

**Figure 32. The deceleration of growth in China has been concentrated on investment**

Contribution to real growth, percentage points



Source: World Bank (2012).

**Although fundamentals support firm commodity prices in the medium- to long-term, near-term developments are more difficult to anticipate.** On the one hand, slowing investment in China and subdued demand from advanced economies will ease pressure on commodity prices. On the other, the risks that the conflict over Iran's nuclear program will intensify are likely to keep oil prices high until a resolution appears on the horizon. Oil prices trickle down into other commodities as they are an important input to production and distribution, and therefore pressures on commodity prices overall may intensify.

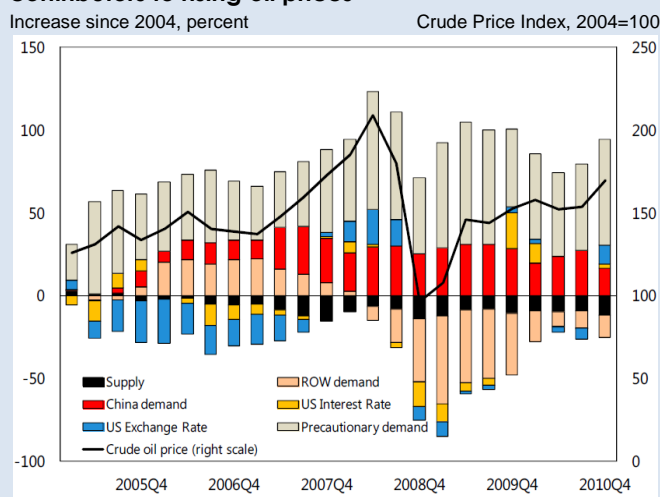
### Box 2. The potential impact of a slowdown in China on commodity prices

China's appetite for commodities is fuelled by increasingly resource-intensive export-processing and by domestic investment. While in 2000 China still predominantly exported consumption goods, by 2009 about half of its exports have been capital goods (IMF, 2011). These goods tend to require a higher share of natural resources in their production. Moreover, China has invested heavily in construction, both for infrastructure and housing. This has increased its demand for construction materials, intensifying its demand for commodities such as steel and energy.

In addition, domestic consumption is increasingly driving commodity imports. Investment growth fell from 12.1 percent in 2010 to 10.3 percent in 2011. However, consumption growth increased from 7.8 percent to 10.0 percent. Imports of final consumption goods have remained relatively stable over the past 20 years, at less than 10 percent of total imports, although it appears that an increasing amount of intermediate goods is imported for production pitched at the domestic market. One area in which domestic consumption seems to strongly translate into import demand is food, where imports have soared for such products as vegetable oils, sugar, and beef (Jenkins, 2011). Strong demand for passenger vehicles in China sustains demand both for rubber and fuel.

Global commodity prices are riding partly on Chinese demand. China is the world's third largest economy and its economic weight makes it a price-setter in global markets. Chinese demand for oil has become a key driver of oil prices (Figure 33). Indeed, China's demand for oil increased by 48.7 percent between 2002 and 2007, while demand for oil in the rest of the world increased by only 6.6 percent. Global demand for oil was thus 2.7 percent higher than it would have been if Chinese and world demand had grown at the same rate. This translates into global oil price increases of 10.8 to 27.1 percent according to the analysis in Jenkins (2011). The expected slowdown in investment will ease the pressure on commodity prices, yet this effect will partly be offset by strong domestic consumption growth. The IMF's most energy forecasts anticipate that Chinese energy consumption is going to double by 2017 and triple by 2025 from its 2008 level.

**Figure 33. Chinese demand is one of the main contributors to rising oil prices**

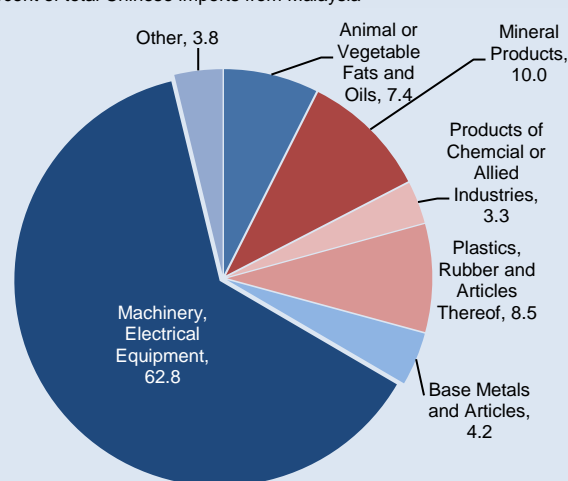


Source: IMF (2011).

Note: Precautionary demand, which is the residual, includes some part of China's effect.

**Figure 34. A considerable amount of Malaysian exports to China are commodities**

Percent of total Chinese imports from Malaysia



Source: CEIC and World Bank staff calculations.

In the context of a slowdown driven by investment, China's demand for Malaysian commodity exports is likely to be relatively resilient. The large majority of Malaysian exports to China is E&E products; yet about a quarter of Malaysian shipments to China are commodity-related, with 10.0 percent in mineral products, 8.5 percent in plastics and rubber, and 7.4 percent in organic oils (Figure 34). Of the latter, the majority is related to palm oil. In 2009, China alone consumed a quarter of all Malaysian palm oil exports (Global oils and Fats, 2010, pp. 2-3). With demand for capital goods slacking in a still fragile global economy and Chinese investment expenditure declining, Chinese demand for metals may soften, yet metals only constitute a small portion of Malaysian exports to China. Chinese demand for Malaysia's key commodity exports, on the other hand, may uphold as energy needs remain high and domestic consumption sustains palm oil prices and, assuming demand for passenger vehicles remains robust, rubber.

Source: IMF (2011) and Jenkins (2011).

## The Malaysian economy is likely to grow cautiously as well

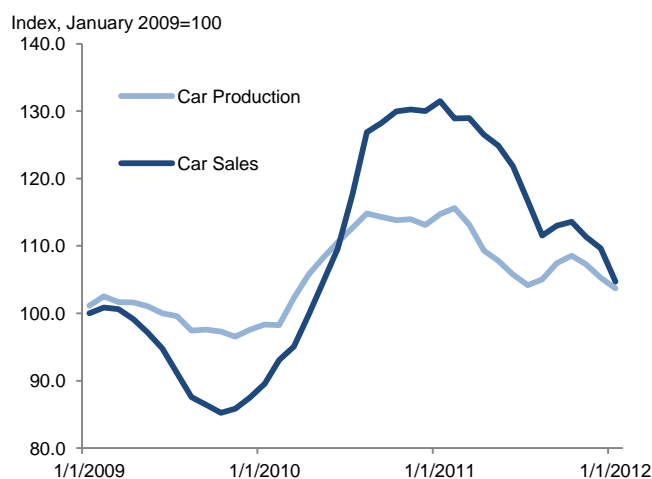
**Export growth is assumed to pick up under a baseline of stronger global recovery in the second half of 2012.** Exports are expected to accelerate from 3.7 percent to 6.6 percent on a modest recovery in advanced economies coupled with solid growth in emerging Asia. This compares with pre-crisis export growth rates of 7.6 percent. Non-commodity exports should post some improvement from the near-zero growth rates of 2011, driven by modest improvements in demand from advanced economies towards the second half of the year, and continued growth in consumption in Asia, albeit from a low base. Normalization of supply chains following the Thai floods and the reconstruction in Japan offer additional support against a backdrop of structural weakness both in the Malaysian E&E sector but also in advanced economies, which are not expected to return to pre-2008 growth rates for some time. Growth in commodity exports is likely to decelerate somewhat given base effects and capacity constraints in the production of palm oil. However, the possible resolution of production problems in the oil sector could offer some upside, especially in the second half of the year.

**Domestic demand is expected to remain the main growth driver in the economy, but the performance is unlikely to match that of 2011.** Value-added consumed or invested in Malaysia is expected to expand by 6.4 percent in 2012 compared to 7.2 percent in 2011. Domestic demand as defined in the national accounts is expected to contribute 5.3 percentage points to GDP growth, down from 6.5 percentage points in 2011.



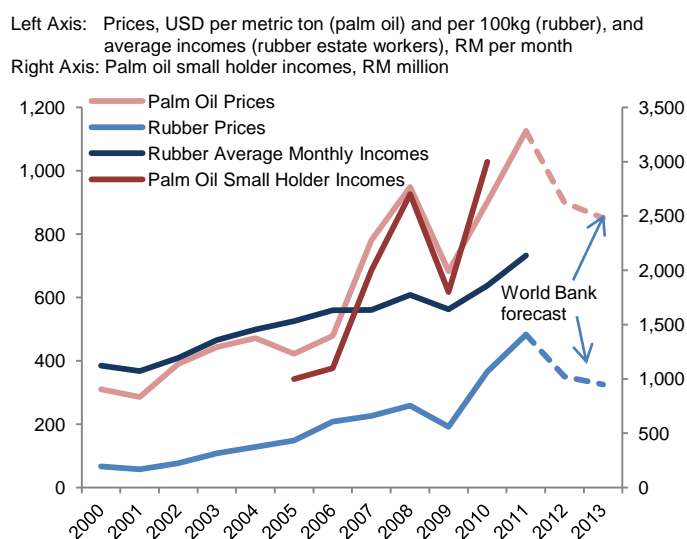
**Private consumption growth is expected to decelerate modestly due to prudential measures to rein in credit growth and slower growth in commodity revenues outweighing favorable developments in labor markets and government transfers.** The prudential measures discussed in Chapter 1 to avoid an unsustainable build-up of household debt may slow down consumer credit and indeed, January data document a drop in loans for cars, properties, and personal uses, both on a sequential and a year-on-year basis. Car sales and production appear to be slowing, although this may also be due to the impact of the Thai floods (Figure 35). In addition, output and prices of agricultural commodities are unlikely to be as buoyant in 2012, with risks that further increases in oil prices could again dampen global demand and put further downward pressure on volumes. This implies slower income growth for large number of smallholders (Figure 36). Finally, risks to global demand may impact consumption behavior through asset prices and labor market prospects. On the other hand, government transfers to lower income individuals (with high propensity to consume), stable inflation, still-accommodative monetary policy and possibly higher wages following the announcement of a minimum wage as well as higher civil servant salaries should support growth. On average, private consumption is expected to maintain the vigorous growth rate of 2011 and expand by 6.6 percent.

**Figure 35. Car sales have decelerated further into 2012 along with car production**



Source: CEIC.

**Figure 36. Income growth for households dependent on agriculture is likely to moderate on stable or lower prices**



Source: CEIC, BNM, World Bank (DECPG).

Note: World Bank forecasts as of January 2012.

**Government consumption is likely to remain robust, but it will be difficult to repeat the 17 percent expansion of 2011, considering that the Government intends to stay on a fiscal consolidation path.** With elections widely expected to be announced in 2012, growth in Government consumption will still be robust at 9 percent before slowing into 2013. Overall consumption is expected to contribute 4.9 percentage points to growth from 5.9 percentage points overwhelmingly on account of a lower contribution from government consumption.

**Fixed capital formation is expected to expand further supported by robust investments from Government-Linked Companies (GLCs).** Private investment growth is expected to accelerate as entry-point projects from the Economic Transformation Programme such as the MRT continue to come online. In addition, liberalization in services sectors could bring higher levels of FDI in services in the second half of the year assuming implementation proceeds apace. On the other hand, private investments are weighed down by large uncertainties in the global environment (which affect FDI) as well as uncertainties about the timing of Malaysia's parliamentary elections (which may have a small impact on domestic investments). PETRONAS has announced plans to spend RM 300 billion over 5 years, and based on recent patterns of capital expenditures, at least 2/3 of these investments are likely to be in Malaysia. Specific PETRONAS investments include regasification terminals in Sungei Udang (Melaka), Pengerang (Johor) and Lahad Datu (Sabah), the Sabah Oil and Gas Terminal and Sabah-Sarawak Gas Pipeline between Kimanis and Bintulu, and the development of Gumusut-Kakap Oil and Gas field (expected completion in November 2012). In addition,

broadband roll-out is expected to continue into 2012. As a result, gross fixed capital formation is expected to accelerate from 6.0 to 7.5 percent in 2012 and increase its contribution to growth from 1.3 to 1.7 percentage points.

**The outlook for 2013 is predicated upon a sustained global recovery.** Projections for 2013 assume a continuation in the recovery of advanced economies and therefore a more substantial pick up in exports although external demand continues to contribute negatively given a further acceleration of investment growth, which involves the a pick-up in the growth of capital goods imports. Similarly, imports of consumer goods are also likely to expand. Without the drag from inventories, domestic demand contributes 6.6 percentage points to growth.

**Table 1. GDP growth is expected to slow...**

Year-on-year growth, percent			
	2011	2012	2013
GDP	5.1	4.6	5.1
Domestic demand	7.2	5.8	7.0
Final Consumption	8.9	6.8	6.3
Private sector	6.9	6.5	7.0
Public sector	16.8	7.6	4.0
GFCF	6.0	7.5	8.2
Change in Stocks	n.a.	n.a.	n.a.
External demand	-14.4	-9.6	-22.5
Exports of G&S	3.7	6.6	9.0
Imports of G&S	5.4	7.9	11.0

Source: CEIC, World Bank staff projections.

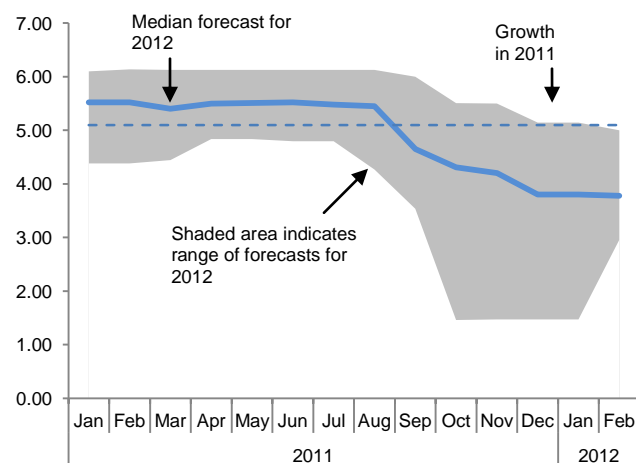
**Table 2. ... mainly due to slower growth in government consumption**

Percentage contributions to GDP growth			
	2011	2012	2013
GDP	5.1	4.6	5.1
Domestic demand	6.5	5.3	6.6
Final Consumption	5.9	4.7	4.5
Private sector	3.7	3.5	3.9
Public sector	2.2	1.1	0.6
GFCF	1.3	1.7	1.9
Change in Stocks	-0.7	-1.0	0.2
External demand	-1.4	-0.7	-1.5
Exports of G&S	4.0	7.2	9.9
Imports of G&S	-5.4	-7.9	-11.4

Source: CEIC, World Bank staff projections.

**Figure 37. Forecasts for 2012 growth have been deteriorating since August 2011...**

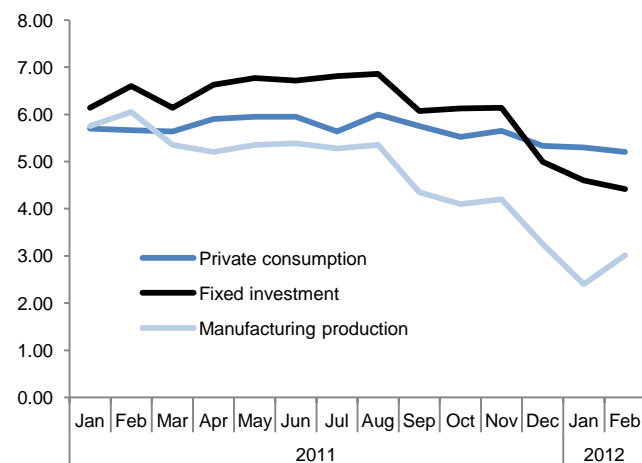
Real GDP, year-on-year growth, actual (2011) and forecasts (2012), percent



Source: Consensus Economics.

**Figure 38. ... as expectations about manufacturing and investment worsened**

Real GDP components, year-on-year growth, actual (2011) and forecasts (2012), percent



Source: Consensus Economics.

**In summary, on a year-on-year basis Malaysia is expected to register real GDP growth of 4.6 percent in 2012 and 5.1 percent in 2013.** On a sequential basis, the expectation is for growth to accelerate from 2.9 percent (annualized) in the first quarter, to 6.2 percent in the third quarter, before normalizing towards 4.8 percent into 2013, in line with the post-2008 potential output. The World Bank's forecast lies above the March median consensus forecast of 3.9 percent (Figure 37), which is based on a more bearish assessment of investment and the global recovery, affecting production (Figure 38). The new GDP growth forecasts are lower than the 4.9 percent forecast in the previous edition of the Malaysia Economic Monitor mainly due to a revision of domestic demand in light of

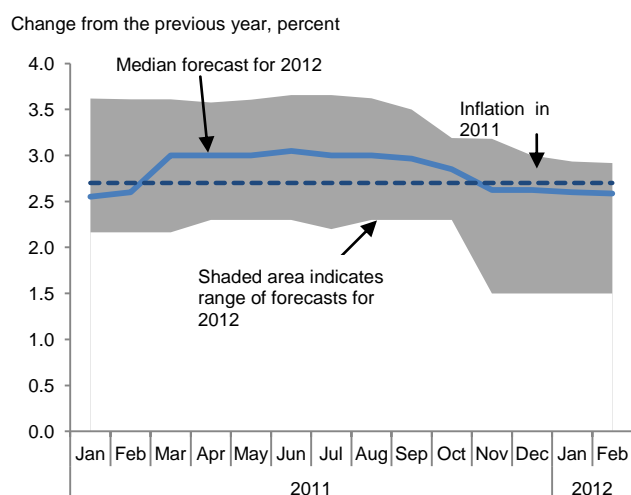


the somewhat stronger headwinds expected to affect the domestic economy (especially consumption) and higher base from the strong performance in 2011.

### Inflation to stabilize near current levels

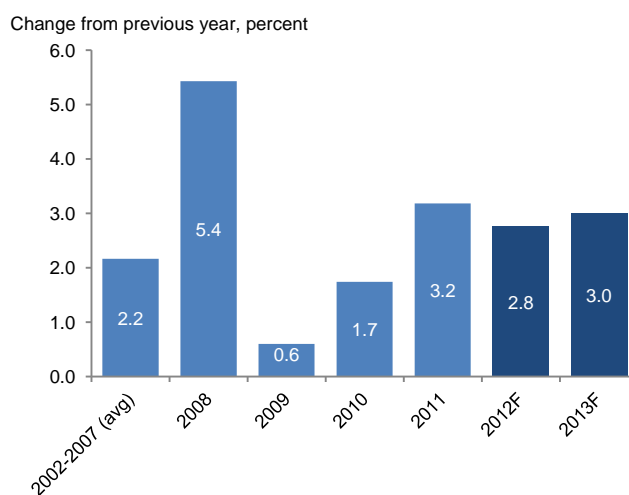
**Amid cooling commodity prices and moderate domestic growth, consumer prices are likely to increase more slowly in 2012 compared to 2011.** Malaysia's headline inflation rates are projected to come between 2.7 and 2.8 percent in 2012, virtually unchanged from our earlier forecast of 2.7 percent in the November Malaysia Economic Monitor and in line with consensus estimates for a reading of 2.6 percent (Figure 39). The producer price index, which tends to lead trends in the CPI, has started to decline more decisively in 2012, but the difference between the PPI and CPI has been relatively high, suggesting the possibility of pass-through from producer to consumer prices if the domestic economy continues to perform well. The forecast for 2012 is slightly higher compared to the average rate observed during the 2002-2007 period (2.2 percent) given the expected impact of higher wage growth (including from the introduction of the minimum wage) and firm oil prices (Figure 40).

**Figure 39. Inflation expectations declined in October as the global environment deteriorated**



Source: Consensus Economics.

**Figure 40. Inflation is expected to decelerate from 2011, but is likely to remain above the pre-crisis average**



Source: Consensus Economics and World Bank staff forecasts.

**Global commodity prices and the timing of key reforms remain the key risks to the inflation outlook.** Notwithstanding price controls and subsidies, historical experience suggests that prices in Malaysia are sensitive to large swings in global commodity prices, as was the case in 2008. Should the conflict in the Middle East escalate and global oil prices accelerate further, inflation in Malaysia would accelerate as well. Given the increased frequency of extreme weather events, the risk of supply shocks to domestic food production cannot be ignored, although the Government has adequate stockpiles of key staples such as rice. Key reforms announced by the Government are likely to have a short-term impact on inflation – namely the introduction of the minimum wage, the implementation of a goods and services tax (GST) and the rationalization of consumer price subsidies. The Government has indicated that the latter two reforms are unlikely to be implemented in 2012, whereas the former is only expected to have a modest impact on prices, already taken into account in the baseline projections. Risks to inflation are relatively balanced, however, as a new shock to global demand could lead to a sharp drop in commodity prices and domestic demand, which would lead to lower inflation.

### The current account balance is likely to narrow slightly

**The current account balance is expected to narrow slightly as imports pick up and export demand remains below par.** In light of subpar global demand and a slowdown in investment demand from China, commodity prices are unlikely to post the same gains as in 2011 even as political tensions and solid consumption demand in China may keep them from declining. Meanwhile, exports of non-commodities are likely to gain only modestly in volume terms, and price dynamics remain constrained by global excess capacity. On the other hand, imports of capital and consumer goods are expected to grow robustly in tandem with the strength of domestic demand. The income,

services and transfer accounts are expected to post a smaller deficit as a percent of GDP as Malaysia's service exports begin to slowly pick up. Therefore, although the current account is still expected to widen in nominal terms, it narrows slightly as a percentage of GDP from 11.5 percent in 2011 to 11.1 percent in 2012 (Figure 41).

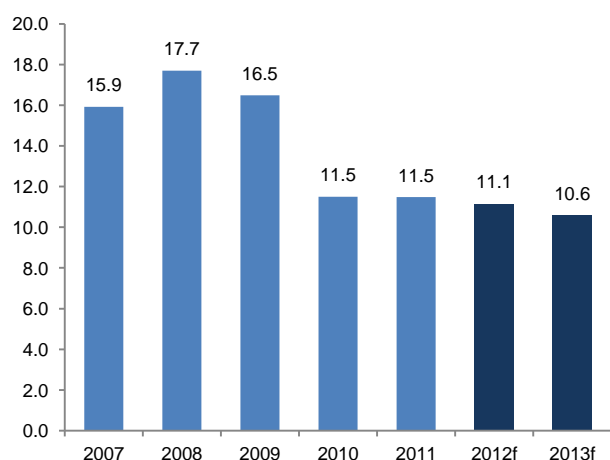
### Fiscal consolidation proceeds while monetary policy remains watchful

#### Fiscal consolidation is expected to continue in 2012 despite the recently-announced pay raises for civil servants.

Expenditures are likely to exceed the budget (and a supplementary budget is therefore likely) as the Government has recently announced pay rises for civil servants between 7 and 13 percent, replacing in the near-term the reform of civil service pay that had been proposed in the Budget 2012. In addition, as oil prices remain high, expenditures on subsidies are likely to exceed the budget as well. However, the latter category of expenditures (subsidies) is naturally hedged by higher oil-related revenues, which exceed oil-related expenditures. Moreover, administrative reforms and continued growth in gas-related revenues (which may be partly captured in corporate taxes, in addition to their contribution to oil-related revenues) are likely to lead to further increases in non-oil revenues in 2012. On balance, the Government is likely to achieve the target of reducing the deficit to 4.7 percent of GDP as proposed in the budget (Figure 42). Consolidation is expected to continue into 2013, supported by higher growth but also by the assumption that key reforms such as the introduction of GST and subsidy rationalization will go ahead.

**Figure 41. The current account is expected to remain in surplus, albeit a slowly narrowing one**

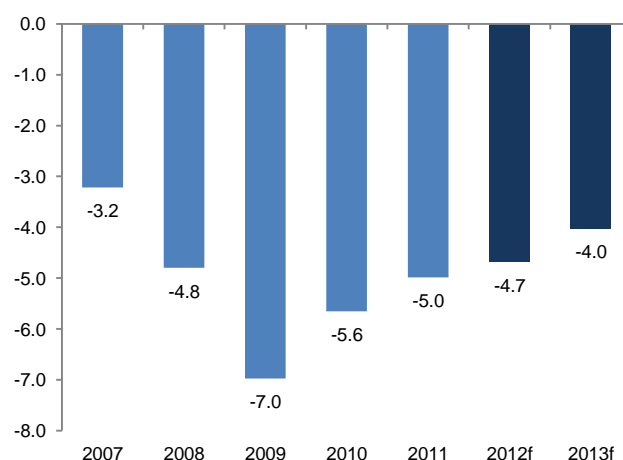
Current account balance, as a percent of GDP



Source: DOS, World Bank staff projections.

**Figure 42. Despite higher expenditures, the federal balance is expected to come in line with the budget**

Balance of the federal Government, percent of GDP



Source: MoF, World Bank Staff projections.

#### The debt-to-GDP ratio will decline modestly in 2012 and fall further in 2013—assuming consolidation efforts are maintained.

With the fiscal balance is predicted to improve in 2012 the ratio of federal debt to GDP is expected to decline slightly to 53.2 percent of GDP in 2012 from 53.5 percent of GDP in 2011. As both fiscal consolidation and economic growth pick up further steam in 2013, the federal debt is expected to fall to 52.5 percent of GDP. Therefore, short of a new shock to the economy, federal debt levels are likely to remain below the Government's stated target of 55 percent of GDP.

#### Monetary authorities remain watchful of external events.

In its March policy statement, BNM stated that viewed risks linked to the European debt crisis as partially alleviated and noted tentative signs of improvements in the US economy. The authorities remain cautious of subdued growth in advanced economies, however, and also expect Malaysia's economy to slow in 2012 compared to 2011. At the same time, while headline inflation is likely to continue its moderate descent, BNM acknowledges the potential for price shocks due to supply disruptions and the 'financialization' of commodities – which is partly a response to hedging against the risk of shocks to energy prices.

## Risks to the outlook center on the global environment

**The main risks to the outlook are external to Malaysia.** While concerns about fiscal sustainability in Europe have receded from their peak, the challenges faced by peripheral economies remain significant, especially in an environment of near-zero growth. Moreover, the signals coming from the US economy are not all positive. In February, the Case-Shiller index of home prices declined again. The US unemployment rate remains well above historical averages and there is a risk that fiscal concerns (or fiscal drag) could reemerge. Finally, there is a risk (though small) of a sharp deceleration of growth in China. A steeper decline in Chinese investments would have significant implications for commodities, as discussed in Box 2. Higher oil prices are generally beneficial to Malaysia, but a substantial escalation due to geopolitical risks may have negative consequences (see Box 3). Within Malaysia, there are some risks linked to the timing of elections, where the concerns are related to potential delays in the Government's reform agenda (and the corresponding impact on investor confidence), which is crucial for medium- and long-term prospects.

### Box 3. Will Malaysia still benefit from higher oil prices?

The price of Brent crude oil rose steadily in the first quarter, reaching USD 125 in March, up 16 percent from December levels. This raises the specter of a repeat of the price movements seen in the first half of 2008, when oil prices climbed 45 percent over six months. At that time, prices spiked due to strong oil demand amidst high economic growth, especially in emerging economies. This time around, the main drivers of rising oil prices are elevated geopolitical risks that could lead to disruptions in the key oil producing region of Middle East and North Africa. As a net oil and gas exporter, Malaysia stands out from its Asia-Pacific peers who are mostly net oil and gas importers. It is a generally held view among regional economists that Malaysia will benefit from higher oil prices from two main channels: higher exports, leading to elevated trade surplus, and higher Government revenues through the Petroleum Income Tax (PITA), royalties, export duties and dividends from PETRONAS.

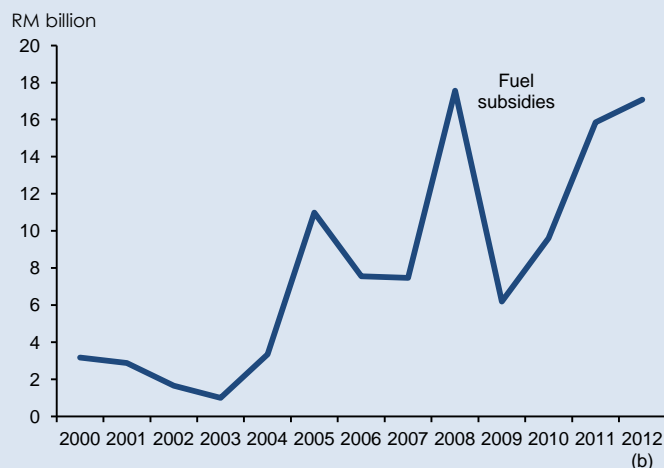
However, Malaysia's position as a net gainer from oil price increases has been increasingly challenged. First, the higher the oil price goes, the higher the subsidy burden will be on the Government's expenditures, especially with the continued use of the Automatic Pricing Mechanism in determining the retail price of RON95 petrol and diesel. The Government had committed to a capping of subsidies of these fuels to 30 sen per liter under the Subsidy Rationalization Plan announced in 2010; however, as of March 2012, the subsidies paid to RON95 and diesel are at 92 sen and 101 sen respectively, primarily because the crude oil price rise has not been passed through to the consumer. In 2008, the oil subsidy borne by the Government reached nearly RM18 billion (Figure 43). Although this was still well below the RM30 billion dividend payment paid by PETRONAS or the RM24 billion collected in petroleum income tax (PITA) later than year, the surge in the subsidy bill is likely to have posed challenges to cash flow management since the subsidy payments are monthly in frequency while the oil-related revenues are realized only once or twice a year depending on the source. This was one of the reasons for the Government's decision to move the PITA payment based on current, rather than previous year's profits<sup>a</sup>. The mismatch in oil-based revenue and expenditure also contributed to the Government in May 2008 embarking on a fuel subsidy restructuring exercise that led to a sharp 40.4 percent hike in retail fuel prices.

Second, Malaysia's oil production has been declining over the past decade, with output at only 572,845 barrels per day in 2011, the lowest since 1988. Meanwhile, consumption continues to rise (Figure 44). The lower output is due to natural depletion in existing mature fields and major issues with new oil reservoirs, particularly the deepwater Kikeh oil field offshore Sabah. Fuel subsidies have distorted incentives for domestic oil consumption, which has risen steadily to about 530,000 barrels per day in 2011, according to the US Energy Information Administration. These dynamics have led to a decline in net exports of about 43,000 bpd in 2011 from an average of 142,000 bpd between the years of 2005 and 2010 (Figure 44).

Nevertheless, steps have been taken to address the challenges on both the production and consumption sides of the equation. PETRONAS has embarked on aggressive efforts to increase domestic oil production through higher capital expenditure, mostly through developments of marginal oil fields (with attractive tax holidays offered to private oil and gas companies, both foreign and domestic) and enhanced oil recovery of existing maturing fields.

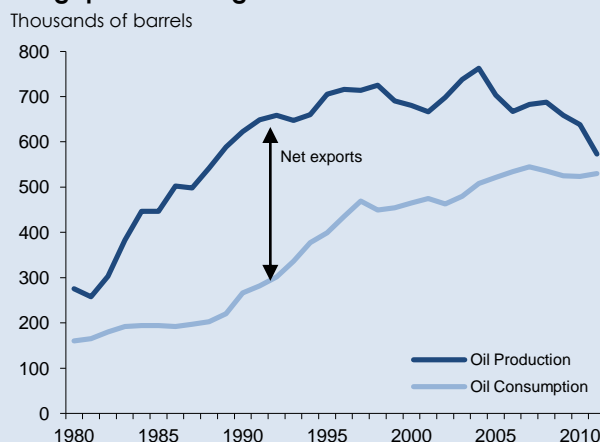
With new deepwater oil fields also coming onstream in late 2012 and 2013, oil production is expected to recover sufficiently by then. In terms of consumption, near and longer term measures to reduce vehicle mileage have been announced by the Government. The former includes the promotion of renewable energy in vehicles through a differentiated tax regime that favors the use of hybrid and electric vehicles, while the latter includes the construction of a new Mass Rapid Transit (MRT) line and extensions to the two existing Light Rail Transit (LRT) lines.

**Figure 43. Fuel subsidies paid by the Malaysian Government have increased since 2000**



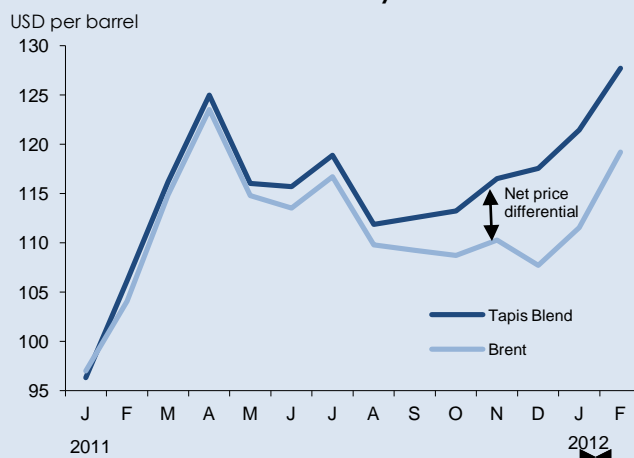
Source: MOF. Note: (b) = budget

**Figure 44. Oil production exceeds consumption but the gap is narrowing**



Source: PETRONAS & US Energy Information Administration.

**Figure 45. The net price differential between Tapis and Brent oil increased since January 2011**



Source: Thomson Reuters & Bloomberg.

Moreover, Malaysian crude oil is of the light and sweet variety (defined as having a low amount of sulfur), which continues to be in high demand. As a result, Tapis Blend, the benchmark oil grade for Malaysia, currently enjoys a premium of USD9 to 10 per barrel over Brent, as of January and February 2012 (Figure 45). This is important, for this shows that Malaysia has the unique advantage of an inherent 'double surplus' element in its oil exports ('surplus volume, surplus price' effect). Malaysia is both a net volume exporter and a net price exporter of oil, with sufficient domestic refinery capabilities. Malaysia relies mostly on cheaper imports of heavy and sour crude oil, in addition to domestic crude oil, to refine fuel for domestic consumption. This price differential helps to insulate Malaysia somewhat from an oil import price shock. As such, Malaysia is different from other oil producer nations, such as Nigeria and Iran. While these countries may have significant net exports of crude oil, due to insufficient domestic refinery capacities, they import a substantial volume of refined petroleum products such as gasoline and diesel, which leaves them more vulnerable to an oil import price shock.

Finally, the pricing of Malaysia's liquefied natural gas or LNG exports is determined by crude oil prices using the Japanese Crude Cocktail formula. This is important as LNG exports have overtaken crude oil exports in value terms since 2009, and are second only to palm oil as the biggest commodity exports in Malaysia. In 2011, LNG exports (at RM50 billion) are about 1.7 times bigger than oil exports (RM32 billion). This was due to a couple of factors, namely the rise in crude oil prices during 2011, and, most significantly, the up shift in LNG demand from Japan, Malaysia's biggest LNG buyer, following shutdowns of 52 out of its 54 nuclear plants following the Fukushima nuclear incident in March 2011. As a result, this caused a sharp rise in LNG prices to about RM2,400 per ton in January 2012 compared to RM1,530 per ton a year earlier and RM1,073 per ton on average between 2000 and 2010. Along with the higher crude oil price, and with demand from Japan likely to remain elevated amidst the continued shutdown of nuclear plants throughout 2012, the rise in LNG prices will help support Malaysia's exports and trade surplus.

Therefore, a medium-term trend of firm or rising oil prices is likely to benefit Malaysia overall. Nevertheless, as a small, open economy, Malaysia's non-commodity exports (which are still the bulk of the country's exports) leave the country highly exposed to risks to global growth should oil prices reach high and unsustainable levels (see Box 1). As oil prices moved beyond USD140 per barrel in mid-2008, this caused the phenomenon of 'demand destruction,' a sharp reduction in consumption in the major advanced economies, which are mostly net oil importers. In addition, as noted earlier, the benefits of higher oil price do not preclude stress to the Government's cash flows; this may exacerbate the pressure to implement further subsidy rationalization as seen in 2008. If retail fuel prices are allowed to increase, this will have a direct impact on cost-push inflation, with the resultant worries over second-round wage-price spiral effects, and, inevitably, lower growth, especially if accompanied by a slowdown in global demand. Thus, managing the sensitivity of rising oil price to the domestic economy in 2012 may be just as challenging for oil-exporting Malaysia as it is for the rest of Asia and the world as a whole.

Note: a. The main reason for changing the timing of the PITA assessment was to standardize the tax system and align PITA with corporate and individual income taxes.

## The medium-term outlook hinges on the implementation of structural reforms

**Implementation of structural reforms lies at the core of Malaysia's economic transformation and medium-term prospects.** Malaysia has embarked on a series of reform efforts with the overall goal of transforming its economy towards a high-income, inclusive and sustainable nation by 2020. The New Economic Model (NEM) identifies a set of structural reforms to achieve these goals—which the NEM suggests should be “at the core of the ETP [Economic Transformation Programme]” (NEM, p. 116). The implementation of the NEM has taken an innovative approach to combine projects with the structural reforms, which were grouped under six Strategic Reform Initiatives (SRIs). While the projects can catalyze economic transformation with targeted, strategic investments, the 'core' of economic transformation remains the reforms that are needed to lock in the progress in creating an enabling environment conducive to higher productivity and private sector-led growth. Similarly, while the Government Transformation Programme (GTP) aims to make improvements in a number of critical areas, these initiatives may be best viewed as providing valuable support to the broader structural reform agenda rather than as ends in themselves.

**Notable progress has been made, especially in the GTP's National Key Results Areas (NKRAs).** The progress on crime reduction has been solidified, with indices declining and trust in the police increasing. There were also improvements delivered through better management at the municipal level, for example public transport and public infrastructure in Kuala Lumpur. Achievements in pre-school enrollment and rural infrastructure were also significant. On education, an important development has been the ranking all schools according to student performance. PEMANDU is working to improve the poor performers, though publishing the schools' rankings (even within broad bands) would help increase accountability and accelerate improvements. On the SRIs, there have been encouraging announcements with respect to international standards and the liberalization of services sectors. Divestments from GLCs are going ahead, most prominently with the recent sale of the national-car-maker Proton to a private sector investor. The competition law has been in effect since January 1, and while it is still too soon to assess its impact, increasing competition in the economy will be critical to economic transformation.

**Structural reform needs to go beyond 'quick wins.'** Structural reforms are by their nature more time-consuming, as they require greater efforts to build consensus. Therefore, while the progress registered in GTP objectives is laudable, Malaysia needs to look beyond the narrow targets of the NKRAs and integrate them in a renewed focus on implementing the more difficult, but potentially more rewarding, structural reforms identified in the NEM. For instance, while NEM Part 1 included a recommendation to "review the education system – shift educational approach from 'rote-learning' to 'creative and critical thinking'" (NEM, p. 123), this critical reform is only implicitly included in the GTP and ETP. Although the report from the National Education System Evaluation Panel, which was set up in December 2011, is due to be completed this year, it remains to be seen whether the Panel's recommendations will fall under the ambit of the ETP or the GTP, which would ensure more effective implementation and follow-through.

**Reforms need to be seen as a package; partial implementation will lead to less-than-partial results.** For example, as one of the members of the international review panel of the ETP noted, "It is very difficult for Malaysia to achieve the target share of public transport in overall transport while the current structure for the subsidy of petroleum continues to exist" (ETP Annual Report 2011, p. 248). Another example, discussed in greater detail below, is ensuring the consistency of significant investments in commodities<sup>8</sup>, reduced subsidies, and higher wages with maintaining Malaysia's competitiveness in tradable sectors—in other words, avoiding 'Dutch disease'. Without the higher productivity from a more skilled labor force and a competitive business environment, higher wages could result in higher costs. Finally, improving education and the supply of skills will not suffice without parallel reforms to create a vibrant private sector that demands, and rewards, talent. These examples illustrate the broader point that the reform agenda needs to make steady progress on all fronts, lest it become less than the sum of its parts.

**In sum, there is momentum to structural reforms, but a steady focus on implementation should be maintained.** In that regard, the message from the ETP Annual Report for 2012 is encouraging: "[2012 is a year] where we must follow through on our existing programme and execute, execute, execute" (ETP Annual Report 2011, p. 16). Implementation can be assisted by increasing the coordination of related reform efforts (for example on safety nets), building capacity within the civil service to lead reforms, and continuing to build consensus around major reforms such as educational reform, subsidy rationalization and the introduction of the goods and services tax.

### **The Government Transformation Programme continues to show progress**

**The Government Transformation Programme has made significant strides.** Among the six National Key Results Areas (NKRAs) for which 2011 targets were set (a seventh NKRA on cost of living was introduced early in 2011), targets were generally met or exceeded. All targets were met with respect to reducing crime and extending rural infrastructure (Table 4). Notable improvements are higher public satisfaction with the Royal Police Malaysia. Moreover, a quarter more rural households than targeted now have access to clean water, as well as welcome developments in education with respect to pre-school enrollments and quality improvements.

**A new cost of living NKRA focuses on cash transfers and discounted supply outlets targeted at low income earners.** The initiatives under the new cost of living NKRA can be grouped into three categories. First, a number of discounted supply outlets targeted at low income earners will be created. Second, a number of cash transfer schemes were proposed with the 2012 budget. Notably, a total of RM1.92 billion was distributed to 3.8 million households through early March under the BR1M scheme and final figures are likely to be higher as some households that were denied the benefit are appealing and others had until the end of March to file. The outcome exceeded the target of 3.4 million beneficiaries (and the budget of RM1.8 billion). Finally, two special funds were created to assist fishermen and support small holders. While these initiatives are welcome, they risk becoming fragmented efforts unless they are placed under a broader framework for modernization of social safety nets.

**As the absolute poverty is low, the policy focus on low income households has shifted towards households at the bottom forty percent of the income distribution.** The incidence of general poverty and hard core poverty has been reduced, respectively, to 3.8 percent and 0.7 percent in 2009. Following up on programs to eradicate hard core

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<sup>8</sup> Over 40 percent of the total expected GNI contribution from EPPs comes from commodity-related sectors (oil, gas, energy, palm oil and rubber).



poverty under the NKRA on low income households (LIH), a comprehensive blueprint is being developed to increase income and raise the living standards of the bottom 40 percent of households. As with the NKRA on cost of living, the shift of focus to relative rather than absolute poverty is welcome, however it needs to be inserted into a broader framework for modernization of social safety nets towards a more comprehensive system with a robust targeting mechanism. As of 2009, data from the household income survey suggests that only 27 percent of the bottom 10 percent of the income distribution received assistance through social programs. Although the LIH NKRA is likely to have improved these figures, the lack of a robust targeting mechanism remains a major obstacle.

**The Government faced challenges to achieve its targets in some areas.** In its anti-corruption drive, the Government aimed to close 70 per cent of corruption trials within one year but achieved 59 per cent. In addition, Malaysia declined to 60<sup>th</sup> place in Transparency International's rankings of corruption perceptions. The 21 per cent target for public transport modal share was also missed, hitting only 15 per cent, as growth of private transport usage outstripped the growth of public transport ridership.

**Table 3. Many of the 2011 targets for the GTP have been achieved**

NKRA	Measure	Target	Actual
<b>Cost of Living</b>	<i>Supply outlets targeted at low-income earners</i> Development of Kedai Rakyat 1Malaysia (KR1M) Menu Rakyat 1Malaysia Klinik 1Malaysia		
	<i>Cash transfers</i> Incentives for taxi drivers Cash assistance of RM 500 for households with income of RM 3,000 and below RM 100 cash assistance for school children from Year 1 to Form 5 nationwide. RM 100-200 book voucher to all Malaysian students 1Malaysia Rakyat's Welfare Programme (KARISMA)	3.4 mn beneficiaries	more than 3.8 mn
	<i>Special Funds</i> Special Housing Fund Commercial Agro Fund		
<b>Crime</b>	Index crime	5 percent	11.1 percent
	Street crime	40 percent	39.7 percent
	Fear of Crime Index	50 percent	52.9 percent
	Arrest cases brought to trial	20 percent	23.4 percent
	Public Satisfaction with police	60 percent	70.5 percent
<b>Corruption</b>	EPPs under Corporate Integrity Pledge	70 percent	64 percent
	Ministries scoring above 90% in Procurement Accountability Index	19	18
	Number of arrest cases brought to trial	20 percent	23.4 percent
	Number of people in the database of convicted offenders	100	496
	Number of summons issued vs. Total hours of operation (PDRM Traffic)	12	12.41
	Number of summons settled vs. number of summons issued by JPJ	60 percent	49 percent
	Transparency International (TI) Corruption Perception Index	4.9	4.3
	TI Global Corruption Barometer survey	50 percent	49 percent
	Government contracts under Integrity Pact	80 percent	77 percent
	Trials completed within one year	70 percent	59 percent
	TNS perception survey on how much enforcement agencies are perceived to be affected by corruption	3.5	2.9
	Produce a clear procedure for effective implementation of Whistle Blower Act and begin the process of reporting actual numbers of whistle blower cases	n.a.	implemented
	Completion of compliance unit activities	60 percent	99 percent
<b>Rural basic Infrastructure</b>	Km of rural roads	905.12	1,013
	Number of rural houses with clean water supply	58,087	73,227
	Number of rural houses with electricity supply	26,882	27,004
	Housing delivery (number of units)	9,146	14,365
<b>Urban public Transport</b>	Increase modal share	17 percent	16 percent
	Population within 400m of public transport route	70 percent	67 percent
	Customer satisfaction survey	50 percent	53 percent
	Bus peak hour load factor	56 percent	96 percent
	Reduce KTM Komuter load factor	125 percent	105 percent
	Rapid KL Kelana Jaya line load factor	80 percent	80 percent

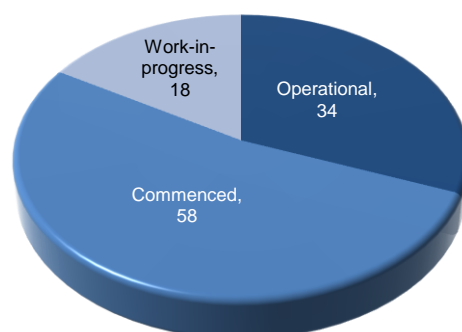
<b>Urban public Transport (cont.)</b>	AM peak public transport ridership	346,184	321,487
	Reduce weighted average ratio of public journey time to private journey time	1.70:1	1.49:1
	Road Safety (deaths per 10,000 vehicles)	3.12	3.21
<b>Low income households</b>	Number of households in 1AZAM	57,793	63,147
	Backlog cases verified under eKasih	100 percent	96 percent
	To train and develop women entrepreneurs	n.a.	n.a.
	Number of low-cost houses handed over	4,965	4,865
<b>Improving student outcomes</b>	LINUS Numeracy rate (Cohort 1=Primary 2)	95 percent	97.5 percent
	LINUS Literacy rate (Cohort 1=Primary 2)	95 percent	99 percent
	LINUS Numeracy rate (Cohort 2=Primary 1)	90 percent	91 percent
	LINUS Literacy rate (Cohort 2=Primary 1)	90 percent	95 percent
	Number of Higher Performing Schools	50	52
	Pre-school enrollment rate	80 percent	77 percent
	New Deals—Primary school principals exceeding target	3 percent	5 percent
	New Deals—Secondary school principals exceeding target	2 percent	4 percent
	New Deals—Primary school principals performing below target	8 percent	1.17 percent
	New Deals—Secondary school principals performing below target	10 percent	10.89 percent
	Increase Band 1 and 2 schools	8 percent	22 percent
	Reduce Band 6 and 7 schools	20 percent	40 percent

Source: PEMANDU.

### The ETP has performed better on investments than structural reforms

**The ETP continues to make progress with respect to investments.** Between October 2010 and December 2011 72 Entry Point Projects (EPPs) were announced. These EPPs are divided into a total of 110 sub-projects of which 92 have commenced or are already operational (Figure 46). Within the ETP framework, in 2011, RM 179 billion of investments were committed against the 10-year target of RM 1,700 billion (10.5 percent) while 313,741 jobs are projected to be created, against the 10-year target of 3.3 million (9.5 per cent). Figures on realized investments and job creation are not readily available, and it is challenging to link firm-level investments in the EPPs to national account aggregates. Nevertheless, progress on the ground is visible both large and small: from the recently-opened RM150 million Johor Outlets to the TUKAR program, which helped 519 'mom-and-pop' shops increase their productivity through capacity building and technology upgrades.

**Figure 46. A third of ETP projects are operational**  
Number of projects



Source: PEMANDU.

**Incremental achievements on some SRI's were made, but implementation is only slowly gaining momentum.** The competition law has gone into effect, and high profile divestments have taken place (e.g. Proton) or are expected shortly (e.g. Felda Global Ventures). PEMUDAH continues to make impressive strides to improve the business environment by reducing the number of permits. There was progress – if not yet full implementation in other areas. With regard to the SRI on standards, amendments have been made to the Standards Act to allow the establishment of multiple standard development agencies to accelerate the adoption of international standards. A minimum wage, part of the SRI on human capital, is expected to be announced in the first half of 2012. The



liberalization of 17 services sectors has started and is expected to be fully implemented by the end of 2012. This could be a key reform to attract new investments and increase competition in the economy in the medium-term, but implementation details will be critical such as ensuring sustainability of the reform momentum, coherence with domestic regulations and coordination with bilateral and multilateral liberalization efforts (Box 4). On the other hand, important reforms such as the introduction of the GST and the rationalization of subsidies have been postponed (and indeed subsidies to sugar were increased in January), and implementation of comprehensive reforms in the educational sector, while under study and debate, has yet to commence.

**Table 4. Progress on SRIs has been incremental**

SRI	MAIN POLICIES	WHAT HAS BEEN ACHIEVED	EXPECTED OUTCOMES
<b>Competition, Standards &amp; Liberalization</b>	Competition Act 2010	<ul style="list-style-type: none"> <li>Malaysia Competition Commission set up in April 2011</li> <li>Law came into force on 1 January 2012</li> </ul>	<ul style="list-style-type: none"> <li>Prevent anti-competitive agreements &amp; abuse of dominant position or monopoly</li> </ul>
	Multiple standard development agencies	<ul style="list-style-type: none"> <li>Amendment to Standards Act to enable appointment of multiple standard development agencies has been gazetted on 9 February 2012</li> </ul>	<ul style="list-style-type: none"> <li>Reduction of timelines for adoption of international standards (6-9 months vs. 1 year) &amp; development of local standards (1-1.5 years vs 3 years)</li> </ul>
	Services sectors liberalization	<ul style="list-style-type: none"> <li>Seven sectors were effectively liberalized since 1 January 2012: (i) courier services; (ii – iii) technical &amp; vocational secondary education (incl. for children w/ special needs); (iv) skills training services; (v) department &amp; specialty stores; (vi) incineration services; and (vii) accounting and taxation services</li> </ul>	<ul style="list-style-type: none"> <li>Up to 100 percent foreign equity participation will be allowed in phases during 2012 for remaining 10 sectors</li> <li>Sectors include teaching hospitals; telecommunication services (2 sub-sectors); international schools; private hospital services; stand-alone specialized medical &amp; dental clinics (2 sub-sectors); architectural, engineering and legal services</li> </ul>
<b>Public Finance</b>	Accrual accounting	<ul style="list-style-type: none"> <li>New accounting policies have been drafted</li> </ul>	<ul style="list-style-type: none"> <li>Proposed policies will be tabled to the Accrual Accounting Steering Committee for approval in 2012</li> </ul>
	Transparent procurement	<ul style="list-style-type: none"> <li>E-bidding's original threshold value was reduced from RM200,000 to RM50,000 for the procurement of goods and services and implemented in April 2011; savings estimated at RM 25mn in 2011</li> </ul>	<ul style="list-style-type: none"> <li>Value Management (VM) for OE Procurements: Est. savings of RM296 million in 2012</li> </ul>
	Rationalization of incentives		<ul style="list-style-type: none"> <li>Review of the Promotion of Investments Act targeted to be tabled to Parliament in the 3<sup>rd</sup> quarter of 2012</li> </ul>
	Improve Tax Collection	<ul style="list-style-type: none"> <li>Enhancement of audits &amp; enforcement implemented in the second half of 2011. Estimated additional revenue of RM 67 mn</li> </ul>	<ul style="list-style-type: none"> <li>Targeted additional revenue in 2012 of RM 1.9bn</li> </ul>
	Implementation of GST		<ul style="list-style-type: none"> <li>Government remains committed to implementing GST at appropriate time</li> </ul>
	Expenditure control		
<b>Public Service Delivery</b>	Business Process Reengineering	<ul style="list-style-type: none"> <li>405 of 761 business licenses identified to be abolished</li> </ul>	<ul style="list-style-type: none"> <li>Identified licenses abolished by June 2012</li> <li>272 licenses simplified and incorporated into an online system</li> </ul>
	Real-time performance monitoring & counter rating system	<ul style="list-style-type: none"> <li>Counter rating system implemented in 82 police stations in Selangor</li> </ul>	<ul style="list-style-type: none"> <li>Tender for Real Time Performance Monitoring System in October 2011, with pilot in five agencies to be launched in Q2 2012</li> </ul>
	Increase the talent pool in the civil service		<ul style="list-style-type: none"> <li>The Government intends to implement open recruitment for senior and middle management posts</li> <li>Enhance portability characteristics of current pension scheme</li> </ul>

<b>Human Capital Development</b>	Modernize labor legislation	<ul style="list-style-type: none"> <li>Phase I of amendments to Employment Act 1955 passed in Parliament in Dec 2011 including 28 amendments to the current provisions, 17 new provisions, 2 provisions repealed</li> <li>National Wage Consultative Council (NWCC) set up in September 2011 pursuant to the National Wage Consultative Council Bill passed in Parliament July 2011</li> </ul>	<ul style="list-style-type: none"> <li>To be tabled in Parliament: Minimum Retirement Age; Industrial Relations Act; Private Employment Agencies Act</li> <li>Minimum wage to be endorsed by Cabinet and announced in the first half of 2012</li> </ul>
	Upskilling, reskilling and upgrading the workforce	<ul style="list-style-type: none"> <li>National Occupational Skills Standards (NOSS) for TVET Curriculum in O&amp;G launched</li> <li>Pilot batch of eco-nature guide training programs</li> <li>NTEP launched covering 5 states/regions and 550 placements across Malaysia</li> <li>MyProCert program launched October 2011 for business services &amp; CCI</li> <li>E&amp;E PSD Fastrack attracted 104 apprentices with 101 of them recruited</li> </ul>	<ul style="list-style-type: none"> <li>"Train the Trainer" program in solar installation</li> <li>Recommendations to enhance as well as standardize the eco-nature guide curriculum will be announced and implemented in 2012.</li> <li>NTEP will expand to seven regions with 650 placements across Malaysia</li> <li>MyProCert targets to produce 5000 new certified professionals by 2014</li> <li>MyUniAlliance aims to upskill at least 12,000 undergraduates by 2015</li> </ul>
	Strengthen human resource management	<ul style="list-style-type: none"> <li>National Human Resources Centre (NHRC) launched</li> </ul>	
	Leverage on women's talent to increase productivity		<ul style="list-style-type: none"> <li>Legalize and set-up 800 childcare centers and train up to 4,000 childcare minders</li> <li>Re-train 280 women who wish to re-enter the workforce</li> <li>200 corporate women who will be trained in 2012 to be ready for promotion into Board of Directors level</li> </ul>
	Undertake a labor market forecast and survey program	<ul style="list-style-type: none"> <li>The Institute of Labour Market Information and Analysis (ILMIA) was set-up to provide comprehensive and timely labor market information</li> </ul>	<ul style="list-style-type: none"> <li>Labour market analysis reports for two NKEA sectors (E&amp;E and Oil &amp; Gas) to be produced</li> </ul>
	Enhance labor safety net by introducing unemployment insurance	<ul style="list-style-type: none"> <li>MOHR has appointed the ILO to undertake a comprehensive study and to propose recommendations on the design of the UIS</li> </ul>	<ul style="list-style-type: none"> <li>2012: completion of the study;</li> <li>2013: implementation of UIS</li> </ul>
<b>Government's Role in Business</b>	Divestment from GLCs through listing, paring down of stakes or outright sale	<ul style="list-style-type: none"> <li>11 divestments have been completed in 2011 and 1 in 2012</li> <li>High profile divestments include PLUS, EON Capital, Pharmaniaga, Felda and Proton</li> </ul>	<ul style="list-style-type: none"> <li>Additional 12 targeted for completion in 2012 and remaining nine in 2013.</li> </ul>
<b>Narrowing Disparity</b>	<p>Market friendly, transparent, needs and merit-based programs to support Bumiputera SMEs</p> <p>Capacity building programs provided to Bumiputera as well as non-Bumiputera SMEs with a focus on building talent, identifying new technologies and enhancing collaboration</p>	<ul style="list-style-type: none"> <li>Bumiputera Economic Transformation Programme (BETP) launched</li> <li>Setting up of TERAJU, which will lead the BETP and drive Bumiputera participation through new and existing initiatives</li> <li>Setting up of TERAS a program to increase Bumiputera SMEs' participation in the economy</li> </ul>	<ul style="list-style-type: none"> <li>Bumi SMEs to contribute 20 percent of national GDP by 2020 (from current 13 percent)</li> <li>30 SMEs have been selected to undergo the TERAS Program, with an additional 170 companies are currently being evaluated by the independent selection panel</li> </ul>

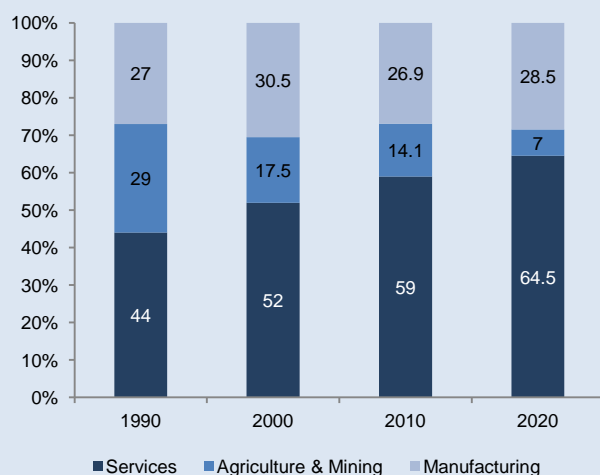
Source: PEMANDU.

#### Box 4. Liberalization of services sectors in context of broader trade liberalization in Malaysia

Transforming Malaysia into a high-income economy by 2020 requires diversifying sources of growth towards greater reliance on the services sectors. This is for two reasons. First, the manufacturing sector needs to shift the source of its comparative strength from high-volume and low-cost to unique value, which will require transitioning to more skill-intensive tasks in the production process. Efficient services are not only drivers of economic growth on their own but are also critical for the transformation of manufacturing and primary sectors. Second, with the emergence of new manufacturing hubs such as Vietnam and Indonesia, Malaysia needs to deepen the diversification of its export structure and in this respect the services sectors offer promising opportunities. Accordingly, the Third Industrial Master Plan anticipates that services will represent over 65 percent by 2020 (Figure 47) and the sector has been receiving increasing interest from investors. During 2011 the services sector captured RM 64.4 billion or 43.3 percent of total approved investments, followed by manufacturing (37.8 percent). In contrast with the latter, investment in services originated mostly from domestic sources (74.8 percent).

**Figure 47. Services increasingly constitute the backbone of the Malaysian economy**

Percentage share to GDP by sector

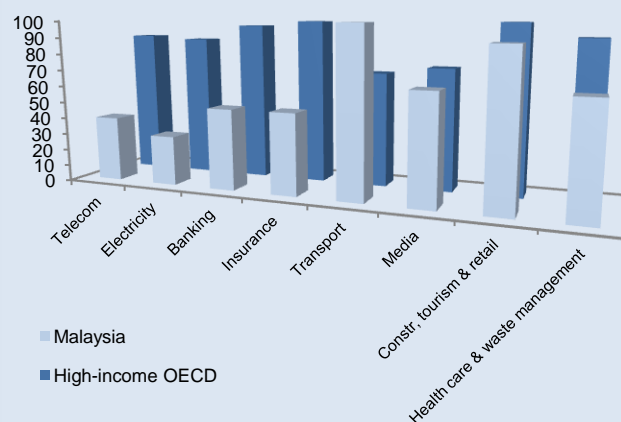


Source: MITI Weekly Bulletin (various issues). Ministry of Finance Economic Report (various issues). Department of Statistics. Estimates for 2020 from Third Industrial Master Plan.

Notes: Services includes Government and construction services.

**Figure 48. Services are more protected in Malaysia compared to high-income OECD economies**

Foreign equity ownership indexes (100 = full foreign ownership allowed)



Source: World Bank *Investing Across Borders*.

The services sectors in Malaysia have grown to cover a wide range of economic activities, some increasingly internationalized and sophisticated (e.g. logistics, banking, consulting, telecommunications, etc.) that have been radically transformed by advances in technology. Development of a variety of strong services subsectors involves the existence of adequate physical infrastructure and human capital but also the reduction of barriers to investment and trade, and the strengthening of domestic regulatory frameworks. Gradual exposure of incumbent domestic providers to domestic and foreign competition fosters their productivity. In addition to new capital, relaxation of restrictions in foreign ownership is likely to result in efficiency and technology gains. In this line, Malaysia has a relatively liberal FDI regime in most manufacturing industries but foreign participation in services has traditionally been more restrictive (Figure 48). In addition, Malaysia's Government-linked companies (GLCs) continue to have an important presence in some services subsectors.

As part of its economic transformation initiatives, Malaysia has committed to further liberalization of its services sectors to increase competitiveness. Malaysia has had a generally protected services sector, restricting commercial presence for foreign firms and practice by foreign professionals. For most subsectors, foreign firms could only

operate in partnership with local companies but without exceeding 30 percent of total equity. In addition, in most cases, at least 30 percent of the issued and paid-up capital upon listing had to be held by Bumiputera. In 2009, the Government eliminated foreign equity restrictions on 27 services subsectors—including healthcare and social services, tourism, transport, business services and computer-related services—and relaxed barriers and issued new licenses for foreign financial firms. In late 2011, the Government unveiled plans for the liberalization of 17 more subsectors during 2012. This new liberalization round will allow full foreign control in selected subsectors in healthcare, education and training, telecommunications, department and specialty stores and certain professional services (see Table 4 above).

Since 2010, trade in goods has been liberalized among the largest ASEAN economies, but services are lagging. A commercial presence in one ASEAN country does not automatically allow providers to supply their services to other ASEAN members. In 1995, ASEAN countries adopted the ASEAN Framework Agreement on Services (AFAS) that established a schedule for liberalization beyond national commitments under the General Agreement on Trade in Services (GATS). ASEAN accorded to progressively eliminate all barriers for cross-border supply of services and consumption abroad, raise the foreign equity ceiling for commercial presence and improve the movement of natural persons. Up to now, ASEAN Economic Ministers have signed eight liberalization packages covering construction, telecommunications, business services, financial services, air and maritime transport, and tourism. As part of AFAS, Malaysia has already made commitments in 96 services subsectors. ASEAN members have also been negotiating mutual recognition arrangements (MRAs) for qualifications in selected professional services. In 2007, ASEAN members endorsed a blueprint for the establishment of the ASEAN Economic Community (AEC) with the goal of achieving regional economic integration by 2015, including free flow of services. While there has been significant progress, liberalization of services within ASEAN lags behind liberalization of goods trade.

Some liberalization has taken place in the context of other FTA negotiations. As of February 2012, Malaysia has implemented five bilateral Free Trade Agreements (FTAs) and is part of five ASEAN+ regional FTAs. Most of these FTAs contain chapters covering trade in services as well as MRAs for academic and professional qualifications. Concessions on services included in most FTAs have been, however, limited. In the Malaysia-Pakistan FTA, Pakistan offered Malaysian firms up to 60 percent of equity participation in all services subsectors and lifted all restrictions to the employment of Malaysian professionals. On the other hand, Malaysia granted Pakistani services firms the possibility of full ownership in information and communication technology (ICT) and Islamic financial services. The FTA with New Zealand grants Malaysian firms easier access for the provision engineering, environmental and ICT-related services in that country. Meantime, the Malaysia-Japan FTA exchanges concessions in several services—including financial—and offers Japanese cooperation for the development of Malaysia's manufacturing- and ICT-related services. Commitments to facilitate trade in services, including movement of natural persons, are also part of the Malaysia-India FTA. The FTA with Chile entered into effect in February 2012 for trade in goods and mandates that negotiations on services and investment liberalization should start within two years. Provisions in services are also part of ongoing FTA negotiations with Australia, the European Union, and members of the Trans Pacific Partnership group. Under ASEAN+ FTAs, Malaysia has offered commitments beyond GATS in selected subsectors including business, ICT, telecommunications, distribution, educational, tourism, transport and financial services.

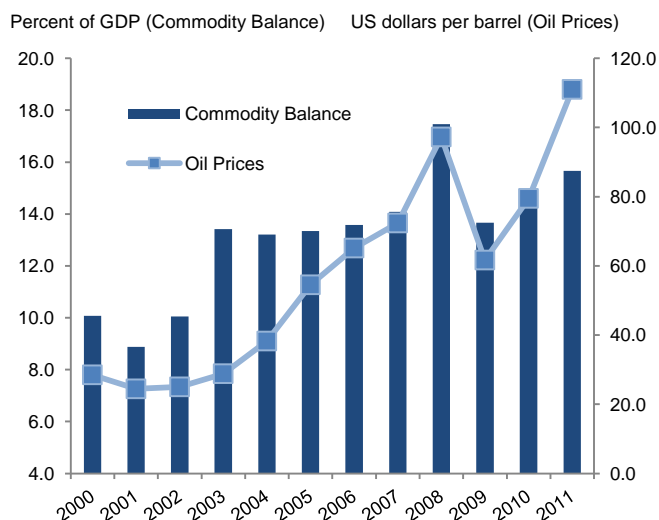
Liberalization efforts in services in Malaysia have generally been undertaken unilaterally and have proceeded at varying speeds across sectors. The rationale for the deliberate and variable pace of liberalization is to prepare the domestic private sector and allow them time to build capacity before the signature of legally-binding external agreements. Upcoming liberalization during 2012 in legal, courier, accounting and taxation services will help reduce business costs across the economy, but the varying speed of liberalization across sectors may reduce the potential for reaping vertical (through segments in a production/distribution value chain) and horizontal (across subsectors) synergies emanating from services reforms. At the same time, sectoral- or firm-level productivity gains in liberalized segments of a value chain (e.g. manufacturing) could be eventually reduced or neutralized by inefficiencies in protected segments.

Contributed by A. Postigo

## Economic transformation must boost productivity to prevent ‘Dutch Disease’

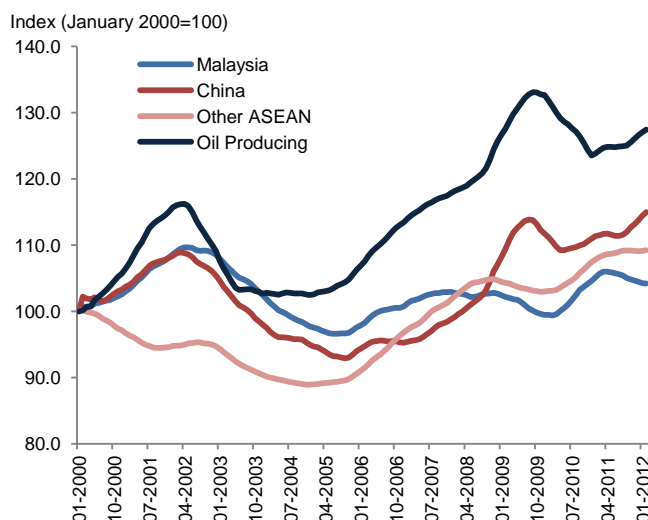
In the face of escalating commodity prices in the 2000s, Malaysia implemented what has in practice amounted to a very successful strategy to avert so-called ‘Dutch Disease.’<sup>9</sup> Oil prices increased significantly from an average of USD 29 per barrel in 2000 to USD 80 per barrel in 2010. The prices of other key commodities such as palm oil and rubber have also increased significantly in the meantime. This has resulted in Malaysia's commodity balance (the amount of commodity exports less commodity imports, except food), to increase from 10 percent of GDP in 2000 to 14 percent of GDP in 2010 (Figure 49). Such an increase in flows from commodity revenues brings the risk of so-called ‘Dutch Disease,’ whereby higher supply of foreign currency leads to some combination of nominal exchange rate appreciation and higher inflation, causing an appreciation in the real effective exchange rate. This, in turn, affects the competitiveness of the tradable sectors (such as manufacturing). Since tradable sectors tend to have higher productivity growth compared to non-tradable sectors, the result can be a deceleration of potential non-resource output. However, while some evidence of Dutch Disease is visible in a composite of oil-exporting countries, the real effective exchange rate in Malaysia has moved in line with its peers that are net commodity importers (Figure 50). As a result, Malaysian manufacturing remained competitive and performed in line with its peers through most of the 2000s (Figure 51).

**Figure 49. The commodity balance has increased as a percent of GDP**



Source: CEIC.

**Figure 50. The real effective exchange rate has appreciated in line with other currencies in the region**



Source: BIS and World Bank staff calculations.

Note: "Oil producing" includes Russia, Saudi Arabia, UAE and Venezuela

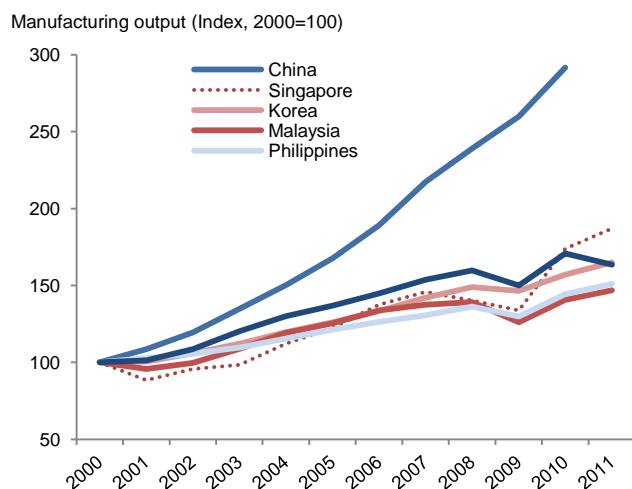
**On the external side, a key piece of Malaysia's strategy was an increase in direct investments abroad by Government-Linked Companies.** Despite the high current account balances and a floating exchange rate, as Figure 52 shows, the nominal exchange rate has remained fairly stable over time. A key factor in driving exchange rate stability has been the balancing effect of higher overseas investments of Malaysian companies. Starting in the 1990s, PETRONAS started re-investing some of its earnings overseas. Globally, PETRONAS has investments in pipeline operations in Argentina, Australia, Indonesia and Thailand, as well as gas storage and LNG regasification facilities in Europe (Petronas Annual Report 2011). This trend was intensified in the 2000s, when PETRONAS was joined by other GLCs such as Sime Darby, Maybank, CIMB, and Telekom Malaysia in making large overseas investments, partly as a result of the GLC Transformation Programme. As a result, FDI by Malaysian firms increased from about 1.2 percent of GDP in 2000-2001 to 5.5 percent of GDP in 2006-2008.<sup>10</sup> The increase in outflows of 4.3 percentage points of GDP

<sup>9</sup> Back in the 1980s Malaysia already had in place a National Depletion Policy to avoid the 'Dutch Disease.' The main objectives and strategies of National Depletion Policy are: (i) to safeguard the depleting oil reserves; and (ii) to limit the total of production of crude oil.

<sup>10</sup> Despite a decline since the global financial crisis, as of 2011, Malaysian investments abroad on mining and financial services totaled RM25.3 billion and RM23 billion respectively. With CIMB's recent expansion into the Philippines and Maybank's acquisition of Kim Eng Holdings, Malaysian banks now have a presence in 14 markets around the world.

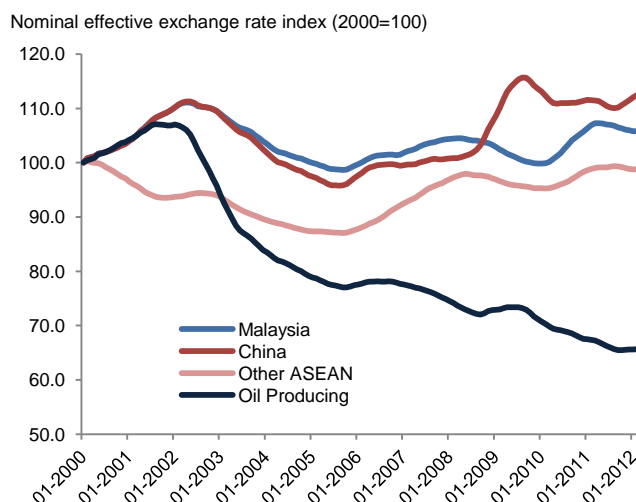
partially offset an increase in a 5.6 percentage points in the commodity balance during the same period (Figure 53). As GLCs moved to invest overseas, however, they imported less capital goods into Malaysia, which led to an increase in the non-commodity balance.

**Figure 51. Manufacturing output also moved in line with regional peers in the 2000s**



Source: CEIC and World Bank staff calculations.

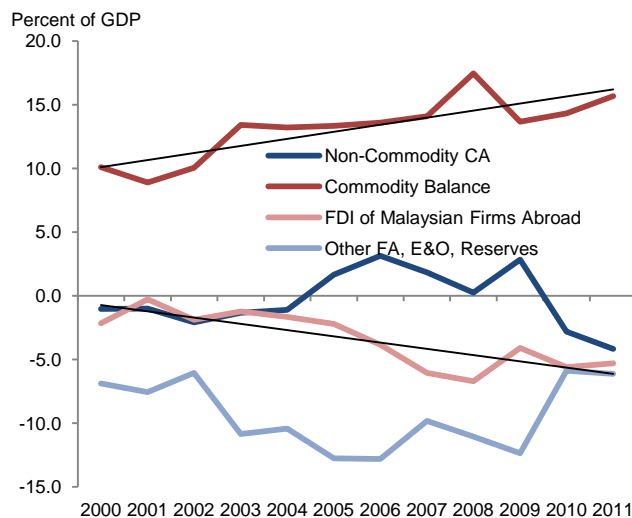
**Figure 52. The nominal exchange rate was similarly stable**



Source: BIS and World Bank staff calculations.

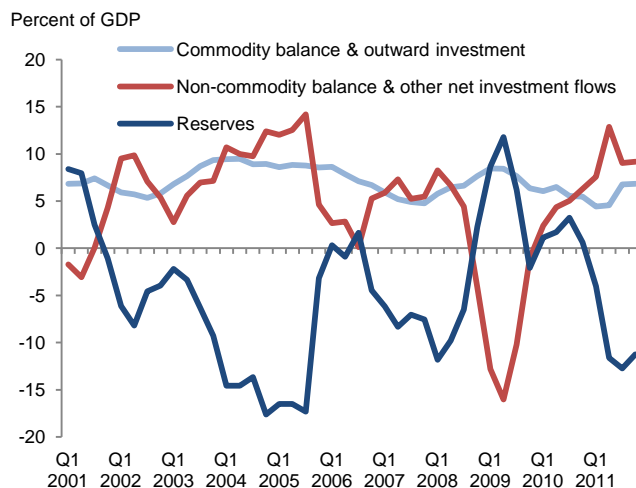
Note: "Oil producing" includes Russia, Saudi Arabia, UAE and Venezuela

**Figure 53. An increase in the commodity balance was followed by an increase in FDI from Malaysian companies abroad**



Source: CEIC and World Bank staff calculations.

**Figure 54. Reserves counteracted volatile flows**



Source: CEIC and World Bank staff calculations.

**The final component of the external part of the strategy was reserve accumulation by BNM.** Reserve accumulation generally counter-acted volatile portfolio flows to stabilize the exchange rate, but on average also accelerated in the second part of the decade (Figure 53 and Figure 54). The balance in capital flows achieved by increasing FDI abroad, maintaining large outflows of bank deposits overseas (something that was already taking place in the early 2000s) and some reserve accumulation effectively reduced the supply of foreign currency, reducing pressures on the money supply and nominal exchange rate.

**Some resource receipts made their way to the economy through the fiscal accounts.** The non-oil primary deficit increased from 6.5 percent of GDP in 2000-2004 to 9.7 percent of GDP in 2006-2010 (Table 5). Put it differently, by



2010 oil revenues and debt financed about half of all expenditures, up from less than 40 percent in the early 2000s (Figure 55). While development expenditures declined as a share of GDP during the period, operating expenditures climbed about 2.5 percentage points of GDP. Subsidies accounted for most of the increase (1.4 percentage points), of which 0.8 percentage points were contributed by fuel subsidies. Therefore, while an additional 3.7 percentage points of GDP was made available to the Government through oil revenues, only 0.8 percentage points were used for fuel subsidies. The remainder of the additional revenues, net of the reduction in development expenditure, (4.8 pp) was used for emoluments (0.7 pp), non-fuel subsidies (0.6 pp), other operating expenditure (0.4 pp), deficit reduction (0.2 pp) and reduced effort for non-commodity revenues (2.8 percentage points).

**Table 5. The non-oil primary deficit has grown substantially**

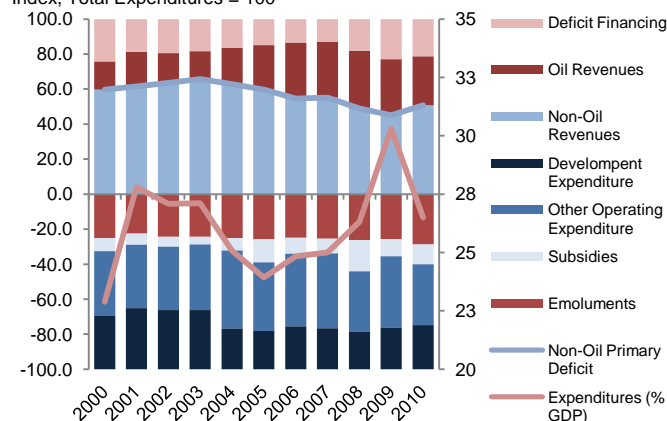
Percentage points of GDP

	2000-2004	2006-2010	Change
Other Operating Expenditure	9.9	10.3	0.4
Emoluments	6.3	7.0	0.7
Subsidies	1.6	3.0	1.4
Development Expenditure	8.2	6.3	-1.9
Oil Revenues	4.7	8.3	3.7
Non-Oil Revenues	16.3	13.5	-2.8
Deficit Financing	-5.0	-4.8	0.2
Non-Oil Primary Deficit	-6.5	-9.7	-3.2
Expenditures (% GDP)	26.0	26.6	0.6

Source: CEIC, MoF, World Bank Calculations.

**Figure 55. Only half of expenditures are financed through non-oil revenues**

Index, Total Expenditures = 100



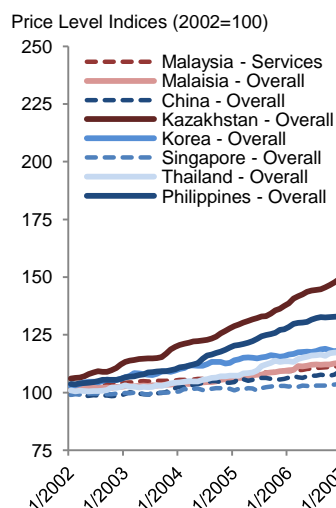
Source: CEIC, MoF, World Bank Calculations.

**Any inflationary pressures from higher emoluments, transfers, and lower taxes were contained through an extensive network of subsidies and price controls.** Inflation in Malaysia has been low by regional standards, and certainly by standards of oil-producing countries (Figure 56). This is remarkable considering the demand boost provided by increased Government spending, as described above. The Government has used some of the resource revenues to keep fuel prices contained. As of last September, the price of RON95 fuel was RM2.75; yet the price at the pump was RM1.90, implying a subsidy of 31 percent of the actual price (these figures have since increased). Some off-budget subsidies have also been implemented, such as PETRONAS sale of subsidized gas to electrical utilities, which reduces the price of electricity to consumers. Importantly, a number of prices, especially of food items, are controlled by the Government (Table 6). According to BNM, price administered items make up nearly 30 percent of the CPI basket (BNM, 2010).

**The final piece of the puzzle has been increased reliance on low-skill foreign workers.** A key channel through which the Dutch disease may erode competitiveness in tradable sectors is through an increase in low-skill wages in excess of productivity. This is because excess demand from resource revenues increases demand of both tradables and non-tradables, but only the price of non-tradables tends to rise as the price of tradables is largely determined in global markets. The main component of the cost of non-tradables (such as services) tends to be labor. As wages rise in the non-tradable sector, they push up low-skill wages throughout the economy, diminishing the competitiveness of manufacturing. Returns on skilled labor have been increasing rapidly on a global scale, and therefore the key added pressure would come from low-skill labor. Enter foreign workers, which have become a significant part of Malaysia's labor force (see the next chapter) in the past decade. This helps explain why manufacturing wages, as well as prices of services, have not risen noticeably in the past decade.



**Figure 56. Inflation in Malaysia is low compared to regional peers**



Source: CEIC and World Bank staff calculations.

**Table 6. This has been helped by subsidies and price controls**

Price-administered goods	
Price Control Act, retail price determined by the Government	Items where any changes in prices require Government approval
Items	Items
<b>Food</b>	<b>Alcoholic Beverages and Tobacco</b>
Rice	Beer
Flour & other cereal grains	Wines
Bread & bakery products	Spirits & Liquors
Fresh meat	Cigarettes, cigars, etc.
Oils	<b>Housing, water, electricity, gas and other fuels</b>
Sugar	Water supply
<b>Non-food</b>	Electricity
Gas	<b>Communication</b>
Fuel & lubricants	Telephone and telegraph services & equipment
	Postal services
	<b>Transport services</b>
	Passenger transport (rail, road, air, sea)
	Other transport charges

Source: BNM (2010), p. 51.

**Although this strategy has served the country well, it is unlikely to be compatible with Malaysia future aspirations.** A growth strategy based on commodity revenues is, at a minimum, risky. Fuel subsidies, coupled with a national automotive policy, have led to high growth in oil consumption. Production, meanwhile, has been falling, which has led to a decline in Malaysia's status as a net exporter of oil in volume terms (see Box 3). Although significant investments are being made in oil and gas, including in downstream activities, the sustainability of a surplus in the commodity balance is uncertain. In addition, high oil prices may continue into the near term, but risks of both downside and upside shocks are elevated and could be highly disruptive.

**Even if commodity revenues were to continue to increase, the 'medicines' against the Dutch Disease are likely to become less effective.** Although global prices of commodities are likely to remain firm, to ensure the growth in domestic production, PETRONAS has switched towards a higher share of domestic investments, which along with a continued large surplus in the commodity balance and renewed FDI inflows from the ETP could put further upward pressure on the exchange rate. Subsidies are becoming increasingly distortionary as global prices rise, and most importantly, pressures for higher wages are mounting, with manufacturing firms starting to switch to more human- and physical-capital intensive production in anticipation for a reduction in the availability of foreign workers. Finally, based on recent trends, the dependence of the budget on oil revenues is likely to increase absent any reforms.

**Without implementing the structural reforms in the SRIs, partial implementation of the ETP could exacerbate the Dutch Disease.** The ETP calls for renewed investments in oil and gas in Malaysia to leverage on high oil prices, higher levels of FDI, the introduction of a minimum wage, rebalancing of foreign workers towards higher skills, rationalization of subsidies, expenditure reform and broadening of the tax base through the introduction of a GST. The consistency of these ETP objectives with long-term growth depends crucially on structural reforms to improve productivity growth in the tradable sectors. This is compatible with the central preoccupation of the New Economic Model that "future growth must come from higher factor productivity, nurtured by more innovative processes as well as supported by a healthy dose of private investment and talent" (NEM, p. 102). As discussed in the NEM and previous editions of the Malaysia Economic Monitor, productivity growth would be enhanced by building up capabilities and enhancing competition in the economy. Without these crucial changes, partial implementation of the ETP could aggravate the Dutch Disease.

**A new strategy for Malaysia to avoid 'Dutch Disease' that is consistent with the NEM rests on two pillars: increasing productivity growth through structural reforms and making the use of oil revenues more rules-based.** First, it is critical to invest in skills to increase the productivity of Malaysia's labor force and boost innovation. Higher productivity is the only sustainable and non-inflationary source of wage growth, and requires both supply and demand measures. Higher wages and improved social protection would also offset higher inflation that may result. The second pillar

passes through Government finances, which needs to be fundamentally reformed as envisaged by the New Economic Model, and beyond. Measures anticipated in the NEM include the adoption of a goods and services tax, which will increase the tax base and the share of non-oil revenues. Subsidies should be rationalized, with savings converted to transfers to the bottom 40 percent of households. In addition, Malaysia should consider building on recent announcements (see Box 5) to transform the National Trust Fund ('KWAN') into an 'oil stabilization fund', which manages all of the country's oil wealth and revenues and invests most of its assets overseas.<sup>11</sup> This would compensate for the reduction in the overseas investments of GLCs. The Fund would make disbursements to the budget, but these would be based on rules dependent on oil prices, production, and return on assets in the fund.

#### **Box 5. Changes to the National Heritage Fund (KWAN) in 2012**

Beginning in 2011, the rules governing PETRONAS's contribution to Malaysia's National Heritage Fund (KWAN) have been modified to a new formula, with contributions to vary depending on the 'Weighted Average Realized Price' or WARP<sup>a</sup> of oil for a given year:

- If WARP is less than USD70 per barrel, contribution to KWAN is RM100 million
- If WARP is between USD70 and USD100 per-barrel, contribution is RM500 million
- If WARP is more than USD100 p/b, contribution is RM1 billion

For 2011, as the WARP was above USD100 per barrel, PETRONAS contributed RM1 billion to KWAN, with the asset size of KWAN at RM4.8 billion (as of 31 December 2011). This compares with a yearly dividend payment to the budget of RM 30 billion.

*Note:* a/ WARP: Weighted average price of all foreign and domestic oil grades produced by PETRONAS

*Source:* BNM, Accountant General's report, PETRONAS.

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<sup>11</sup> A discussion of the potential impact of such fiscal rules can be found in the November 2011 Malaysia Economic Monitor.

### 3. MODERN JOBS

#### Modern jobs: higher wages, secure workers, competitive firms

**Becoming a high-income nation will involve the creation of modern jobs in the Malaysian economy.**<sup>12</sup> The ultimate goal of becoming a high-income nation is not to achieve an abstract statistic but rather to raise the living standards of individual Malaysians. Therefore, supporting higher and more secure incomes for Malaysian households is central to Malaysia's efforts to transform its economy. Since the majority of household income comes from labor, transforming jobs and labor markets will be critical. 'Traditional jobs' have involved the performance of simple, routine tasks and commanded low wages. Meanwhile the lack of modern social safety nets placed the burden to provide job security on large firms or on the informal sector (including family-run businesses). Firms' competitiveness was partly derived from a steady flow of low-wage, low-skill labor coming largely from agriculture. Malaysia's transformation to a high-income economy requires a transformation of the types of jobs available in its labor markets, from 'traditional' to 'modern' (Table 7).

**Modern jobs are higher-productivity jobs, justifying higher wages.** Malaysia's economic transformation will require the creation of new types of jobs (and the upgrading or 'modernizing' of existing jobs) that involve the performance of increasingly complex tasks and command higher wages. This would generally demand higher levels and different types of skills compared to those involved in 'traditional jobs.' Whereas memorization and manual skills were crucial to early stages of industrialization, modern, high-wage jobs involve soft skills such as communication, problem-solving, and proficiency in modern information technology. Modern jobs are related to high productivity growth, as well as innovation, but are not restricted to 'modern' sectors: the TUKAR program, which aims to modernize small shops, including through providing training to shop owners and increasing the use of information technology, can be viewed as 'modernizing' jobs in the retail sector.

**Modern labor markets are flexible: workers are protected, not jobs.** Modern labor markets allow firms and workers to adapt to changing market conditions, make room for 'creative destruction' that benefits the economy as a whole, and facilitate the matching between workers and firms. Although modern jobs may lack some traditional protections, they are not incompatible with greater income security. On the contrary, flexibility in labor markets should come hand-in-hand with well-designed and comprehensive social safety nets that facilitate job transitions and balance the flexibility in labor markets with security for individuals and their families. In Malaysia's case, this means that a vital component of modernizing labor markets and introducing more flexibility in labor regulations is moving from 'traditional' social assistance based primarily on consumer price subsidies to comprehensive social insurance based on targeted transfers.

**Modern jobs are inclusive and leverage on the entire stock of talent in the economy.** In Malaysia's case, women are currently a substantial untapped source of talent, and creating more inclusive jobs can help draw this talent into the economy. Modern jobs can help achieve this objective by offering flexible working arrangements, including part-time assignments, job sharing and flexible hours, that make it easier for women to reconcile family with work. Social policies can also support inclusiveness in the labor market by ensuring adequate provision of child and elderly care. Modern jobs are likely to be more attractive to women, both because of flexible working arrangements and greater support for household tasks, but also because they command higher wages and tend to be in sectors where the type of work is more attractive.

**Modern jobs are offered by competitive firms.** The competitiveness of firms in a high-income economy is not derived from low wages but rather from the productivity of its workers. In addition, transitioning to protecting workers instead of protecting jobs contributes to the competitiveness of firms by lowering costs and promoting an efficiency-enhancing reallocation of risks from firms to workers and the government. A country's competitiveness is

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<sup>12</sup> In this chapter "modern" is not meant to imply jobs in a specific sector, nor is it equivalent to "skilled jobs". Rather, it is meant to reflect (i) higher labor incomes for workers derived from higher productivity; and (ii) modern labor market and social safety net policies that protect workers rather than jobs and promote inclusion.

to a considerable degree a function of its institutions and human capital.<sup>13</sup> Malaysia has benefited from good institutions during its development, but other countries are catching up. That calls for a focus on skills and the quality of human capital as Malaysia's long-term source of competitiveness. Germany is an example of a country that remains highly competitive internationally – and whose firms are also globally competitive – but where wages are fairly high.

**Table 7. Traditional vs. Modern**

<b>Traditional</b>	<b>Modern</b>
Simple, routine and standardized tasks	Complex, analytical and differentiated tasks
High supply of low-skill labor that can perform the tasks → low wages	Tight supply of specialized labor and higher productivity → High wages
Most jobs in agriculture, labor-intensive manufacturing	Most jobs in knowledge intensive tasks across all economic sectors
Strict labor regulations make it difficult to hire and fire workers, effectively placing the burden of providing income security on firms at the cost of lower efficiency	Flexible labor regulations reduce the cost of hiring and firing and increase efficiency, while effective social safety nets protect workers
Rigid job structures and expectations that are not conducive to the participation of large segments of the population, especially women	Jobs that leverage on the entire stock of human capital by making it easier and more attractive for women to join the labor force
Competitiveness derived from institutions, security of investments	Competitiveness derived from the quality of human capital, in addition to good institutions

**The New Economic Model (NEM) recognizes the need to develop a quality workforce and improve the functioning of labor markets as critical requirements to achieve both its high-income and inclusiveness objectives.** According to the NEM, “[I] labour markets must work well: jobs and workers must be matched efficiently to increase productivity and thus raise wages for all.” It further recognizes the central role of skills: “High income emanates from skilled people applying their talents to successfully meet the economic challenges faced by society.” To achieve the NEM's aspirations, the 10<sup>th</sup> Malaysia Plan emphasizes “Revamping the education system to significantly raise student outcomes; raising the skills of Malaysians to increase employability; and reforming the labour market to transform Malaysia into a high-income nation.”

**As part of the Economic Transformation Programme, the NEM's recommendation has been translated into the Human Capital Strategic Reform Initiative (SRI).** Key pillars of the SRI include: (i) modernizing labor legislations; (ii) upskilling and upgrading the workforce; (iii) leveraging on women's talent to increase productivity; and (iv) enhancing safety nets by introducing unemployment insurance. Also incorporated in the SRI are reforms to implement a minimum wage, and to increase the retirement age. Other Government reform programs that can facilitate the creation of modern jobs include the Education NKEA and NKRA, which are now being integrated with the Human Capital SRI.

**Jobs have also gained prominence on the global agenda.** Increasing income inequality in many advanced and emerging countries (or at least increasing popular awareness of income inequality) has contributed to social tensions in a number of places from the United States to the Middle East. While redistributive schemes can help reduce inequality, sustainable improvements and truly inclusive economic growth involve raising labor market returns for a majority of workers. Reflecting the importance of the jobs agenda and the transformational nature of jobs, the World Bank's World Development Report for 2013 currently under preparation focuses on the topic (see Box 6 below).

#### **Box 6. The World Development Report 2013 on Jobs**

The conceptual framework of the World Development Report (WDR) 2013 focuses on jobs as the link between individual, household and societal opportunities and assets (such as education, land, and capital), and outcomes

<sup>13</sup> Costinot (2009) argues that good institutions (such as security, contract enforcement and macroeconomic stability) make it easier to form teams (firms themselves, or teams within firms) to solve complex problems. High levels of human capital on the other hand reduce the average number of team members needed to solve a given complex problem.

(economic and social). The development process is about some jobs improving, and others disappearing; about people taking jobs and changing jobs; and about jobs migrating from some places to others.

The report will focus on three aspects of jobs: (i) the relationship between jobs and *living standards*; (ii) the relationship between jobs and enterprises, where the creation, destruction and evolution of jobs are at the root of *productivity gains*; and (iii) the importance of jobs in the context of *social cohesion*, for example through their effect on equity, empowerment, engagement of certain groups, and political stability. The report will present jobs as the 'hinge' on which rest three transformations that are key to development: rising living standards, greater productivity, and tighter social cohesion. Since jobs play a mediating role between opportunities and outcomes, the policy emphasis of the report will be on public interventions that stimulate the types of jobs that, all other things equal, increase living standards, raise aggregate productivity, and promote social cohesion.

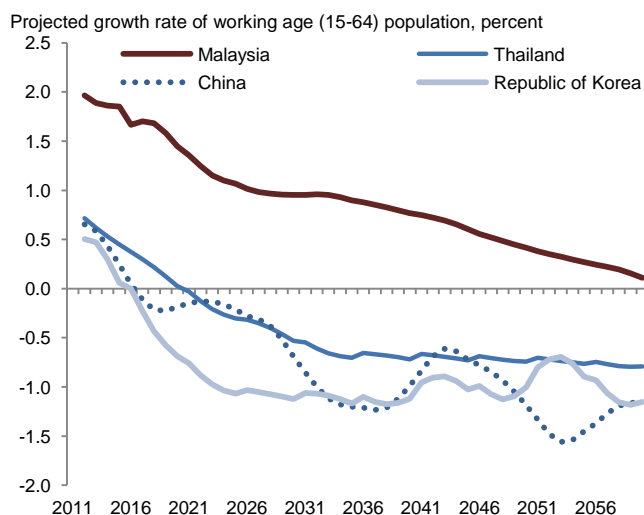
Source: WDR 2013 Board Paper.

**This chapter is organized as follows: the first part surveys the current landscape of Malaysia's labor markets.** It acknowledges positive developments in employment growth, rising educational attainment of the labor force, and the growth in skilled jobs, while noting where further improvements are needed. **The second part is about increasing productivity and wages.** It looks at the issue of skills provision, the role of a minimum wage, and of foreign workers in the wage structure. **The third turns to the themes of inclusiveness and flexibility with security as characteristics of modern labor markets.** Namely, it considers labor market regulations and discusses possible reforms to increase flexibility. It then considers existing social safety nets and the way forward. **The final part provides an overview of the implications of a higher wage structure.** It emphasizes the importance of the structural reform agenda to address productivity issues, without which higher wages can lead to diminished competitiveness.

## What is the current landscape of Malaysia's labor markets?

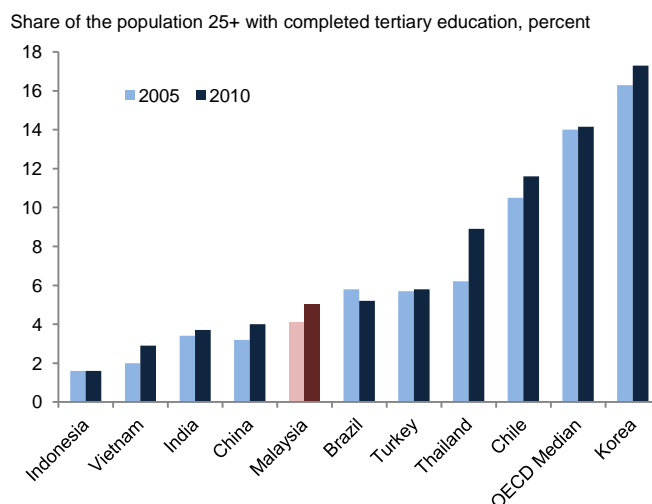
**Malaysia's working-age population is relatively young compared to other high- and middle-income countries, and well-educated compared to low- and middle-income countries.** As shown in Table 8, as of 2009 over 60 percent of the working age population was under 40 years old, and over 35 percent was under 25 years old. Malaysia's working age population is not expected to start declining until after 2060 (see Figure 57), whereas countries such as Thailand and China can expect to see declines in their working age population in 2021 or sooner. About 57 percent of the workforce has some form of secondary education certification and 14.4 percent has a post-secondary certification, with over 5 percent having a tertiary education degree. This is in line with countries of similar income level and higher than other ASEAN nations such as Vietnam and Indonesia, but below the levels of OECD countries (Figure 58). Finally, there are clear regional disparities. For example, the working age population in East Malaysia, especially Sabah/Labuan, has less education than that of Peninsular Malaysia (see Table 8).

**Figure 57. Malaysia's population is young...**



Source: UN Population Projections.

**Figure 58. ... and relatively well educated**



Source: World Bank EdStats.

**Table 8. Working Age Population as of 2009**

	Peninsular	Sarawak	Sabah and Labuan	Total
<b>General Demographics</b>				
Male	50.3	49.4	50.0	50.2
Malaysian Citizen	95.6	96.5	75.6	93.7
Never Married	46.8	42.7	47.3	46.5
Married	48.9	53.4	48.9	49.3
Widowed	3.3	2.7	2.6	3.2
Divorced / Separated	1.0	1.1	1.2	1.0
<b>Highest certificate obtained</b>				
Not Applicable	3.6	10.2	13.1	5.1
No Certificate	10.0	12.8	16	10.8
UPSR/UPSRA or equivalent	11.5	17.1	17.9	12.6
PMR/SRP/LCE	23.9	24.3	20.8	23.7
SPM/MCE	35.3	27.6	22.5	33.4
STPM/HSC or equivalent	2.9	2.4	2.9	2.9
Certificate	1.5	0.8	0.9	1.4
Diploma	5.4	2.3	2.6	4.8
Degree	5.8	2.6	3.4	5.3
<b>Age</b>				
15-24	37.7	37.2	43.4	38.2
25-39	26.2	25.9	25.8	26.1
40-44	23.3	23.7	21.9	23.2
55-64	12.8	13.1	8.9	12.5

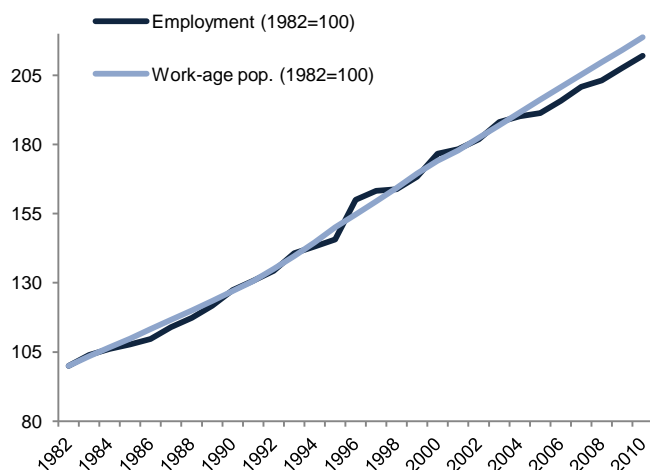
Source: DOS – Labor Force Survey 2009.

Note: The Labor Force Survey does not sample collective housing. All figures are percentages using LFS sample weights.

**Employment growth has lagged population growth since 2000 but the unemployment rate has remained low and stable as more young men and women entered tertiary education rather than the labor force.** Between 2000 and 2010, Malaysia experienced growth in employment, but even faster growth in the working age population (Figure 59). The adult population grew by an average of 2.9 percent annually over this period, while employment grew by an average of 2.3 percent. The unemployment rate remained stable at around 3.3 percent as the labor force participation rate declined during the period from 65.3 percent in 2000 to 62.7 percent in 2010 (Figure 60). This was largely due to a decline in the participation rate of men, and corresponds to an increase in tertiary enrollment ratios for young men during the period. The labor force participation of men aged 20–24 dropped from 85.4 percent in 2000 (above the overall male labor force participation rate of 83 percent) to 72.4 percent (well below the overall labor force participation rate for men of 78.7 percent, see Figure 61). Meanwhile, labor force participation of women aged 20–24 also declined (by 10 percentage points), but this was offset by higher participation of women aged 25–39 so that overall the labor force participation of women was largely unchanged (Figure 62). The decline in labor force participation from young men and women was likely associated with an increase in enrollments in tertiary education (Figure 63). Women's gross enrollment ratio increased nearly 20 percentage points between 2000 and 2009, while men's enrollment ratios climbed 10 percentage points. Table 9 summarizes the characteristics of the Malaysian labor force as of 2009.

**Figure 59. Employment grew less than the working-age population in the 2000s...**

Index (1982=100)

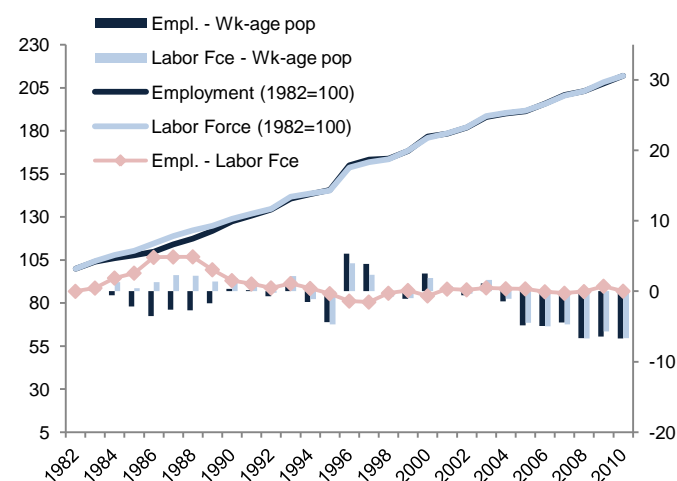


Source: DOS – Labor Force Survey Time Series Data, 1982-2010

**Figure 60. ...but unemployment was stable as participation declined...<sup>14</sup>**

Index (1982=100)

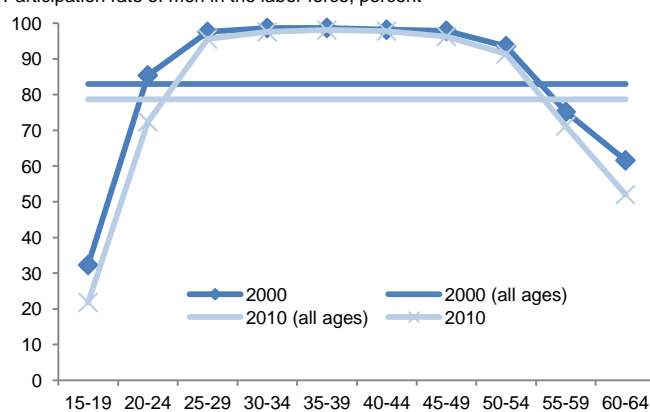
Difference in indices (bars and dotted line)



Source: DOS – Labor Force Survey Time Series Data, 1982-2010

**Figure 61. ...because both young men...**

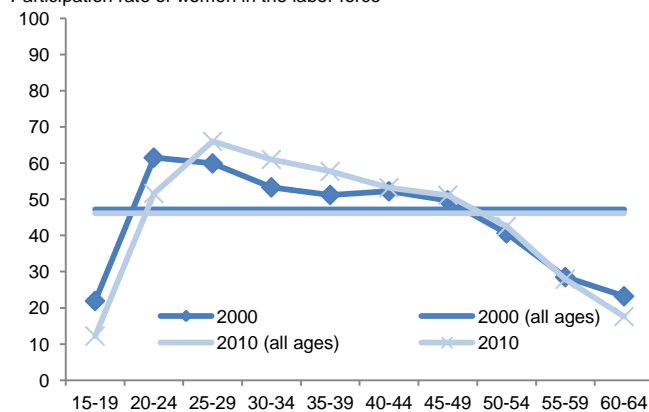
Participation rate of men in the labor force, percent



Source: CEIC.

**Figure 62. ...and women...**

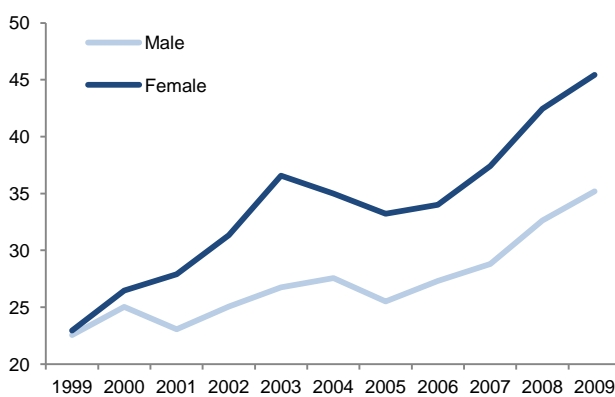
Participation rate of women in the labor force



Source: CEIC.

**Figure 63. ... pursued further studies rather than join the labor force**

Gross enrollment in tertiary education, percent



Source: UNESCO Institute for Statistics.

<sup>14</sup> In Figure 60, the dark blue bars illustrate the excess growth of employment vis-à-vis the working-age population; light blue bars illustrate the excess growth of the labor force vis-à-vis the working age population (i.e. changes in the labor force participation rate). The difference between employment changes and changes in the labor force (red dotted line) translates into the change of the unemployment rate compared to 1982: as shown, the unemployment rate in 2010 was virtually the same as in 1982.



**Table 9. Labor Force as of 2009**

<b>General Demographics</b>			
Male	50.7	51.1	51.6
Malaysian Citizen	94.8	95.7	74.2
Never married	39.7	35.3	38.0
Married	56.2	61.0	58.3
Widowed	2.9	2.3	2.4
Divorced/Separated	1.2	1.4	1.3
<b>Highest certificate</b>			
Not Applicable	3.3	8.7	11.3
No Certificate	9.0	12.3	15.9
UPSR	12.5	17.8	18.6
PMR	18.4	19.2	17.1
SPM	37.7	29.1	24.8
STPM	3.6	3.3	3.5
Certificate	1.8	1.1	1.1
Diploma	6.8	4.0	3.8
Degree	7.0	4.4	3.9
<b>Status Employment</b>			
Not employed	3.3	4.6	5.6
Employer	3.7	2.8	2.7
Government Employee	13.5	14.8	13.5
Private employee	59.9	49.9	54.6
Own Account worker	16.0	18.7	18.2
Unpaid family Worker	3.5	9.3	5.5
<b>Age</b>			
15-24	28.2	27.8	32.2
25-39	34.7	34.8	36.5
40-44	10.0	10.4	9.6
55-64	10.4	10.4	7.3

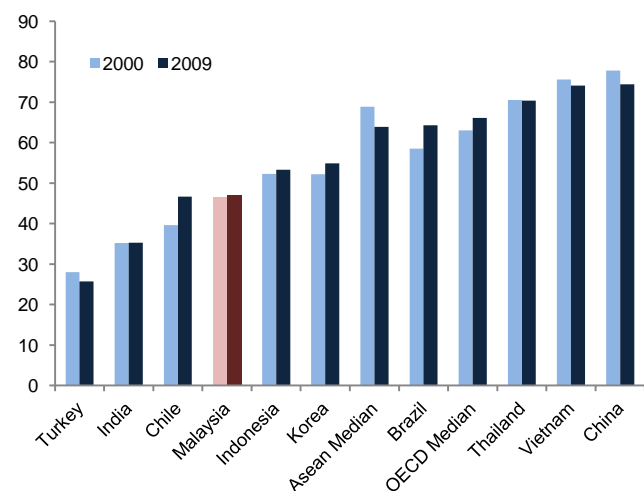
Source: DOS – Labor Force Survey 2009.

Note: The Labor Force Survey does not sample collective housing. All figures are percentages using LFS sample weights.

**Labor force participation, especially among women, is low by regional and international standards.** Despite the increase in the labor force participation of women aged 25–49 noted above (and therefore the effective combined increase in participation in tertiary education and the labor force), women's labor force participation remains low compared to regional and higher income peers (Figure 64). Participation is relatively low at all ages and tends to decline after marriage (Figure 65). Unlike the 'double-peaked' pattern observed in some countries, Malaysian women tend not to return to the labor force after marriage and child birth. In fact, Malaysia is the only country in the region that has a single-peaked profile of labor force participation for women. Although the combined enrollment in tertiary education and participation in the labor market have increased, many of Malaysia's peers have also experienced increases in tertiary enrollment while maintaining relatively higher labor force participation rate of women.

**Figure 64. Women's labor force participation is low relative to other Asian and OECD economies**

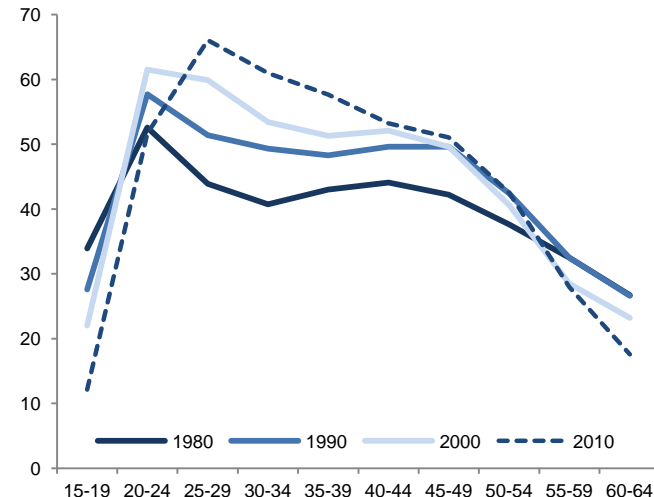
Women's labor force participation rate (percent)



Source: World Development Indicators (WDI).

**Figure 65. Labor force participation of women peaks before marriage and declines thereafter**

Women's labor force participation rate (percent)

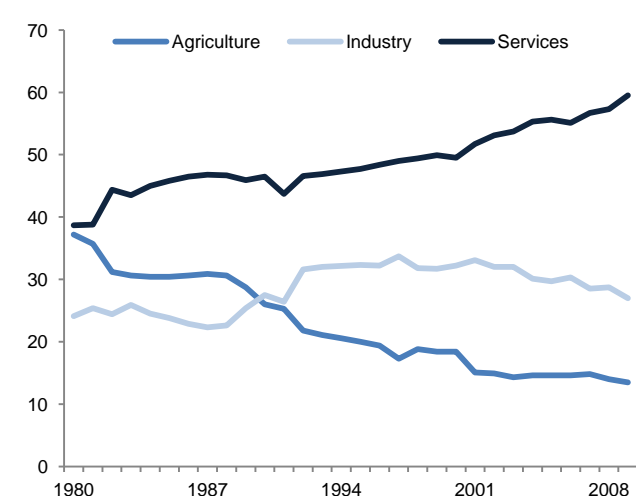


Source: CEIC and ILO Laborstats.

**Most new jobs created during the past decade were in the services sectors.** As a result, since 1980 the share of total employment in services sectors expanded from 39 to nearly 60 percent of total employment (Figure 66). Within services sectors, the financial sector posted the strongest employment growth (157 percent between 2000 and 2010), while community, social and personal services grew by only two percent (Figure 67). Meanwhile, the share of total employment in the agriculture sector fell by 25 percentage points to 13 percent. The industrial sector grew as a share of total employment between the 1980s and the 1990s, but since the early 2000s it has started to decline as well. Overall, between 1980 and 2009, the share of industry has increased from 24.1 to 27.0 percent of total employment. The reduction in agricultural employment towards industry and then services represents a natural transition path as Malaysia has moved up the income ladder.

**Figure 66. Employment shares in services increased...**

Share in employment, percent

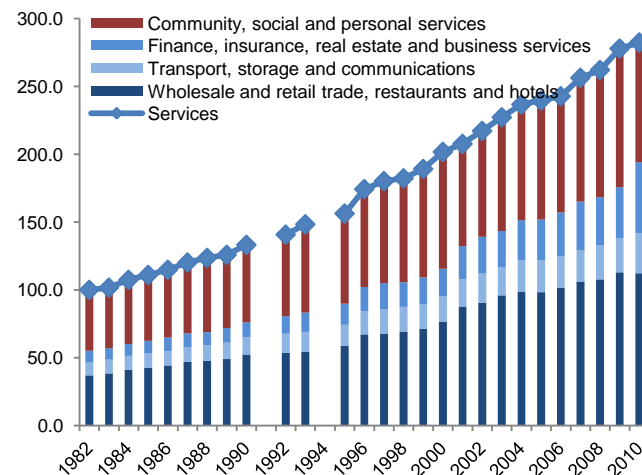


Source: CEIC.

Note: Data up to 2009.

**Figure 67. ... with significant gains in finance jobs.**

Index based on number employed, 1982 total=100



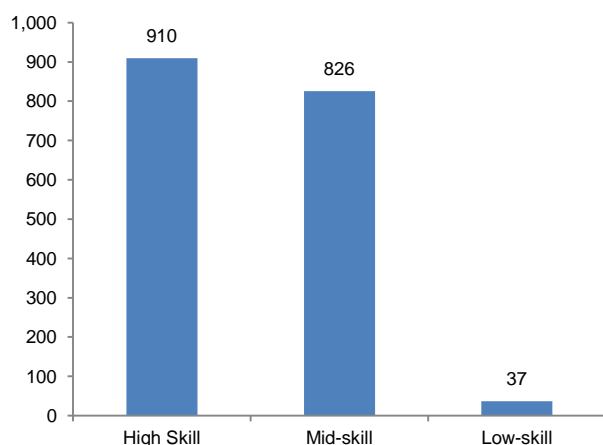
Source: DOS – Labor Force Survey Time Series Data, 1982-2010.

**Most jobs created over the past ten years have been for skilled professionals.** With the growth in the services sectors and decline in the share of manufacturing in employment between 2000 and 2010, most jobs created in the past decade have been at the middle- or high-skill level (Figure 68). Professional occupations grew at an average pace of 5 percent per year while technicians and associate professional positions expanded at a similar pace of 4.3

percent. Positions of plant and machine operators have declined at an average pace of 1.3 percent during the period. This suggests that labor markets have started moving in a modernizing direction.

**Figure 68. Most jobs created since 2001 have been skilled...**

New net jobs created between 2001 and 2010 by skill level (thousands)

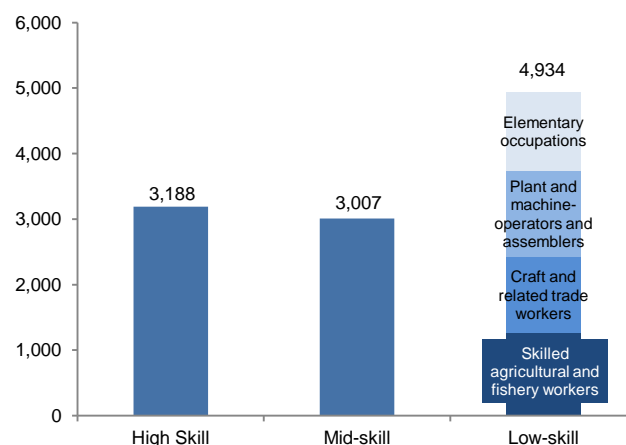


Source: DOS – Labor Force Survey 2001, 2010.

Note: 'High Skill' includes legislators, senior officials, managers, professionals, technicians and associate professionals; 'mid-skill' includes clerical workers, service workers and shop and market sales workers; 'low-skill' includes agricultural and fishery workers, craft and related trade workers, plant and machine operators and assemblers, and elementary occupations. See also Footnote 15.

**Figure 69. ... but the largest share of existing jobs is still relatively low-skilled**

Number of jobs in 2010 by skill level (thousands)



Source: DOS Labor Force Survey 2010.

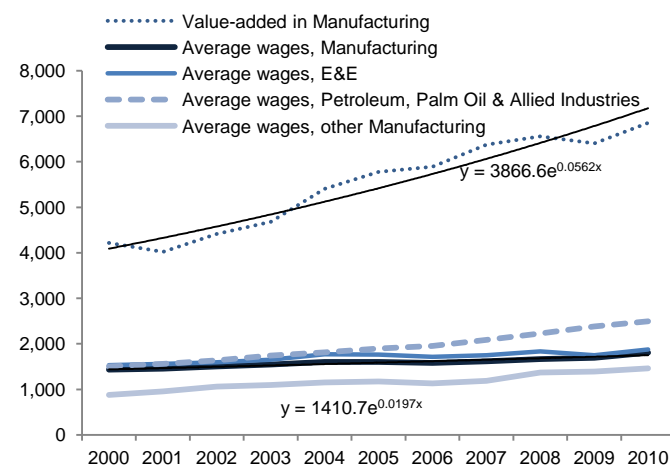
**But the majority of jobs in Malaysia, especially in the private sector, are still low-skill.**<sup>15</sup> While the flow of new jobs has been towards skilled service-sector jobs, the largest portion of the stock of jobs in the Malaysian economy is still relatively low-skilled (Figure 69). Service and other retail workers are now the largest category of employment, comprising nearly 17 percent of jobs, but low-skill occupations still account for 44 percent of all jobs. In addition, considering that a majority of the 1.4 million jobs in the civil service would be classified as skilled or semi-skilled, among private sector jobs, only about one quarter would be classified as skilled, with another quarter as semi-skilled and about half as low-skill.

**Wage growth has been slow and lagged productivity growth in manufacturing, though service wages appear to be growing faster.** Whereas labor productivity in manufacturing (measured simply as real value-added per worker) grew by an average of 5.0 percent per year over the past decade, real average manufacturing wages expanded by a much slower 2.4 percent per year during the same period (Figure 70). As a result, the estimated share of wages in manufacturing value-added has declined from 36 percent in 2000 to 26 percent in 2010. This could suggest that manufacturing growth has been largely capital-intensive, or that firms have wage-setting powers in labor markets. As would be expected given the rising commodity prices, wages in the commodity-related petroleum, palm oil and related industries rose the fastest among manufacturing sectors. Labor productivity in services expanded at a similar pace (4.7 percent) compared to manufacturing, but wages appear to have grown faster on average since 2005, when data become available (Figure 71).

<sup>15</sup> This is not a standard definition of skill levels in Malaysia. Based on the Malaysian Standard Classification of Occupations (MASCO) 2008, only "elementary occupations" are regarded as unskilled, with agricultural and fishery workers; craft and related trade workers; and plant and machine operators and assemblers generally regarded as mid-skilled.

**Figure 70. Wage growth lagged productivity in manufacturing...**

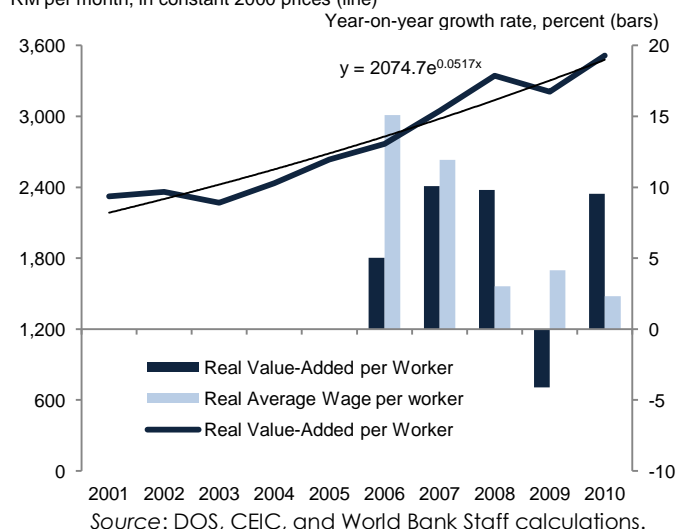
RM per month, in constant 2000 prices



Source: DOS, CEIC, and World Bank Staff calculations.

**Figure 71. ... but grew faster in services**

RM per month, in constant 2000 prices (line)



Source: DOS, CEIC, and World Bank Staff calculations.

**There are substantial regional and other disparities in wage levels.** Compensation is lower and informality higher in East Malaysia, especially in Sabah/Labuan where hourly wages are only 57 percent of the rate paid in Peninsular Malaysia. Young people (under 25 years of age) earn less than half as much as 40 to 54 year olds despite being more likely to be employed in a formal job. As Table 10 shows, earnings for the least educated are very low and their rate of informality very high. Lastly, wages in the primary sectors (especially agriculture) are the lowest. Manufacturing, on the other hand, pays RM2.3 more per hour, on average, than primary sector jobs, and the EPF and SOCSO extend pension coverage to almost 85 percent of all wage and salary jobs in the sector. The variation in compensation, hours worked and formality among groups (gender, region, age, level of education, and sector of activity) is also important. For example, men's base monthly compensation is on average 17 percent higher than women's total monthly compensation (and hourly compensation is 15 percent higher).

**Table 10. Compensation, Hours, and Distribution**

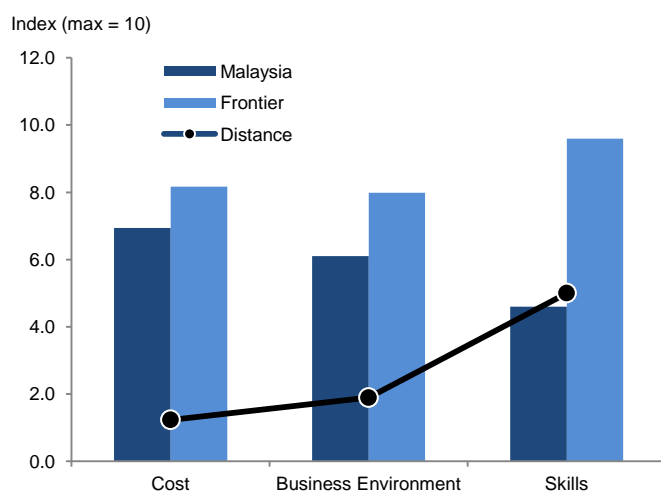
	Base Monthly Compensation	Total Monthly Compensation	Total Weekly Hours Worked	Total Hourly Compensation	Share of Employment	Share Formal: All Jobs	Share Formal: Wage & Salary Jobs
Women	1,246	1,331	44.0	7.41	33.5%	53.5%	68.0%
Men	1,456	1,580	46.0	8.51	66.5%	46.5%	61.5%
Peninsular	1,484	1,596	45.1	8.69	81.3%	37.9%	64.2%
Sarawak	1,012	1,094	44.9	6.13	8.5%	30.9%	62.0%
Sabah_and_Labuan	821	938	47.2	4.94	10.3%	31.1%	62.0%
Age 15-24	790	854	46.1	4.55	20.6%	34.5%	67.8%
Age 25-39	1,514	1,635	45.2	8.86	39.6%	33.4%	69.7%
Age 40-54	1,705	1,844	44.8	10.14	29.7%	22.9%	57.3%
Age 55-64	1,442	1,548	44.5	8.64	10.2%	9.3%	35.8%
Completed Primary or Less	802	862	46.1	4.55	32.7%	9.6%	43.3%
Completed Lower Secondary	987	1,059	46.0	5.60	15.3%	16.9%	58.1%
Completed Upper Secondary	1,163	1,274	45.5	6.87	35.5%	22.3%	68.8%
Completed Pre-University	1,952	2,125	43.6	11.89	10.1%	25.0%	72.2%
Completed Higher Education	4,111	4,358	42.7	24.29	6.4%	26.1%	73.4%
Resource-Based Industry	952	1,027	44.7	5.62	8.4%	10.8%	44.1%
Manufacturing	1,355	1,454	44.6	7.93	38.1%	55.0%	84.0%
Services	1,668	1,952	43.7	11.36	53.5%	34.2%	58.6%

Source: DOS – Labor Force Survey 2009 (compensation, hours and employment share); HIS 2007 (share of formal jobs).

Notes: Base Monthly Compensation, Total Monthly Compensation, and Total Hourly compensation are expressed in 2010 RM by using the CPI to convert the nominal 2009 figures. Figures refer only to wages and salaries received and do not include any residual income earned by entrepreneurs. Calculations include private employees and own-account workers for employment share, hours, and compensation.

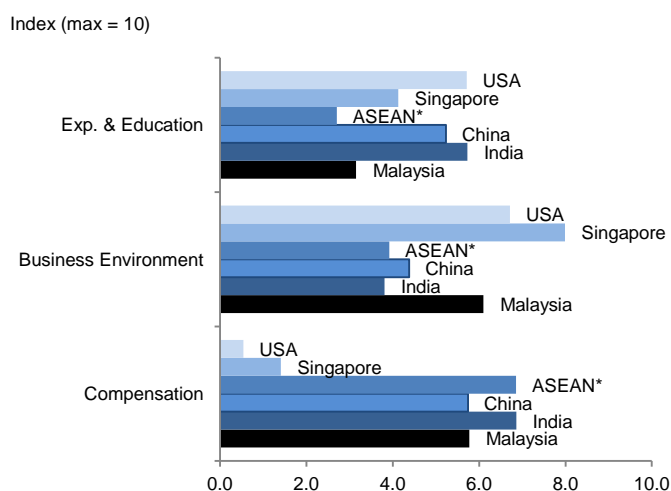
**Malaysia still derives much of its competitiveness from low-cost labor.** As noted in the November 2011 Malaysia Economic Monitor, Malaysia does very well in the A.T. Kearney Global Services Location Index (ranking 3<sup>rd</sup> out of 50 countries) because its business environment compares favorably against lower-income countries and labor costs remain much closer to lower-income countries than advanced economies (Figure 72). Meanwhile, China and India rank highly despite relatively poor business environments because they have high levels of skills. To some extent this is due to their large labor forces (a separate sub-index for availability of labor), but even focusing only on the experience and education sub-indices still shows these countries on par with advanced economies (see Figure 73). According to the Malaysia Productivity Corporation, industry profits are often derived not from innovation and creativity but from low wages. As Malaysia moves to becoming a high-income economy, the source of its competitiveness needs to shift to skills and the business environment and away from 'cost competitiveness.'

**Figure 72. Malaysia's greatest absolute advantage remains 'cost competitiveness'**



Source: A.T. Kearney and World Bank staff calculations.  
Note: A high index for 'cost' means lower costs.

**Figure 73. Malaysia's indicators on labor costs are closer to lower-income countries**

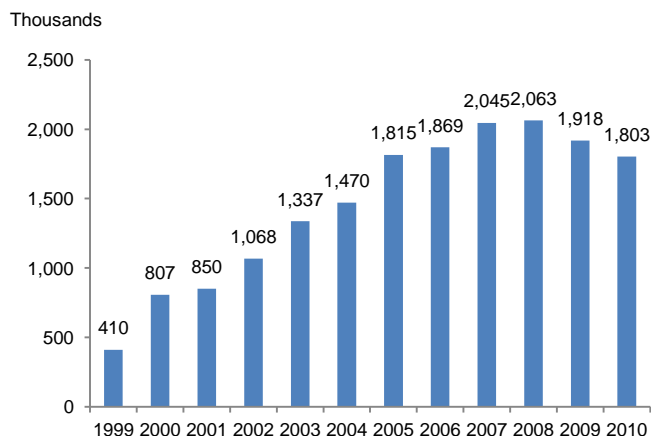


Source: A.T. Kearney and World Bank staff calculations.  
Note: ASEAN includes Thailand, Philippines, Indonesia and Vietnam.

**The low-cost production mode has been linked to a large inflow of low-skill foreign workers.** Since the 1970s, the number of legally recruited foreign workers has increased exponentially, reaching around 2.06 million in 2008 or about 17.5 percent of the labor force (Figure 74). The number of migrants declined starting in 2009 due to the global financial crisis, and by 2010, the number of legal migrants in Malaysia was 1.8 million according to the Ministry of Home Affairs. As Figure 75 indicates, most foreign workers have low levels of skills and command low wages. About 35 percent of legal foreign workers were in the manufacturing sector in 2008, where they comprise over a quarter of the labor force.<sup>16</sup> This is consistent with the previous argument that industrial activities in Malaysia still derive a large share of their competitiveness from low labor costs; in the absence of Malaysians to perform the tasks, and the upgrading to more skill-intensive tasks, firms have resorted to a growing use of foreign labor. Another way to view the growing participation of foreign workers is to contrast it with the growth in enrollment of young Malaysians in tertiary education. In a sense, foreign workers replaced the young men and women who in the past may have entered the labor force without acquiring additional education.

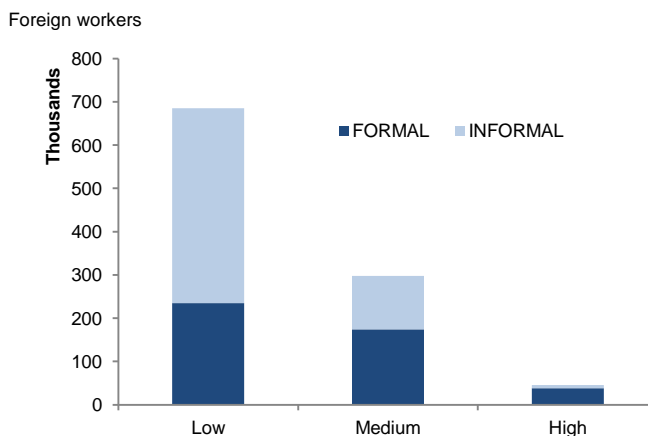
<sup>16</sup> As noted later, the figures related to foreign workers obtained from the labor force survey differ markedly from official numbers from the Ministry of Home Affairs (published by EPU at <http://www.epu.gov.my/populationandlabourforce>).

**Figure 74. The number of registered foreign workers quintupled between 1999 and 2008 but fell since**



Source: EPU, Ministry of Home Affairs.  
Note: Includes legal migrants only.

**Figure 75. Most foreign workers in Malaysia have low skill levels**

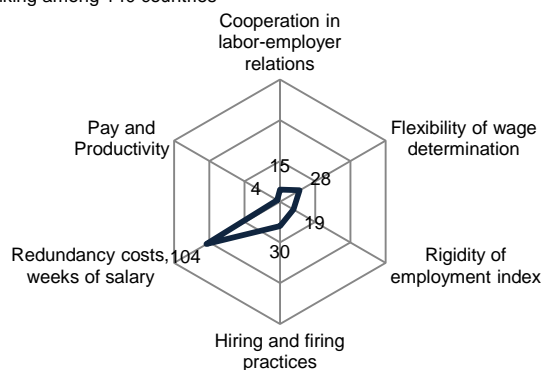


Source: DOS – Labor Force Survey 2009.

**Malaysia's labor regulations are generally flexible, except for redundancy costs.** According to the World Economic Forum's Global Competitiveness report, Malaysia ranks 20<sup>th</sup> in the world for labor market efficiency. Performance is not uniform, however. While Malaysia performs well in linking pay to productivity and having generally good cooperation in labor-employer relations, hiring and firing practices (especially redundancy costs) drag down the overall ranking (Figure 76). Moreover, the WEF report noted that 'restrictive labor regulations' ranked the third most important obstacle to doing business in Malaysia according to survey respondents. Many of Malaysia's labor regulations have not changed since the country's independence and, as the NEM recognizes, some would benefit from being modernized.

**Figure 76. High redundancy costs are perceived as reducing Malaysia's overall competitiveness**

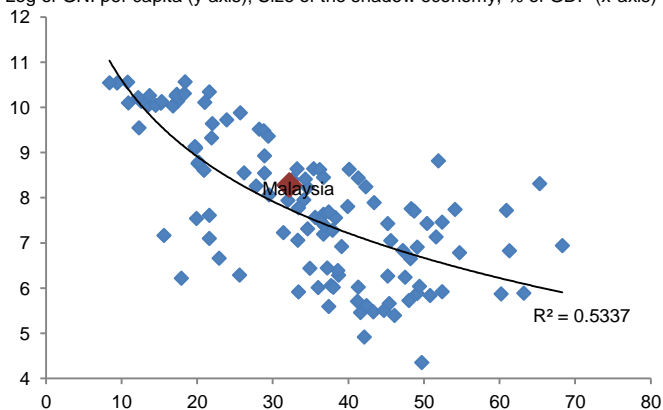
Ranking among 140 countries



Source: World Economic Forum (2011).

**Figure 77. Informality appears in line with Malaysia's income level**

Log of GNI per capita (y axis); Size of the shadow economy, % of GDP (x-axis)



Source: Schneider (2005), WDI, World Bank Staff calculations.

**Social protection is not comprehensive and Malaysia lacks a formal unemployment insurance scheme.** Social insurance in Malaysia comprises three programs: (i) a scheme for pensionable public service workers, funded by the budget; (ii) disability social insurance for private sector employees administered by SOCSO, and (iii) mandatory old-age savings plan for private sector workers administered by EPF. There are several issues with regards to social insurance in Malaysia, including: (i) the three schemes cover only about 60 percent of labor force, thus leaving a significant fraction of workers unprotected; (ii) EPF's contribution rate is very high by international standards and may adversely impact labor costs, competitiveness, job creation and wage reporting; and (iii) there is no income protection against unemployment in Malaysia.

**The informal sector is estimated to account for about 30 percent of Gross National Income (GNI) and between 35 to 40 percent of all workers.**<sup>17</sup> In the absence of formal safety nets, the informal sector serves effectively as a 'safety net' in many developing countries. In Malaysia, the informal economy includes a range of heterogeneous activities, from unregulated firms and salaried workers to undeclared or unpaid employment. Although estimates of informality are likely to be subject to significant uncertainty, Figure 77 suggests the size of the informal sector in Malaysia is in line with what would be predicted by its income level, but likely larger than in high-income countries Malaysia aspires to emulate. Some of the negative implications of informality include inferior working conditions for workers, a lack of formal benefits (health and pensions), low wages, and low productivity levels for firms.<sup>18</sup>

## How to create higher wage jobs?

**Although measures to both pull and push wages higher can help create higher wage jobs, pulling wages higher through more and better skills and higher productivity growth should be the main policy focus.** The earlier discussion suggests that two tracks should be considered to raise the wages of Malaysian workers: the most important is to boost the volume and quality of skills in the labor force to pull wages higher through higher productivity growth. In addition, to the extent that multiple equilibriums exist and market imperfections are contributing to a low-wage equilibrium, push measures, such as well-designed minimum wage and migration policies, can also help. But it must be noted from the outset that push measures must be accompanied by structural reforms to address fundamental issues in the enabling environment for firms to switch to higher value-added activities that create demand for well-paid workers. Inadequate supply of skills in the labor market is a key factor limiting industrial upgrading<sup>19</sup> and provides support to the low-wage/simple-task equilibrium, as relatively slow growth in opportunities for skilled workers reduces incentives for acquiring skills or for using them in Malaysia<sup>20</sup>, which in turn further reduces firms' incentives for upgrading.

## Boosting the quality of skills in the labor force is crucial

**Wages are linked to productivity.** Although wages have not kept up with productivity over time in Malaysia, there appears to be a contemporaneous link between productivity and wages across regions (Figure 78), as well as across different types of jobs (Figure 79). The link between pay and productivity varies across sectors of activity, but is always positive and statistically significant. As shown in Figure 79, the link is strongest for production workers compared to other types of employees in some sectors (manufacturing food and beverages, including palm oil; plastic, glass and non-metals), and strongest for non production workers in others. The average elasticity across sectors for which estimates were possible lies between 0.58 (managers and supervisors) and 0.69 (non production workers).

**There is also a robust correlation between skill levels and wages.** As shown in Table 10 and Table 11, higher levels of formal education are associated with higher wages in Malaysian labor markets. A university graduate can expect to earn wages nearly 5 times higher than a worker without any formal education. This relationship is confirmed by regression analysis, which suggests that completing a university education increases earnings by an average of 88 percent compared to someone who did not complete university, even when controlling for other characteristics. The median income of graduates 18 months after graduation is about RM2,100 per month and is RM2,300 per month a year later (Table 12). This is actually an extremely high level of financial achievement, because bachelor's students' families have an average income of RM2,100 per month. Thus, one can infer that bachelor's degrees

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<sup>17</sup> For the purposes of this report, employment in the "formal sector" is defined as holding a job for which the employer makes EPF or SOCSO contributions. DOS estimates that 8 to 9 percent of workers are in the informal sector based on the Informal Sector Survey. This lower figure excludes agricultural and household employees, which are considered informal in this report. The definition of informal economy used here refers to the share of a country's production of goods and services that does not comply with Government regulation.

<sup>18</sup> Labor informality in Malaysia is primarily a micro and small firm phenomenon (Mohammed, 2004). Smaller firms are often engaged in low-productivity operations with limited access to finance, limited need of key Government services, and a relatively large informal customer base.

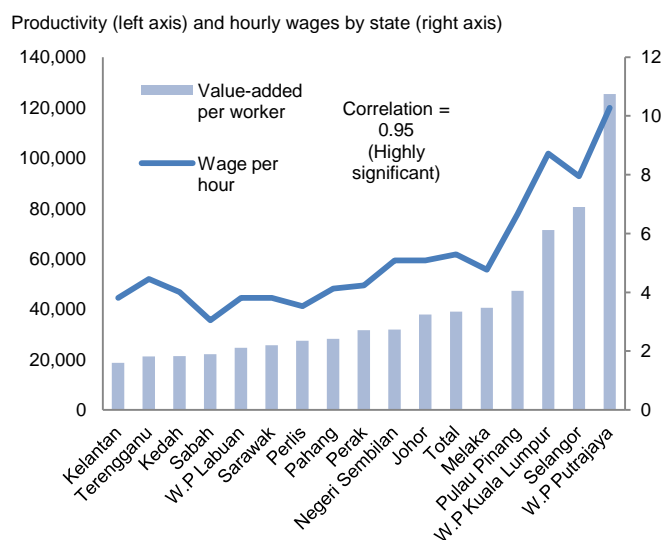
<sup>19</sup> The April 2010 Malaysia Economic Monitor – *Growth through Innovation* identifies talent, technology and finance as the requisite capabilities required for innovation-led growth.

<sup>20</sup> A comprehensive discussion of issues related to the incentives for Malaysians to use their skills abroad rather than in Malaysia can be found in the April 2011 Malaysia Economic Monitor on 'Brain Drain.'



bring great benefits to their holders: after only two years in the labor market, bachelor's holders already have salaries equal to their parents' combined income.

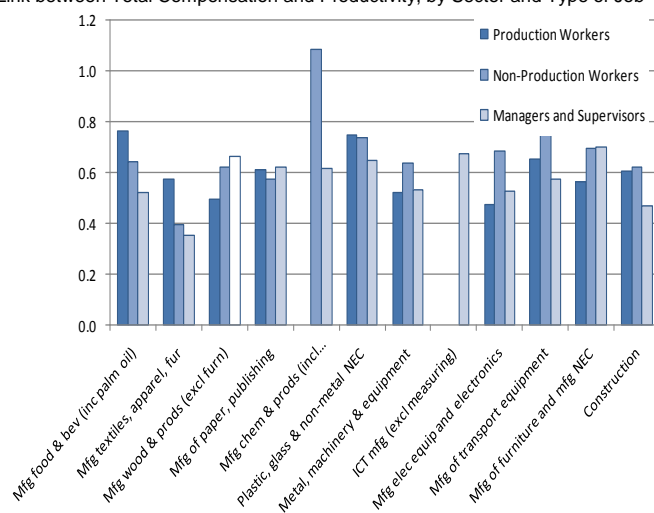
**Figure 78. Wages are linked to productivity by region**



Source: DOS – Labor Force Survey 2009 and Establishment Surveys (various years).  
Note: Hourly wage data include formal and informal jobs, value added per worker only calculated on formal (registered) establishments.

**Figure 79. Across different types of jobs, compensation is linked to productivity**

Link between Total Compensation and Productivity, by Sector and Type of Job



Source: Establishment surveys (various years) and World Bank staff calculations.

**Table 11. Degree recipients receive wages 5.5 times higher than those with no formal education**

	Total salaries and wages	Basic salaries and wages	Total salaries and wages including overtime payment
UPSR/UPSRA or eq.	800	750	800
PMR/SRP/LCE	900	800	950
SPM/MCE	1200	1000	1200
STPM/HSC or eq.	1568	1218	1597
certificate	1500	1232	1515
diploma	2355	2000	2400
degree	3350	2905	3350
not applicable	560	500	600
no certificate	725	700	750

Source: DOS – Labor force survey, 2009.

**Table 12. Wages increase with education levels, but the largest rewards come from tertiary education.**

	Total salaries and wages	Basic salaries and wages	Total salaries and wages including overtime payment
no formal education	560	500	600
primary	750	700	789
secondary	1065	950	1121
tertiary	2538	2148	2600

Source: DOS – Labor force survey, 2009.

**The links between skills and wages, and between productivity and wages, suggests a relationship between skills and productivity.** Although the causality has not been established in the Malaysian case, international evidence supports the hypothesis. Research by Moretti (2005) using US data finds that a one-percent increase in the city share of college graduates is associated with a 0.5-0.6-percentage-point increase in output. Moretti also finds that

productivity gains are translated into higher wages for workers: an extra percentage point in the share of tertiary-educated workers in a city is associated with 1.3 percentage points in higher wages, after controlling for individual observable characteristics. Similarly, Glaeser and Ressenher (2009) find that productivity in skilled cities was much higher than in unskilled cities.

**Table 13. Distribution of Bachelor's-level Graduates by Income Band, at 18 and 30 months after the end of classes (graduating classes of 2006 and 2007)**

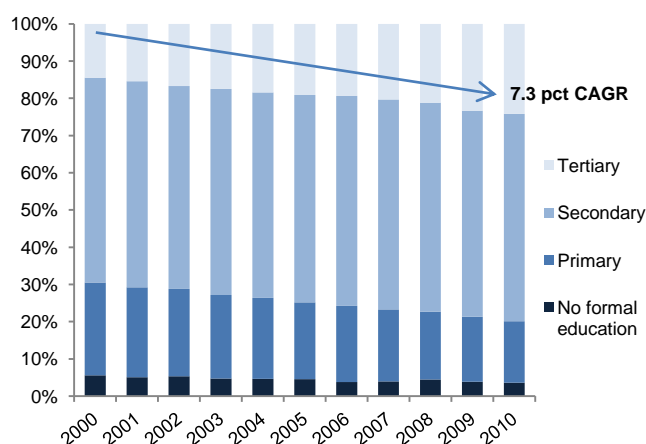
	18 months	30 months
RM500 or less	1%	1%
RM501-1000	8%	6%
RM1001-1500	16%	13%
RM1501-2000	20%	15%
RM2001-2500	29%	25%
RM2501-3000	17%	23%
RM3000+	10%	18%

Source: Ministry of Higher Education – Laporan Kajian Pengesanan, Graduan SKPG II 2008/9.

**The quantity of skills of the work-force has increased but remains low compared to aspirational high-income countries.** Between 2000 and 2010, tertiary graduates joined the labor force at a rate of 7.3 percent per year (net of tertiary graduates leaving the labor force; see Figure 80). This resulted in the share of university graduates in the labor force going up by 10 percentage points to nearly 25 percent. However, compared to the high-income countries Malaysia aspires to emulate, these are still relatively low levels. For example, 35 percent of Korea's labor force had a tertiary education in 2007 (Figure 81). Moreover, as noted in the November 2010 Malaysia Economic Monitor, low educational endowment and skills level is particularly pronounced among the poor. About 62 percent of poor households were headed by a person with primary education or less, and only 1 percent of poor households had a head with a tertiary level of education. This implies that, even if labor market opportunities in higher paying sectors become available, many of the poor will be unable to take advantage of them.

**Figure 80. The share of university graduates in the labor force increased rapidly in the past decade...**

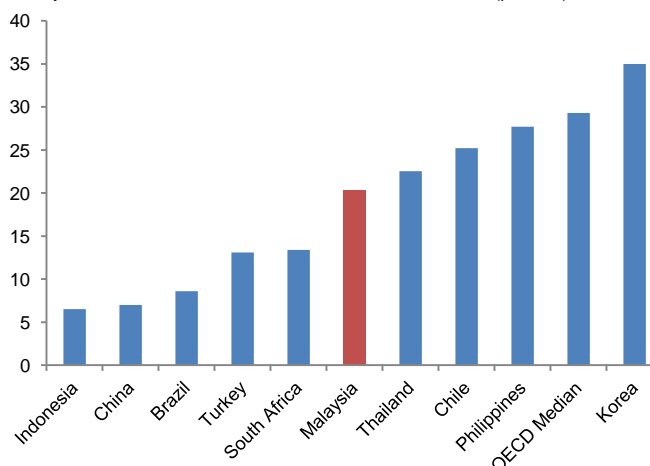
Labor force composition by highest level of education



Sources: DOS.

**Figure 81. ... but remains below that of advanced economies and even some regional peers**

Tertiary-educated workers in the labor force in 2005 – 2007 (percent)

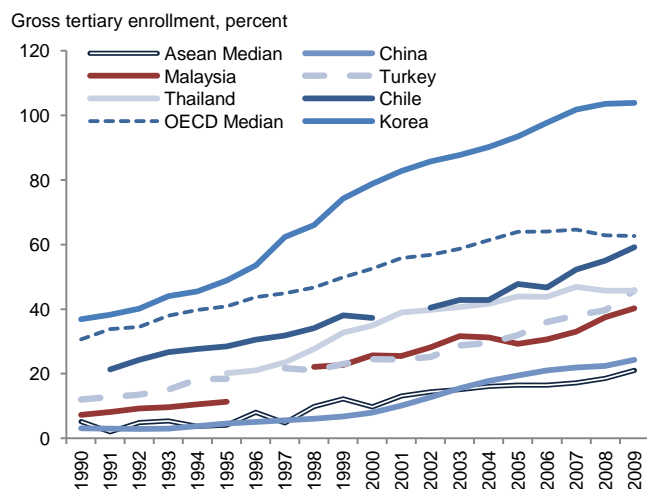


Source: World Bank EdStats.

**One priority is therefore to increase the supply of skills by targeting underserved areas and groups.** Although enrollment rates have increased rapidly in the past decade along with the share of graduates in the labor force, as Figure 82 indicates other countries also continue to expand their enrollments. OECD enrollment ratios, which have stabilized at 62 percent, are still 22 percentage points above Malaysia's. This will require expanding enrollment in

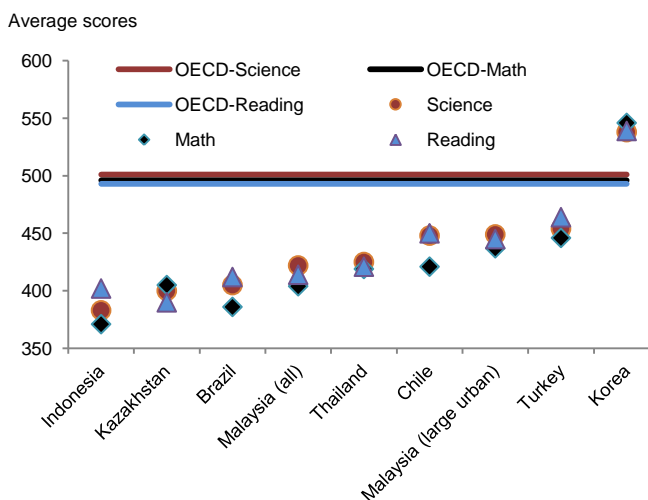
higher education, especially through private universities and targeting groups that lagged the enrollment growth in recent years.<sup>21</sup> In this context, the Government must at the same time ensure access and financing, where necessary, for students to be able to take advantage of private higher education, as well as mechanisms to ensure quality control for private universities. Growing the private higher education sector, including through new partnerships with foreign universities, could support the objective of expanding enrollments further. Targeting underserved areas and groups can bring the largest gains. As noted in Table 8 above, Sabah's population has a lower educational attainment compared to peninsular Malaysia, suggesting room for quick improvements.

**Figure 82. Enrollment ratios need to rise further for Malaysia to catch up**



Source: World Bank EdStats.

**Figure 83. Boosting the quality of education, especially basic education, remains a key challenge**



Source: OECD.

Note: Malaysia values for 2010, all others 2009.

**As important as increasing the supply of skills is ensuring that there is robust demand to retain skills in Malaysia.** The large numbers of skilled Malaysians who choose to work abroad suggest that retaining talent is a key challenge. Addressing structural challenges in the economy will be necessary to ensure that companies will take advantage of the increased availability of skills. This will require companies to pay for skills, which in turn increases incentives to retain skills in Malaysia. Structural challenges relate to increasing competition within the economy to drive innovation and productivity growth. SMEs, which would be expected to make a large contribution to the demand for skills, are squeezed between large multinationals, Government-linked companies, and cumbersome regulation. Modernizing the Government's inclusiveness policies towards need-based criteria would also effectively remove what is effectively a tax on firms and individuals.

**As the quantity of graduates increases, it is important to make parallel efforts to improve the quality of skills produced by the educational system, starting with basic education.** The concerns with the quality of basic education in Malaysia are well-recognized. As noted by EPU, there remain significant gaps to close in order to achieve a first-world talent base with Malaysia increasingly at risk of falling behind. Student performance, as benchmarked by international surveys, has been declining. In the TIMSS 2007 report, around 20 percent of Malaysian students failed to meet minimum benchmarks for both Science and Mathematics, compared to only 5 percent in science and 7 percent in Mathematics in 2003 (Tenth Malaysia Plan, p. 193). The results of the recent PISA+ assessment were also a concern (Figure 83) as Malaysia performed significantly below OECD average levels. There are also significant urban-rural disparities in test results that suggest that as with increasing quantity, targeting underserved areas and groups can bring the largest payoffs in quality improvements as well.

**Higher quality education will require greater autonomy for individual schools and universities.** Accountability requires frequent and rigorous assessments of the quality of education. This can be accomplished through a

<sup>21</sup> MOHE expects 50 percent of the cohort between the ages of 17-23 to be in tertiary education by 2020, with the number of private institutions increasing to 29 private universities, 22 university colleges, 6 branch campuses and 411 private colleges.

comprehensive, ICT-based, assessment system that is used for diagnostics, policy analysis, planning, and monitoring of teacher and school effectiveness. The Government has moved in this direction by ranking all the schools in the country and working with low-performing schools to improve their performance under the NKRA on education. While this is a promising step, disclosing the rankings of individual schools (within bands), as is done with universities, would help empower the communities in which schools are located to demand equal access to quality services. This is likely to be particularly effective in rural areas. A parallel step is to provide schools with greater autonomy. Compared to the 23 countries covered by the 2009 OECD's Teaching and Learning International Survey (TALIS), Malaysia ranks poorly in terms of delegation of authority to schools (Table 14). In this regard, the Government may wish to pilot systems of increased school autonomy, including delegation of authority for hiring and firing staff and greater control of the budget, as well as the option of increased use of contract teachers. The same logic flows through to universities: greater accountability (such as through the refinement of rankings to include standardized university-wide tests) and autonomy can help ensure that the expansion in enrollments in higher education is producing quality graduates.<sup>22</sup>

**Table 14. School autonomy at lower secondary – TALIS 23-country study**

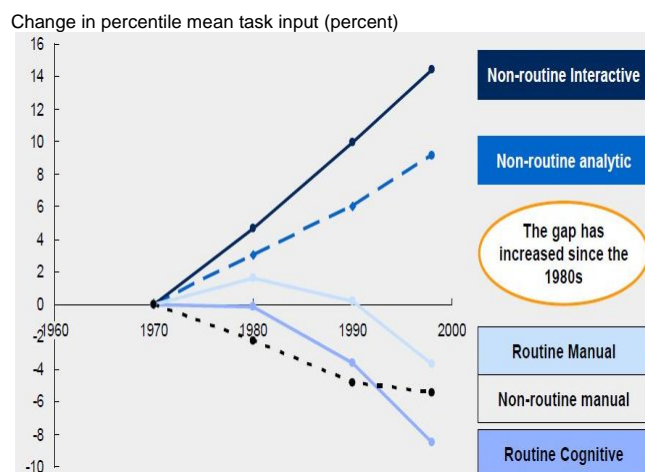
	Malaysia	Korea	23 Country Talis Average	Malasia Rank of 23
1 Selecting Teachers	6.9	31.2	67.7	23
2 Firing Teachers	6.8	20.8	60.7	23
3 Establish Teacher Salaries	4.0	5.7	24.3	18
4 Determine Salary Increases	11.4	3.5	25.6	15
5 Professional Development	33.8	63.2	60.3	17
6 Formulate School Budget	68.8	77.3	75.3	17
7 Allocations within budget	62.5	94.9	88.2	21
8 Discipline Policies	56.7	56.7	93.1	23
9 Assessment Policies	21.6	91.1	88.9	23
10 Admission Policies	21.6	85.8	85.0	23
11 Course Offering	35.4	88.7	72.2	22
12 Course Content	33.3	85.4	65.7	20
13 Choosing Textbooks	19.0	96.7	90.0	23
Average	29.4	61.6	69.0	20.6

Source: OECD (2009, Table 2.7) and World Bank staff calculations.

**In addition to the quantity and quality of skills, the types of skills produced by the education system are also important.** As the price of automating certain types of tasks declines, skills related to procedural, rule-based tasks will tend to decline in value (Acemoglu and Autor, 2010). On the other hand, the productivity of those jobs which are complementary to automation and technology more generally is increasing rapidly (Figure 84). Such jobs require the performance of non-routine tasks, especially analytical, creative and interpretive skills that cannot be automated. In addition, manual but non-routine tasks have also seen their returns increase even as similar but more standardized manual tasks have stagnated (Figure 85). This has important implications for curriculum reform: memorization and rote learning are not particularly suitable for modern jobs. Rather, as noted in Table 15 below, curricula—as well as teacher training—need to emphasize critical thinking over memorization and a greater role for the development of soft skills such as communication and interpersonal skills through sports or other team activities. Employers report that Malaysian workers are weak in soft skills such as communication, creativity, innovation, team work and leadership (Malhi, 2009). To address these concerns, as part of the SRI on human capital the Government has recently announced changes to National Occupational Skills Standards (NOSS) and university curricula to include finishing classes and soft skills training.

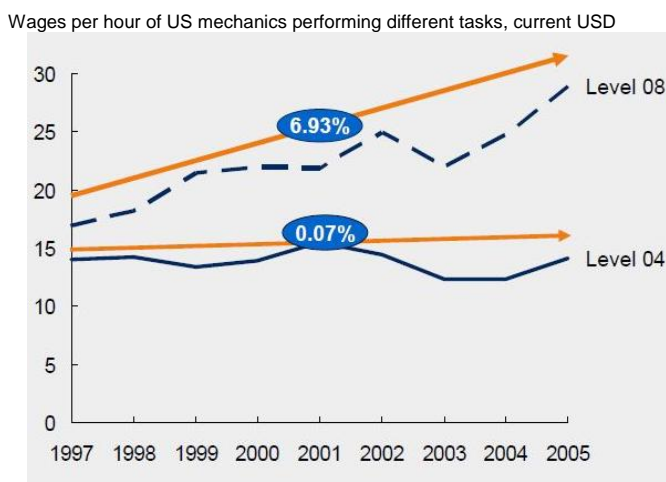
<sup>22</sup> Public and private universities are rated by the Malaysian Qualifications Agency and the ratings are public. Private colleges and polytechnics are also rated periodically. In terms of autonomy, five of the public research universities, namely UKM, USM, UPM, UM and UTM have been given autonomy in areas related to governance, financial and income generating, human resource and academic management as well as students' intake. Private higher education institutions at all levels are fully autonomous.

**Figure 84. There has been an increase in demand for tasks complementary with technology**



Sources: McKinsey Global Institute (2009) based on Autor, Levy and Murnane (2003).

**Figure 85. While returns to routine tasks (such as basic auto mechanics) have stagnated**



Source: McKinsey Global Institute (2009).

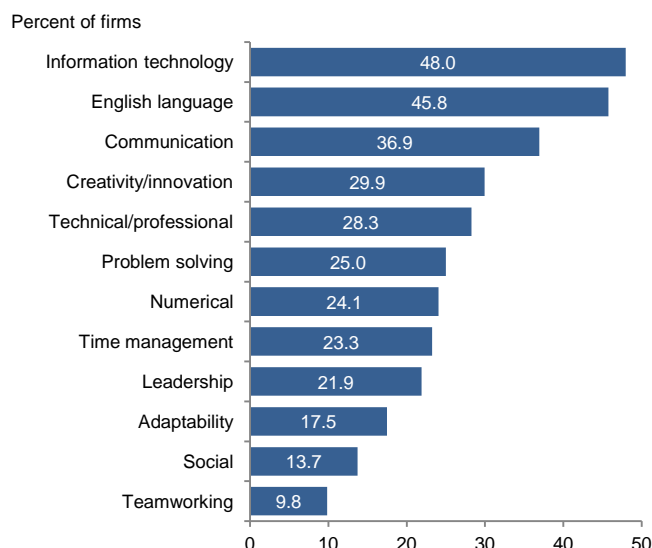
**Table 15. Non-routine skills will be increasingly demanded as routine skills are automated.**

Skills	Non-routine cognitive: Analytical	Non-routine cognitive: Interpersonal	Routine cognitive	Routine manual	Non-routine manual physical
Tasks	Analyzing data/information	Establishing and maintaining personal relationships	Importance of repeating the same tasks	Pace determined by speed of equipment	Operating vehicles, mechanized devices, or equipment
	Thinking creatively	Guiding, directing and motivating subordinates	Importance of being exact or accurate	Controlling machines and processes	Spend time using hands to handle, control or feel objects, tools or controls
	Interpreting information for others	Coaching/developing others	Structured v. Unstructured work (reverse)	Spend time making repetitive motions	Manual dexterity
					Spatial orientation
Examples of occupations demanding high levels of these skills	Lawyers, engineers, higher education professionals, medical doctors, managers		Telephone operators, book keeping, cashiers	Assembly line worker, elevator operator	Industrial truck operator, security, food preparation

Source: Acemoglu and Autor (2010).

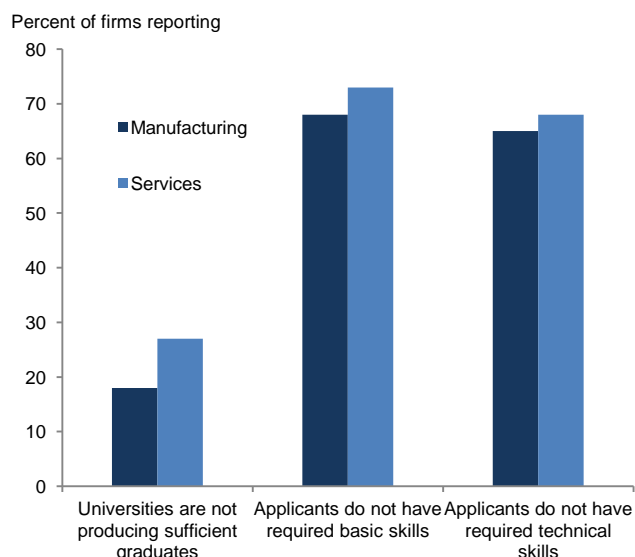
**A related concern regarding types of skills produced by the educational system is ensuring that they match requirements from firms.** According to the 2007 Productivity and Investment Climate Survey (PICS), Malaysian firms also view shortages of non-routine skills as key constraints (Figure 86). Such shortages have led to job vacancies. More than 40 percent of firms have reported vacancies of skilled production workers, and the average time to fill a vacancy is about four weeks (World Bank, 2009). The main reasons given by the firms for this long process were that the applicants did not have the required basic skills or the right technical skills needed to carry out the jobs in question (Figure 87). Lacking choices, firms often hire workers who do not have the appropriate skills for the job. The 2007 PICS shows that many workers lack the appropriate level of education for their jobs or their skills don't match what they were hired to do. Only 10-15 percent of workers believed their chosen field of education suited their current job; likewise, more than 15 percent believed their educational qualifications were irrelevant to their current occupation. Not surprisingly, the PICS found that shortage of skills is the top obstacle to firms, with about 40 percent of participating firms reporting this as one of their top three constraints.

**Figure 86. Firms generally identify non-routine and other soft skills as a key constraint**



Source: World Bank (2009).

**Figure 87. Applicants' lack of skills leads to job vacancies**



Source: World Bank (2009).

**Further evidence of skills mismatches come from the employment outcomes of tertiary graduates.** Given the shortages reported earlier, one would expect very low unemployment rates for graduates in the absence of skills mismatches. The results—shown below in Table 16—suggest that graduate unemployment is relatively high<sup>23</sup>: on aggregate 17 percent among bachelor's graduates at public universities and 19 percent among bachelor's graduates of private ones, with substantially higher rates at lower levels of certification. High unemployment among graduates is not unheard of – in most developed countries, youth unemployment runs at least twice the level of overall unemployment, for instance. And nor is it unheard of to have high unemployment among graduates in countries with a rapidly expanding system of education: see in particular recent reports from China with respect to graduate unemployment rates of 20 percent or higher. Nevertheless, rates such as these in the context of overall unemployment of 3 percent are indicative of some degree of skills mismatch.

**Table 16. Employment Status of 2006 and 2007 Graduates at the end 2008, By Institution Type and Level**

Employment Status	IPTA		IPTS	
	Bachelor's Level	Below Bachelor's Level	Bachelor's Level	Below Bachelor's Level
Employed	73.1%	46.8%	77.5%	57.2%
Waiting for placement	3.1%	0.7%	0.4%	0.5%
Pursuing further study	6.6%	27.4%	2.9%	11.4%
Unemployed	17.1%	25.1%	19.1%	30.8%

Source: Ministry of Higher Education – Laporan Kajian Pengesanan, Graduan SKPG II 2008/9.

**High graduate unemployment even in science and business are further indication that curricula are not meeting firms' needs.** Table 17 decomposes the data in Table 16 somewhat to look at whether or not the differences by sector are explainable by the composition of enrollment. When decomposed by field of and level of study, we find that the IPTS sector has a weaker record than the public sector in all cells except Science at the Bachelor's level. The gap would appear to be especially large in Arts and Business at the Bachelor's level (a sector which in the IPTS

<sup>23</sup> Every second year, the Ministry of Higher education conducts two surveys, one of graduates-to-be, as well as a follow-up survey 18 months after graduation. This incorporates information about the first 18 months of students' time in the labor market and provides insights regarding the matching of skills. The survey results do not appear to distinguish between "unemployed" in the sense of being unable to find a job and "not employed" in the sense of not participating in the labor market due to having children, etc. The translation "unemployed" is retained here even though it seems likely that some of the people should not technically be described that way. In addition, it should be noted that 2008 figures may reflect the impact of the global financial crisis and therefore exaggerate unemployment figures.

sector is almost exclusively 'business'). Interestingly, the only category with low unemployment is education, where graduates are virtually guaranteed a position with the government.

**Table 17. Graduate Unemployment Rates 18-30 Months after End of Classes by Discipline, Level and Type of Institution**

Field of Study	IPTA (Public)		IPTS (Private)	
	Bachelor's Level	Below Bachelor's	Bachelor's Level	Below Bachelor's
Arts/Business	22.9%	28.4%	28.2%	35.4%
Science	16.6%	23.4%	13.2%	26.4%
Technical	11%	20%	11.6%	28%
ICT	13.4%	28.7%	16.8%	30.8%
Education	0.6%	-	-	50%

Source: Ministry of Higher Education – Laporan Kajian Pengesanan, Graduan SKPG II 2008/9.

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

**Improving the take-up and quality of technical and vocational education and training (TVET) can also help bridge the skills mismatches.** Despite the seemingly comprehensive approach to vocational training in Malaysia, the take-up rate of TVET opportunities is low.<sup>24</sup> A recent study attributed the low and declining take-up rates partly to the fragmentation of the training system, which overwhelms students and parents as they lack the necessary information in order to make informed decisions among the plethora of available options. It also pointed out that the quality of the training offered is very variable, which leads industry to distrust the qualifications produced by the vocational training sector as a whole (EPU, 2009). Similarly, a past study found that the complicated financial schemes available for vocational training in Malaysia may have led to low take-up rates by students (Tzannatos and Johnes, 1997)

**Developing an employer-led skills development system will be an important step in improving the performance of Malaysia's TVET system.** The Government could consider adopting measures to encourage employers or industry representatives to participate in the skills standard and certification process, designing the curriculum, providing apprenticeships, and offering internship and scholarship programs to workers to improve their skills. As Figure 88 and Figure 89 indicate, the needs of industries vary greatly and change significantly over time. Therefore, it is only when those industries and employers are closely involved in training decisions that the training system can respond effectively to their needs.

<sup>24</sup> MOHE is in the process of finalizing the framework of TVET's pathway in which students from Certificate level are allowed to continue into Diploma and degree programs through the MTUN (Malaysia Technical University Networks).



**Figure 88. English proficiency is less of a concern in manufacturing...**

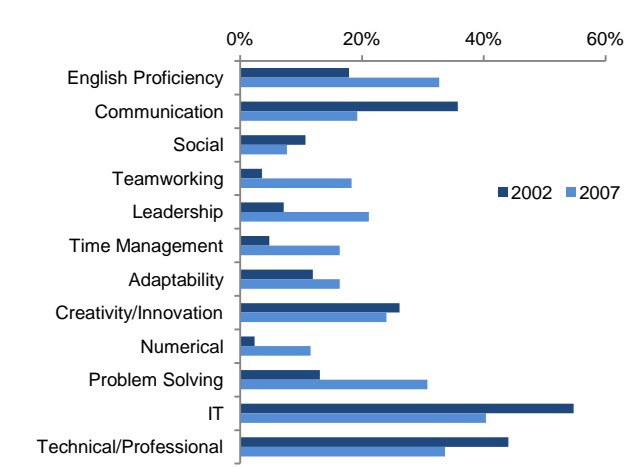
Percent of firms



Source: World Bank (2009).

**Figure 89. ...whereas firms in business support services require more of that skill**

Percent of firms



Source: World Bank (2009).

**In sum, improving the quantity, quality and type of skills provided in Malaysia will require greater information, incentives and capacity.** Parents and employers need better information on the performance of skills providers at all levels to hold them accountable for improved performance. Skills providers require better information on skills demand, R&D and technology needs, and entrepreneurship opportunities. Policy makers need better information on why some programs are failing to perform – highlighting the importance of constant monitoring and evaluation. This requires better communication and engagement between employers, Government and skills providers. The private sector needs to be more involved in the provision of skills, including financing it, so that it has more of a stake in its success. Skills providers will have incentives to perform better if their performance is more transparently communicated to the public, and if there are consequences for non-performance. Greater autonomy to schools and universities can create more competition and also provide better incentives for performance. Finally, teachers need to be retrained to teach a more problem-oriented and analytical curriculum that also emphasizes soft skills. Firms need adequate capacity to signal the demand for specific skills and influence skills development policies and curriculum development. The capacity of the Government in policy formulation and implementation, including quality assurance and enforcement, will also be critical.

### A well-implemented minimum wage can help

**A minimum wage policy is likely to be announced in the first half of 2012 and, if well implemented, can help push up wages.** It has been reported that the Government will announce a minimum wage in the first half of 2011 (ETP Annual Report 2011). This section briefly reviews the rationale for a minimum wage in Malaysia, its potential impact, and offers some considerations on the implementation process. In a nutshell, a well-implemented minimum wage can help push up wages by correcting labor market imperfections and moving Malaysia to an equilibrium of higher wages and higher productivity—though possibly at the cost of slightly higher unemployment or informal employment. Adequate implementation is critical, as long-term predictability regarding minimum wage revisions is likely to be as important to firms as the current level of the minimum wage.

**A minimum wage can help correct imperfections in labor markets.** When firms face limited competition in labor markets they may be able to pay workers lower wages and keep some workers out of the labor force. There is some evidence of such wage-setting power by firms considering that productivity growth has not been linked to wage growth in some sectors and over time. The declining labor participation rate and growing numbers of foreign workers contribute to the view that firms can keep some local workers unemployed (or out of the labor force) while tapping on large supplies of low-wage foreign workers. It is also possible that a minimum wage can lead to some productivity improvements. If it is costly to supervise workers' performance, it may be optimal to pay a higher wage and supervise more sporadically. A higher wage increases the cost of losing the job from the worker's point of view, and increases incentives for effort (and higher productivity) even with more limited supervision. In this context, a minimum wage would help markets move to an equilibrium with higher wages and higher productivity. Georgiadis

(2007) finds evidence of such a wage-supervision trade-off in the context of the introduction of a minimum wage in the UK in 1999.

**A minimum wage is not an effective instrument to address poverty and inequality.** Policymakers have often argued that the minimum wage, by increasing the income of low-income workers, can be used as a tool to reduce poverty and inequality. However, evidence suggests that even though a well implemented minimum wage at a moderate level can have positive social welfare effects, it is not the most appropriate instrument to address poverty and inequality. Indeed, many poor people are not employed or are employed in the informal sector where minimum wages are not binding. Also, poor people often have limited skills and low productivity and thus tend to be among the first to be laid off when wages increase in line with the legislation.

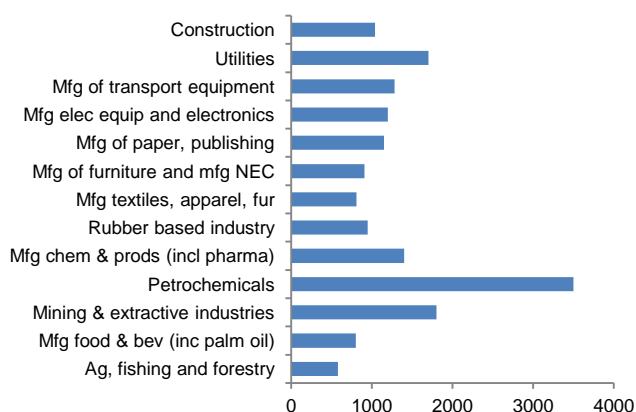
**Nor is a minimum wage the right policy to stimulate the productivity of firms.** A minimum wage policy can cause low-productivity firms that cannot afford the higher cost of labor to go out of business, and this may result in an increase in the average productivity in the economy. However, if the objective is to provide incentives for innovation, the adoption of new technologies, and economic diversification that truly contributes to higher productivity growth across business and sectors, then other policies may take priority. These might include investing in skills and infrastructure and improving the business environment in ways that encourage competition, investment, and entrepreneurship.

**Workers with the lowest earnings—those most likely to benefit from a minimum wage—are largely those who work in agriculture and other sectors intensive in low-skill labor that are also characterized by a high degree of informality.**

Figure 90 illustrates that the typical wage in agriculture was under RM600 in 2009, while other labor intensive sectors such as textiles, furniture, and food also exhibit relatively low wages. Workers in the modern services sectors have the highest earnings on average, and those in the manufacturing sector fall in between (see Figure 90 and Figure 91). Jobs in labor-intensive sectors including agriculture pay only slightly more than RM1,000 per month on average, but only 15.3 percent of these jobs are formal. On the other hand, jobs in the manufacturing sector pay over RM1,450 per month on average, and over three-quarters of those jobs are formal. Therefore, while most potential beneficiaries from the minimum wage may be in wood products, agriculture, and restaurants (Figure 92), they may not be covered: the impact on these workers would depend on whether low wages were due to workers' low productivity or their limited market power, and on the enforcement or influence of the minimum wage in informal labor contracts. Workers in the services sectors, with the possible exception of restaurant workers, are less likely to be affected as typical wages already exceeded RM1,000 per month in 2009. Due to the significant geographic variation in wages (Figure 93), at a level of RM 700 per month (in 2010 prices) up to 30 percent of workers in Peninsular Malaysia would potentially benefit from the introduction of the minimum wage, whereas as many as half of those in Sabah and Sarawak would.

**Figure 90. Median wages in petrochemicals are the highest of the resource intensive sectors**

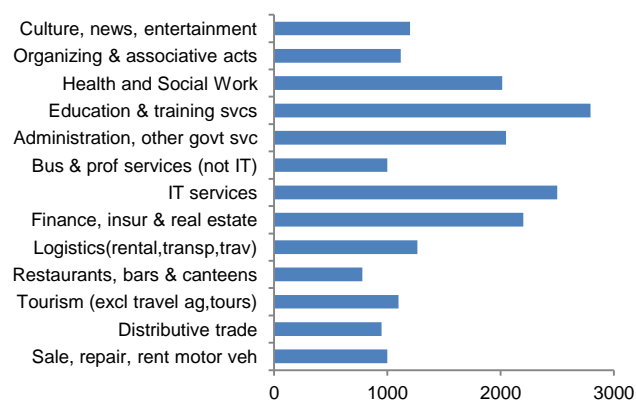
Median wages by sector (RM per month)



Source: DOS – Labor Force Survey 2009.

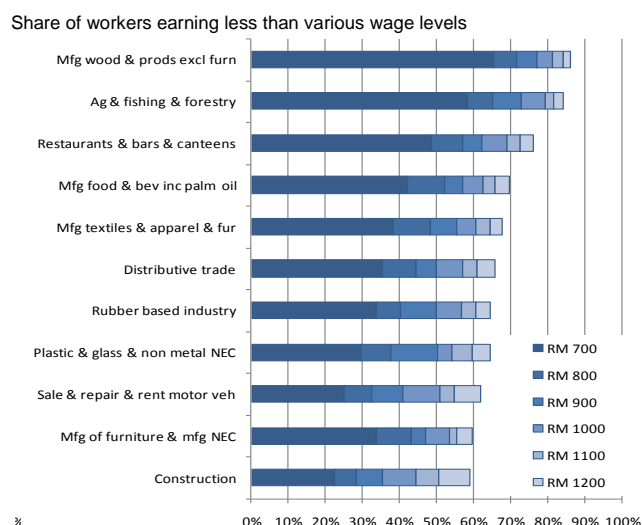
**Figure 91. Wages in services are generally higher than in manufacturing and agriculture**

Median wages by sector (RM per month)



Source: DOS – Labor Force Survey 2009.

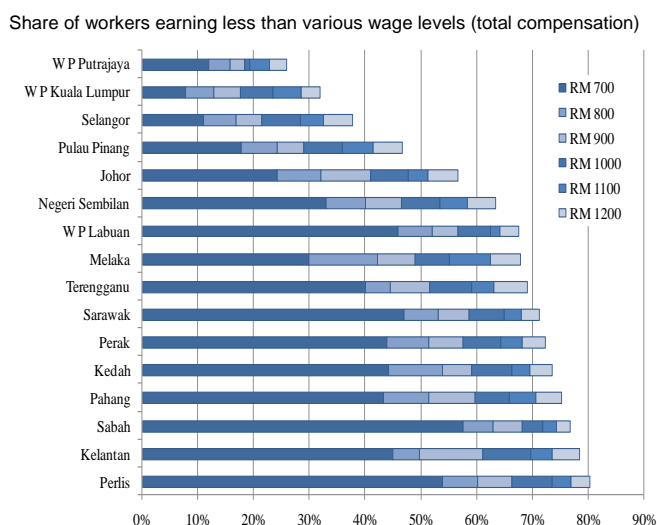
**Figure 92. Labor-intensive, low-skill sectors would be more highly affected by the minimum wage**



Source: DOS – Labor Force Survey 2009.

Note: Base monthly compensation is expressed in 2010 RM by using the CPI to convert the nominal 2009 figures for private sector employees only (excludes non-wage earners and public sector employees). All earnings are converted to full-time equivalent values. All figures are percentages for the state using LFS sample weights.

**Figure 93. There is significant geographic variation in the concentration of low income earners**



**The potential negative impact of the minimum wage on firms and employment will depend on the degree of competition in labor and product markets, the extent of enforcement especially in the informal sectors, as well as productivity dividends.** To the extent that labor markets were at a low-wage, low employment equilibrium, the introduction of the minimum wage may have a *positive* employment effect as some workers rejoin the labor force. However, to the extent that labor markets are competitive, higher labor costs would be passed along to consumers, and potentially lead in the reduction of employment. As noted earlier, most of the potential beneficiaries of the minimum wage are in sectors characterized by a high degree of informality. To the extent that enforcement in these sectors is limited, there would be few changes in employment even if firms do raise wages.

**A single minimum wage for all occupations facilitates compliance, but regional differentiation may be desirable to account for different productivity levels.** Some countries differentiate the minimum wage by occupation. However, this has proven to be detrimental in terms of compliance and market distortions, so most countries are moving away from differentiating wage levels by occupation or sector towards having just one national level for the minimum wage. Regional differentiation in the level of the minimum wage should be based on productivity in each region and not the cost of living. As discussed above, the minimum wage is not meant to address insufficient purchasing power or poverty, but to the extent that different wages in different regions are linked to different productivity levels, different minimum wages could be considered based on geography.

**Economic and social circumstances justify extending coverage of the minimum wage to migrant workers.** A significant segment of these migrant workers are young and employed in low-skilled activities (mainly construction, manufacturing, and agriculture) that earn the lowest wage levels in the labor market. Excluding migrant workers would be counterproductive as it would make migrant workers even cheaper than lower-skilled Malaysians. In any case, by law and international conventions migrants deserve to be accorded the same treatment as Malaysian workers due to the contributions that they make to the Malaysian economy. Nevertheless, since a large number of foreign migrant workers are in Malaysia illegally, they would not receive the minimum wage.

**The process by which the minimum wage is reviewed is important.** Businesses require policy stability in order to make forward-looking plans, and any concerns about arbitrary changes in the minimum wage policy are likely to add a risk premium to investment decisions. Accordingly, the process for adjusting the minimum wage rate should be evidence-based and should avoid excessive rigidity by allowing an appropriate dose of discretion. One of the

main challenges in some countries has been that the frequency and level of adjustments to the minimum wage has depended on the discretion of bureaucrats and policymakers. Rather, the minimum wage should be reviewed regularly (every one or two years by a pre-set date), and the review process should take into account reliable technical information on pre-set criteria such as consumer prices, producer prices, productivity, unemployment, and GDP growth. Most importantly, the process of adjusting the minimum wage should take into account a rigorous evaluation of the policy with regard to its goals. Monitoring and evaluation of the minimum wage and any other policy initiative is essential to evidence-based revisions in the future. This section contains a number of conjectures, which should be tested with data once the policy is in place.

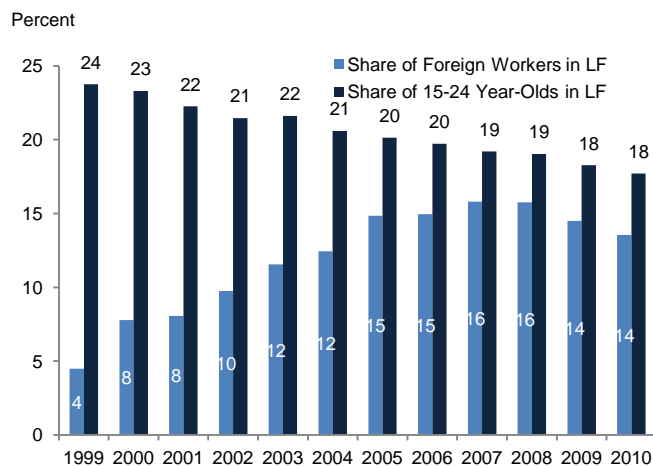
## Leveraging foreign skills – at all ends of the spectrum

### Foreign workers of all skill levels are a characteristic of successful economies with well-functioning labor markets.

Global cities are characterized by relatively large numbers of immigrants of different skill levels. New York, Hong Kong, Singapore, London and Paris count with over one million foreign-born residents across the skills spectrum. High-skilled foreign labor can help create economies of scale through agglomeration of human capital, generating more high-skilled jobs for Malaysians. Low-skilled foreign labor can complement high-skilled labor, for example in manufacturing industries where research and development activities take place around a manufacturing core that still requires a number of machine operators, or in the labor-intensive hospitality sector. The challenge for Malaysia is not to push out low-skilled foreign workers, but rather to rebalance its economy so that it attracts more skilled immigrants vis-à-vis low-skill ones.

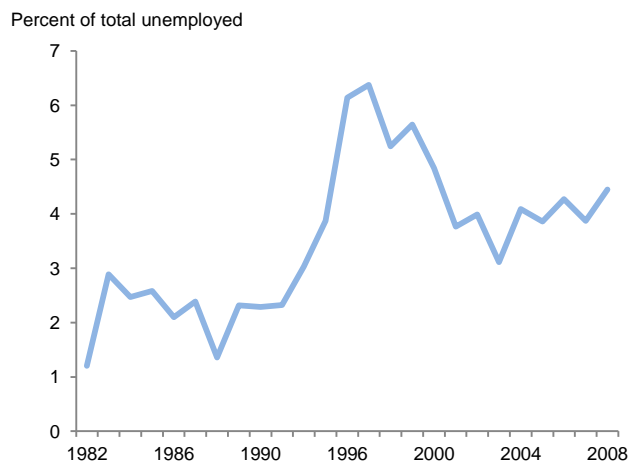
**After growing rapidly through 2008, the number of foreign workers has declined since 2008.** After peaking at 2.1 million in 2008, the number of registered foreign workers has declined to about 1.8 million as of 2010.<sup>25</sup> In addition to registered foreign workers, there are also an uncertain number of undocumented migrants (estimates range from as few as 500,000 to as many as 2 million). The share of migrants in the labor force doubled from 8 to 16 percent between 2000 and 2008 as foreign workers largely took the place of young men, whose participation rate declined (Figure 94). The low unemployment rate among migrants suggests that demand-pull forces were the main drivers of migration (Figure 95).

**Figure 94. Following rapid increase, the share of migrants in the labor force has stabilized**



Source: EPU, DOS, CEIC and World Bank staff calculations.

**Figure 95. The low share of non-citizens among the unemployed reflects strong demand**

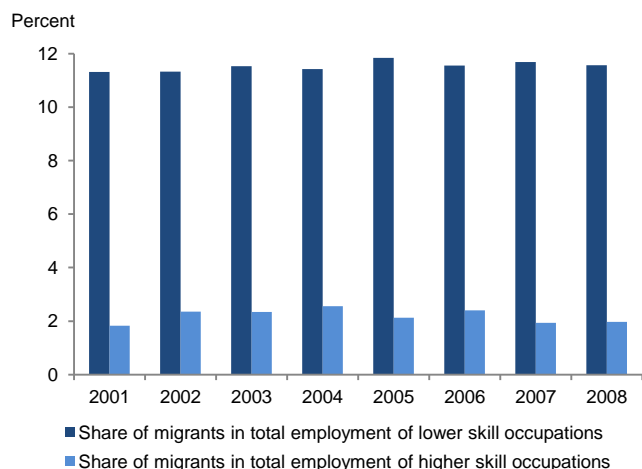


Source: World Bank (2011b).

<sup>25</sup> This section uses a combination of data from the Malaysian labor force survey (LFS) and other sources, which sometimes offers contradictory conclusions. The labor force survey for 2007 contained only 1.03 million foreign workers whereas the official figure from the Ministry of Home Affairs was about double that as cited in the text. The gaps between these numbers highlight the potential undercounting issue in the labor force survey. The most important limitation of the labor force survey data used in this analysis is that it does not cover workers living in group housing or similar communal housing arrangements. This implies that most workers in plantations and mining are likely to be undercounted or omitted altogether. Nevertheless, the LFS provides important insights into the sectoral composition of migrant workers. It also covers both formal and informal workers, which provides a better snapshot of migrant workers in Malaysia than if only formal workers had been included.

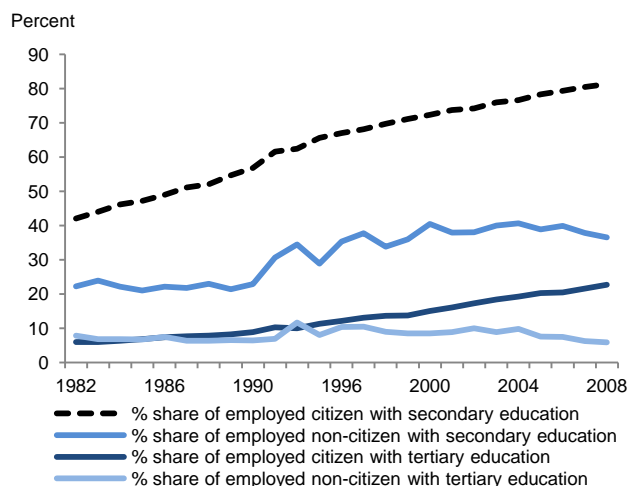
**Most foreign workers in Malaysia are low-skilled and have only primary education or less.** Two-thirds of foreign workers in Malaysia are low-skill and only four percent are high-skilled. Accordingly, the vast majority of migrants work in low-skill jobs (Figure 96). The education levels of workers who are Malaysian citizens have risen rapidly along with economic development and are significantly higher than those of migrants. Among migrants, 60 percent had less than secondary education, whereas among Malaysians the corresponding figure is less than 20 percent. The growing gap between the education levels of migrant and Malaysian workers is evident in Figure 97. The widening gaps further suggest that migrants are filling the demand for low-skill labor in the Malaysian economy as the domestic labor force becomes more skilled.

**Figure 96. In total employment, few foreign workers have high-skill jobs**



Source: World Bank (2011b).

**Figure 97. Secondary educated Malaysian workers rose rapidly, unlike migrants**

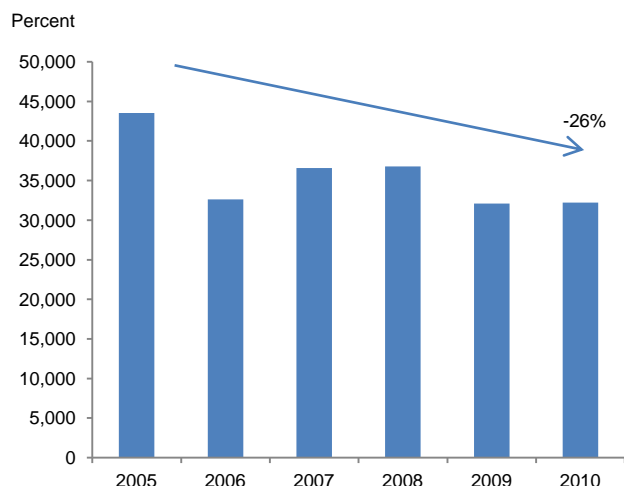


Source: World Bank (2011b).

**The skills levels of migrants have been declining, as the high-skill expatriate base has shrunk by a quarter since 2005.** As Figure 97 indicates, the number of expatriate skilled workers has declined by about 25 percent since 2005. In parallel, as Figure 98 shows, the share of employed non-citizens with tertiary education has declined, and the share of migrants with no formal education increased (Figure 99). Considering that Malaysia aims to move towards higher value-added activities, efforts to attract more highly skilled foreigners are warranted and the Government has taken a number of measures in that regard. In addition to the introduction of the resident pass, the Government has relaxed employment pass conditions, removing the need to advertise executive positions and the 10-year limit for key expatriate executive positions.

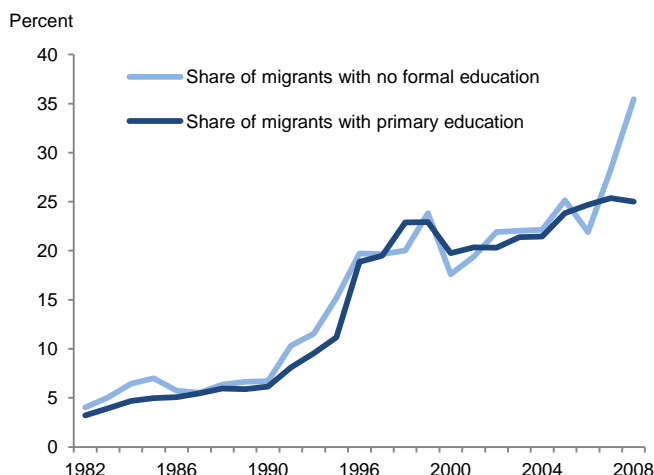
**Not only are migrants primarily in low-skill, low-wage occupations, but they also tend to earn less than natives of the same level of education and within the same occupation.** Figure 100 shows that migrants get paid significantly less than natives for all education levels except tertiary education. The wage gap is negligible for workers without any formal education and higher for workers with a primary education. The largest gap is for workers with a secondary education, in other words, the medium-skilled. Most importantly, a significant portion of migrants with a secondary education (the medium-skilled) earn less than the proposed minimum wage levels, whereas similarly educated natives earn more than these levels. Migrant workers also earn significantly less than Malaysian workers in most occupations (Figure 101), except in those that have the highest wage levels and are the most skill-intensive (and which probably require a tertiary education). There are two basic reasons for these differences. First, migrants within any given sector tend to be less skilled than natives. Second, even with the same level of education, migrant workers earn less. This pattern suggests that the extensive use of migrants may be playing a role in holding down wages in the economy.

**Figure 98. In total employment, increasingly fewer foreign workers have high-skill jobs**



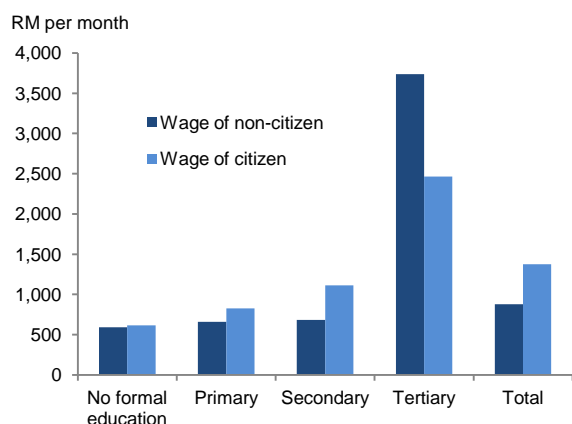
Source: EPU.

**Figure 99. Secondary-educated Malaysian workers rose rapidly, unlike migrants**



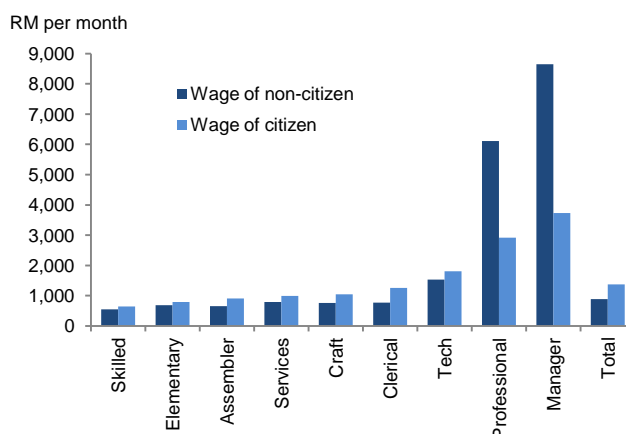
Source: World Bank (2011b).

**Figure 100. Migrant wages are generally lower, except for highly-educated migrants**



Source: World Bank (2011b).

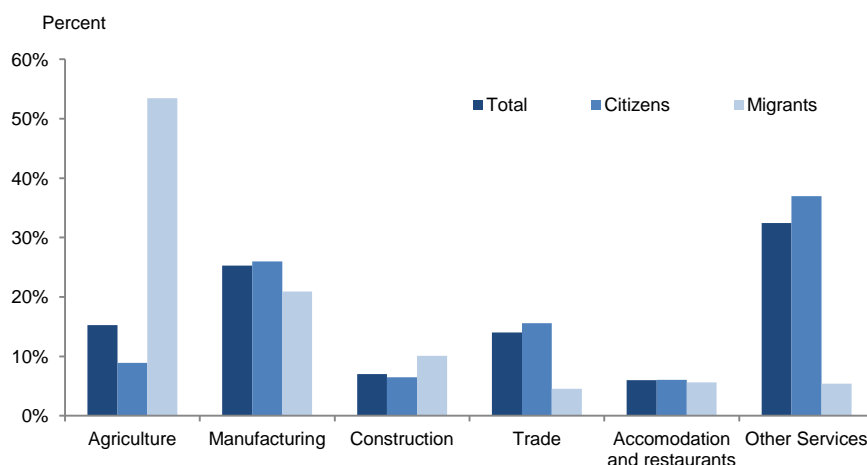
**Figure 101. Migrant wages are lower across occupations, except for the high-skill ones**



Source: World Bank (2011b).

**The sectoral allocation of migrant workers differs considerably from that of Malaysian workers, with migrants concentrated in the agriculture and manufacturing sectors.** For example, 15 percent of the total labor force and 9 percent of citizens in the labor force are in agriculture, which employs 53 percent of all migrant workers (Figure 102). Similarly, the construction sector employs 10 percent of migrant workers but only 6 percent of Malaysian workers. The shares of Malaysian and migrant workers employed in manufacturing (26 compared to 21 percent) and accommodation services (6 percent for both) are similar. At the other extreme, 37 percent of natives and only 5 percent of migrant workers are employed in other service sectors, which tend to require higher skills.

**Figure 102. Migrant and Malaysian Workers, by Sector of Employment**



Source: DOS – Labor Force Survey 2009.

### Three key conclusions emerge from this discussion of foreign workers in Malaysia:

**First, migration inflows are responding to underlying demand-pull forces.** The large numbers of foreign workers in Malaysia are a reflection of underlying structural patterns in the Malaysian economy. Some of these patterns may be unwelcome, such as the lack of industrial upgrading that makes firms rely on low-cost, low-skill workers. But others may be neutral or even desirable, such as the role of foreign workers in replacing young men who now are more likely to be enrolled in tertiary education. Therefore, policies that focus only on restricting the supply of foreign workers are likely to be of limited use – or may yield undesired consequences.

**Second, low-skilled foreign workers put downward pressure on the wages of low-skill workers – but not on skilled workers – highlighting the critical importance of improving skills.** The conclusion here is not that Malaysia should reduce the numbers of foreign workers to artificially raise the wages of local low-skill labor, but rather to highlight the critical importance of making faster progress on expanding the supply of skills in the economy. As discussed earlier, most new jobs that are being created are skilled, and therefore the pressure on the earnings of low-skill workers will continue to grow with or without foreign workers, suggesting that upskilling the existing labor force and investing in skills are the sustainable solution for increasing wage levels.

**Third, Malaysia can benefit from rebalancing the skills composition of its foreign workers towards the high-skilled.** As highlighted in the previous two editions of the Malaysia Economic Monitor, the greatest difference between Malaysia on the one hand and Hong Kong and Singapore on the other with regard to inward and outward migration of skilled labor is not the rate at which natives leave the country, but rather the lack compensating inflows in Malaysia. If Kuala Lumpur aspires to become a global city and an international financial center comparable to Singapore, Hong Kong or New York, the focus should not be on reducing the numbers of low-skilled workers but rather in attracting more high-skilled workers.

### Flexible and inclusive jobs, secure workers

**Modernizing job markets requires a reallocation of risks between the Government, firms and workers.** The rationale for a number of labor laws that regulate how firms and workers interact is essentially to reallocate risks to household income from workers to firms. Firms are perceived to have greater bargaining power vis-à-vis workers, which in the absence of any legislation could lead firms to transfer most risks related to economic and firm performance shocks on to the workers.<sup>26</sup> Workers in turn would suffer from excessive volatility of their earnings, with potential negative spillovers such as excess savings, depressed aggregate consumption and reduced investment in human capital.

<sup>26</sup> See for example Hacker (2006) for a more detailed exposition of these ideas.



Labor laws are meant to ensure that firms take on some risks to performance, for example by creating disincentives to lay off workers during downturns. However, such risk transfer comes at a cost, namely lower profitability for firms, and potentially less employment creation. Recently, there has been greater recognition that the government can play a helpful role in reallocating some of the risks to worker's incomes in a way that increases efficiency in labor markets without reducing the security afforded to workers.

**Modern labor markets reflect a balance between flexibility and security.** Advanced labor markets aim to strike a balance between protection (or security) and flexibility. This has been termed 'Flexicurity' following the Danish model (see Box 7 below). Accordingly, this section argues that modernizing labor market require two parallel reform tracks: the first entails reducing regulations and increasing job flexibility (transfer risks away from firms); the second entails the implementation of social safety nets, which is essentially the Government charging both firms and employees a premium for taking some of the risk in the form of social insurance.

#### **Box 7. Denmark's flexicurity: increasing contestability, the gentler way**

Every year, about 20 percent of Danes lose their jobs. But they do not lose their incomes. Unemployment benefits replace close to two-thirds of their earnings, and the Government helps them find work. Flexicurity, the combination of flexibility for employers and income security for workers, has been in place since at least the 1970s, but it has evolved over time as the active component has been strengthened. And it seems to work well. Between 1995 and 2008, Danish unemployment rates averaged 4.9 percent, while the rest of the EU15 suffered rates close to 8.5 percent. Denmark has been getting a lot of attention among policymakers.

Danish employment laws have evolved from the 'Gent system,' when labor and trade unions, not the Government, paid unemployment benefits. In the 1970s and 1980s, unemployment rates remained high, while those without jobs got good incomes. The arrangements became too expensive and were reformed in the 1990s. The new approach is sometimes called the 'Golden Triangle,' because it added both generous unemployment benefits and active labor market programs to flexible hiring and firing laws.

- The first component, flexibility of firing and hiring, remained practically unchanged. The OECD employment protection legislation index for Denmark fell from 2.4 in 1983 to 1.5 in 2009; the OECD average is 1.9. Relatively flexible laws work in Denmark because the country has a history of self-regulation by employers and unions, going back to the 'September Compromise' of 1899, which set rules for resolving labor disputes.
- The second part of the Danish model is unemployment insurance financed from contributions and taxes. Membership is voluntary, but it covers around 80 percent of the labor force. Benefits last up to four years, and replacement rates cannot exceed 90 percent of wages, capped currently at €2,173 a month. After four years of benefits, recipients have to switch to social assistance, which means a reduction of between 20 and 40 percent of their benefit income (Andersen and Svarer 2007).
- The new system uses active labor market programs like job search assistance and training to nudge the unemployed back to work. The spending on these programs is sizable: out of €13 billion spent on labor market programs in 2010, about 75 percent was on active instruments.

How well does flexicurity work? The unemployment rate dropped from 10 percent in 1993 to 3.3 percent in 2008. The incidence of long-term unemployment (being out of work for more than a year) decreased from a third of total unemployment in 1994 to a tenth in 2009. Despite liberal firing and hiring practices, employment has not fluctuated too much in response to output variability. All this is good.

There are some qualifications. First, though official unemployment has fallen, there is a gap between actual unemployment (adding up the unemployed, those in 'activation,' and early retirees) and official statistics. Second, it is difficult to assess how much of the fall in unemployment is due to flexicurity on its own. Economic performance matters too: active labor policies are useless if the economy is not producing jobs. Finally, the already high fiscal

burden can become enormous in a protracted slowdown. The Danish model costs 4.5 percent of GDP in terms of active and passive labor market measures. And Denmark spent 2.6 percent of GDP for labor market programs in 2008 (a good year), compared with 1.4 percent for the OECD as a whole, 1.5 for Sweden, 2.2 for Finland, and 2.3 in the Netherlands. The Danes have flexicurity because of their history and can afford it in part due to high participation rates of 81 percent; the OECD average in 2009 was 71 percent. Those wishing to learn from the Danes should note this.

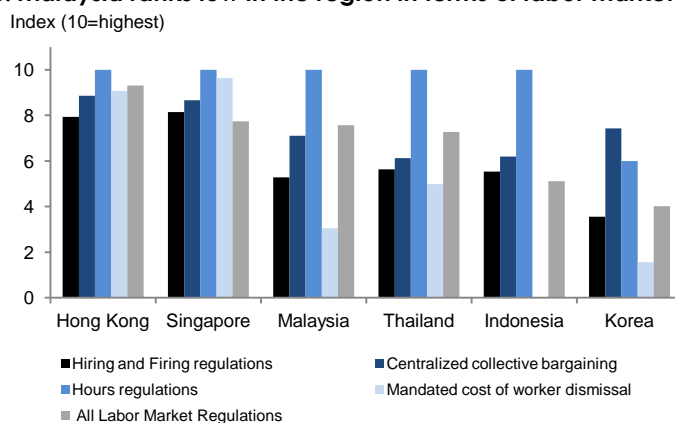
Source: Andersen and Svarer (2007); Bredgaard and Larsen (2007); Hansen (2010); OECD (2010); reproduced from Gill and Raiser (2011).

**Finally, modern labor markets offer flexibility for women to reconcile family and work.** Malaysian women tend to drop out of the labor force following marriage and childbirth. Modern labor markets that offer flexible working arrangements, including part-time work and work-from-home provisions, can help women balance work with family life, thus facilitating their return to the labor force after childbirth as is the case in a number of neighboring countries. Complementary policies to facilitate access to childcare are also important in this regard.

### Labor regulations can be modernized

**Although Malaysia tends to rank highly with regard to labor market regulations, there is room for improvement.** A worldwide survey of labor market flexibility, which rates all countries according to six distinct categories—hiring and minimum wage, hiring and firing, centralized collective bargaining, hours worked, mandated costs of worker dismissal, and conscription—shows that Malaysia moved down in the ranking over a 20-year period (dropping from 15th in 1990 to 22nd in 2008; Figure 103). Although Malaysia still ranks well relative to most countries, it is below Singapore (1st in the ranking on labor flexibility) and Hong Kong (3rd in the overall ranking). Figure 104 shows that Malaysia's score is weighed down by the burden put on firms by the mandated costs associated with worker dismissal and by hiring and firing regulations.

**Figure 103. Malaysia ranks low in the region in terms of labor market flexibility**



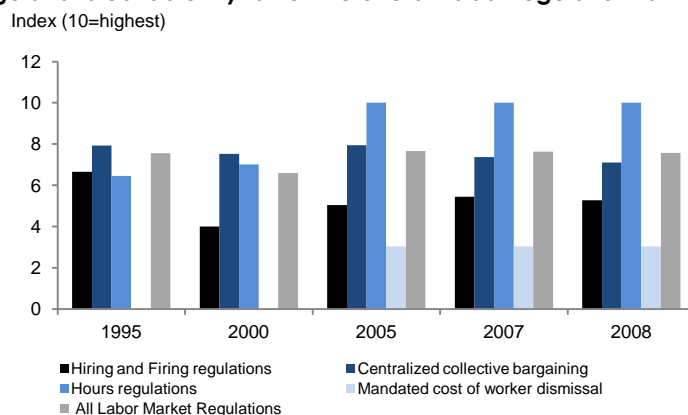
Source: Fraser Index of Freedom, 2009.

**Many of the labor laws currently enforced in Malaysia date back to pre-independence years.** Although many laws have been amended, such an old and complex system of labor laws increases management costs and undermine competitiveness, especially because many amendments in place are not well integrated into the Consolidated Employment Act, thus complicating the structure of the labor legislation even further. For instance, overlapping provisions in the laws prompt contradictions and create inefficiencies. Efforts should be made to harmonize the Employment Act of 1955, with the Weekly Holiday Act 1950, the Employment Information Act 1953, the Employment Restriction Act 1968 and various regulations supporting EA 1955.

**Restrictions regarding termination of employment are relatively rigid.** Although in Malaysia the right of the employer to reorganize the business is recognized and termination resulting from business reorganization is treated as termination

with just cause, the selection of employees to be retrenched must be based on specified criteria including length of service. In this regard, the most junior employees in each category are expected to be retrenched before the more senior employees. Lastly, employers must fulfill the retrenchment criteria of the 'foreign workers first out' rule.

**Figure 104. While improvements were made in some areas, labor dismissal regulations consistently lower the overall labor regulation ranking**



Source: Fraser Index of Freedom, 2009.

**There is also a risk that retrenching employers may be liable to pay compensation.** Termination or dismissal from employment has to be with proper cause. This statutory provision is important as its scope extends to each worker in Malaysia. Every worker who has lost his job and deems that he or she has been dismissed without just cause or excuse may file a claim for reinstatement in the Industrial Relations Department of the Ministry of Human Resources. The remedy for unjust dismissal is reinstatement and back wages up to 24 months or compensation in lieu of reinstatement and back-wages of up to 24 months. Employers' perceive this risk as a substantial one because of the costs and because a claim could be filed whenever a worker loses his employment for any reason.

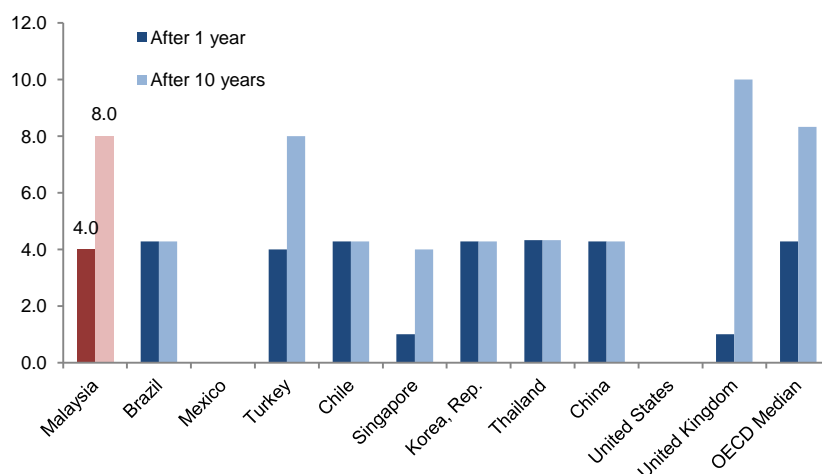
**The length of the required notice period is comparable to OECD countries.** In Malaysia, the length of the required notice to terminate an employment contract is the same for both employer and employee and is at least a) four weeks' for employment that is less than two years; b) six weeks' for employment that is more than two years but less than five years; and c) eight weeks' if the employee has been employed for five years or more. The statutory notice period in Malaysia is stringent when compared to the U.S., Brazil, and most Asian countries, but is near the typical OECD country (see Figure 105).

**Retrenchment benefits are generous and above levels observed in the OECD.** Retrenchment benefits are usually based on the term of the employee's employment contract, and the Industrial Court (IC) has in practice recognized payment of retrenchment benefits in the amount of one month's last drawn salary of the employee for every year of service. For employees covered under the Employment Act, minimum retrenchment benefits step up from zero for workers with less than one year of service to 20 days of wages per year of service for workers with more than five years of service. There are no caps, except that imposed by the retirement age. Figure 106 places the levels of termination benefits in Malaysia in international context. Although in line with levels practiced in many emerging countries in Asia, termination benefits are higher than in countries with well-developed social safety nets in the OECD. Given the considerable evidence suggesting that strict employment protection including hiring and firing rules as well as severance pay reduces employment,<sup>27</sup> Malaysia may consider reviewing its retrenchment benefits in parallel with the introduction of modern safety nets.

<sup>27</sup> Fallon and Lucas (1991) show that strengthening job security regulations led to a strong decline of employment in India and Zimbabwe. More recent studies confirming the link between job security and lower employment levels include Heckman and Pages (2000), for OECD and Latin American countries, Besley and Burgess (2004) and Ahsan and Pages (2009) for India, and Saavedra and Torero (2004) for Chile. See Holzmann et al. for additional references.

**Figure 105. The statutory notice period in Malaysia is higher than in most Asian countries for workers with long tenure**

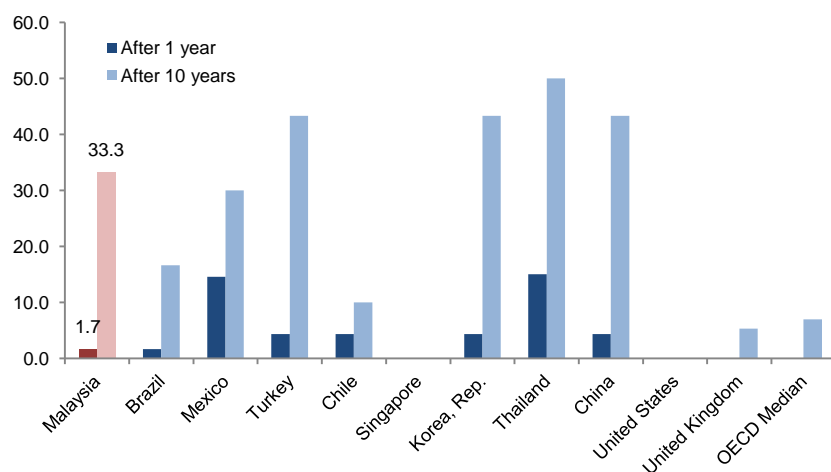
Legally mandated notice period for redundancy dismissal, weeks



Source: Doing Business.

**Figure 106. Termination benefits also become relatively high for workers with longer tenure, exceeding levels in the OECD**

Termination benefits, weeks of pay



Source: Doing Business.

**Malaysia has a fairly open approach to fixed-term contracts.** Studies have shown that fixed term contracts promote flexibility in labor markets and may increase productivity.<sup>28</sup> Fixed Term employment contracts have been in usage in Malaysia for many years and unlike in some other countries there is no legislative provision that prevents the use of fixed term contracts in employment (Table 18). In fact, Section 11 EA 1955 gives recognition to contracts of employment that may be for a fixed period of time or for performance of a specified task.

<sup>28</sup> World Bank SP Discussion Paper No 1006 states that fixed term work provides a buffer for cyclical fluctuations of demand, allowing companies to adjust employment levels without incurring high firing costs. Fixed-term work also allows companies to reap market opportunities by engaging in projects of short duration without bearing disproportionate personnel costs. On the other hand, a study by the Dutch Bureau for Economic Analysis (Cörvers et al., 2011) finds that temporary workers receive less employer-funded training due to the greater risk that they will leave the firm after training is received.

**Table 18. Cross-country comparison of regulations regarding fixed-term contracts**

	Are fixed-term contracts prohibited for permanent tasks?	What is the maximum cumulative duration of a fixed-term employment relationship (in months), including all renewals?
<b>Malaysia</b>	<b>No</b>	<b>No limit</b>
Singapore	No	No limit
Korea, Rep.	No	24
Denmark	No	No limit
Germany	No	24
United States	No	No limit
United Kingdom	No	No limit
Japan	No	No limit
Thailand	Yes	No limit
Vietnam	No	72
China	No	No limit
Brazil	Yes	24

Source: Doing Business.

**Flexible hiring practices such as part-time employment and work-from-home can make labor markets more inclusive and attract more women into the labor force.** Part-time and flexible working arrangements are not the norm in Malaysia. The Government has recognized this and as part of the effort to encourage flexible working arrangements it has introduced the Employment (Part-time Employees) Regulations 2010. This is a subsidiary legislation to the EA 1955. This Regulation provides for the minimum conditions to be fulfilled by employers when employing part-time employees, including EPF and SOCSO contributions. Flexible hiring practices can be helpful in making it easier for women to return to the labor force while they are still responsible for taking care of children.

**Table 19. Cross-country comparison of regulations regarding work hours**

	Can the workweek for a single worker extend to 50 hours per week (including overtime) for 2 months each year to respond to a seasonal increase in production?	Are there restrictions on night work?	Are there restrictions on 'weekly holiday' work?	What is the maximum number of working days per week?
<b>Malaysia</b>	<b>Yes</b>	<b>No</b>	<b>No</b>	<b>6</b>
Singapore	Yes	No	No	6
Korea, Rep.	Yes	Yes	No	6
Denmark	Yes	No	No	6
Germany	Yes	No	No	6
United States	Yes	No	No	6
United Kingdom	Yes	No	No	6
Japan	Yes	No	No	6
Thailand	Yes	No	No	6
Vietnam	Yes	No	No	6
China	Yes	No	No	6
Brazil	Yes	Yes	No	6

Source: Doing Business.

**Working hours regulations can be made more flexible by fixing weekly (rather than daily) standard work hours.** Flexible work hours allow women to align work hours with the hours their children are in school, and represent another example of flexibility that promotes inclusiveness in labor markets. The EA 1955 provides for minimum working conditions that include fixed hours of work, overtime, and rest periods applicable to employees falling

under its scope. The present fixed 8 hours of work per day causes employees to be paid for the time worked rather than for productivity. Pay premiums that range from 150 percent to 300 percent of the hourly rate of wages for work performed outside the fixed hours increases cost and creates rigidities. Many countries have fixed the principal 40-hour as the length of the normal working week. This enables the employers and employees to agree on work hours that suits the firm's business, the employee's needs and ensures productivity. Except for the fixed 8-hour day, regulations regarding working hours are fairly flexible and compare well with other countries (Table 12). For example, unlike Korea and Brazil, Malaysian firms do not face restrictions on night work.

**Options to modernize labor regulations:**

**First, the Government can consider restructuring and consolidating the existing labor legislation.** The different pieces of legislation, regulations, orders and directives relating to labor should be comprehensively reviewed with the objective of modernizing and integrating these laws to eliminate overlapping provisions, inconsistencies, reduce gaps and simplify these laws to encourage efficient and easy compliance. The Government is already reviewing labor legislation in the context of the Human Capital SRI, and the first set of amendments has been passed (see below). Further revisions can benefit from international experience (see Box 8 for the example of the Australian Fair Work Act), but should also be appropriate to Malaysia's institutional set-up (see Box 9).

**Box 8. Australian Fair Work Act 2009**

The Fair Work Act and the supplementary Fair Work Regulations 2009 were created to ensure a balanced framework for cooperative and productive workplace relations. It aims to promote national economic prosperity and social inclusion by providing workplace rules that:

- Are fair to working persons
- Are flexible for businesses
- Promote productivity and economic growth for future economic prosperity
- Take into account international labor obligations
- Ensure a safety net that is fair and relevant
- Ensure that workplace agreements that undermine the safety net of workers are not part of the national workplace relations system
- Help employees balance work and life commitments by offering flexible working arrangements
- Enable fairness at work and prevent discrimination in the workplace
- Achieve productivity and fairness by emphasizing workplace-level collective bargaining between the employer and employees and their representatives.

The FWA establishes the national industrial relations system. Features of the national industrial relations system include a set of 10 minimum National Employment Standards, modern awards that apply nationally for specific industries and occupations, a national minimum wage order, enterprise bargaining, and protection from unfair dismissal. The changes were introduced gradually, starting from July 2009; the most significant changes were introduced in January 2010 and have been implemented during the last two years.

Source: Government of Australia.

**Second, greater flexibility in employment mandates could be considered:**

- A. Following international best practices on fixed-term contracts; placing limits to hiring on successive fixed term contracts.
- B. Allowing greater flexibility to employers in human resource management, in particular with respect to hiring and dismissal decisions, including a revision to the current severance payment levels.
- C. Giving flexibility for employers to introduce working hours that suit both the employer's and employee's needs. Computing work hours on a per week basis.
- D. Promoting part-time and work-from-home arrangements that improve the work-life-balance of women and caregivers in general.

**The Government has already embarked on a path to reform of labor laws as part of the ETP.** As noted in Table 4 above, the first set of revisions to the Employment Act was approved by Parliament in December. Among the amendments were a new definition of contractor for labor to clarify the relationship between principal contractor and sub-contractors who supply labor; inclusion of new provisions to address sexual harassment issues in the workplace and application of these provisions to all employees; flexibility on the time of payment for overtime; maternity protection to all female employees and expansion of the scope of coverage of employees earning up to RM1,500 to employees earning up to RM2,000. With this, the number of employees covered under the Act will increase from 50 to 70 percent.

#### **Box 9. The institutional foundations of skill formation in four advanced economies**

Kathleen Thelen (2004) traces the institutional foundations of skill formation in the UK, the US, Germany, and Japan to the early stages of industrial development. The experience of these four countries suggests that institutions, including labor market institutions, emerge from a country's distinctive political and economic realities governing the interaction of key decision makers. They are the result of an organic process.

In labor markets, skills are a valuable commodity. As in all markets, the price is determined by demand and supply, creating opposing incentives for workers, keen on restricting the supply of skills in return for higher wages, and employers, eager to keep labor costs low. In an early phase of industrialization in the UK and the US, unions increasingly limited the supply of skilled labor. In response, firms resorted to snatching skilled workers from their competitors, reducing the value for individual firms of investing in human capital formation – the cost of training workers simply exceeded the cost of attracting skilled workers from elsewhere. This led to the demise of firm-level training and explains why neither the UK nor the US developed vocational training systems comparable to those in Germany or Japan.

Both Germany and Japan overcame the collective action problem in skills formation by laying institutional foundations for skills formation that made it rational for companies to train workers. Japan followed the classical remedy to collective action problems: Government intervention. The Japanese Government ordered public companies to develop internal corporate training systems which private companies began to emulate. In order to ensure that investing in their workers paid off, they increased incentives for their employees to stay, including seniority wages, internal career ladders, and corporate-level unions, creating large and internal labor markets shielded from outside competition.

Germany, on the other hand, drew on its experience with strong training systems in its traditional artisanal sector (so-called guilds). The newly emerging industrial sector had to compete with the guilds for workers, attracting them with high-quality training justifying high wages. As opposed to the US and UK, unionization in a more authoritarian Germany was weak, eliminating pressures to tighten the labor market, and when there is no shortage of skills there is no incentive for companies to poach workers. Guilds and industrialists thus joined forces in building national vocational training systems that would generate a sufficiently large pool of high-skilled labor.

The diverse experience of these four countries suggests that it is useful to bear in mind the broader institutional landscape of countries when considering adopting lessons from their development experience, as adopting institutions that do not fit the institutional landscape of a country may yield unintended consequences.

Source: Thelen (2004).

### **Social safety nets protect workers**

**In parallel with modernizing labor market regulations, it is essential for Malaysia to develop modern social insurance schemes to protect workers.** Modernizing labor markets entail two parallel and equally important reforms: the first, discussed in the previous section, is to reform labor market regulations to reduce the risk that is borne by firms from shocks to worker's incomes. This reduces costs to firm, but more importantly increases the efficiency in the economy



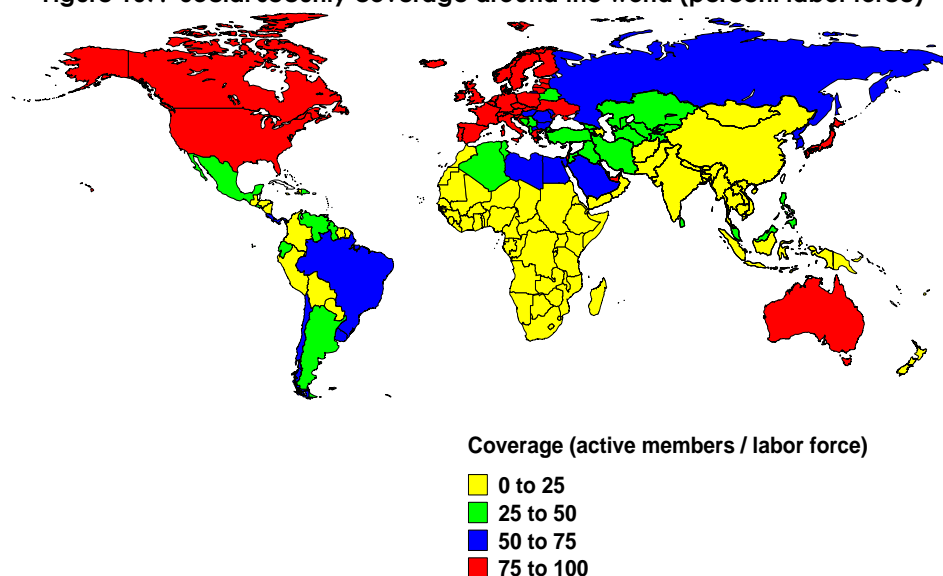
as workers can be allocated to jobs where they can contribute the most. The second is for the government to take up some of that risk in the form of social insurance programs, funded through general taxation. Workers would also be expected to gain from the change as firm-based job protection only covers formal workers, and even then workers still face potentially severe income shocks as firms still fail and redundancies still take place even with restrictive regulations.

**The cost of restrictive regulations such as high mandatory severance payments relative to social insurance schemes increases with the level of development.** Mandatory severance pay as is practiced in Malaysia is an attractive system in developing countries because it requires little administrative capacity to monitor the unemployment status, does not require the collection of social contributions, and given that it is paid as a lump sum, does not act as a disincentive to job search. For low income countries with low capacity to administer social insurance programs, low capacity to raise revenues to fund such programs, and low trust in Government, placing the burden of social insurance on firms is not an unreasonable strategy for social protection. However, for a country at Malaysia's stage of development (and certainly the stage that Malaysia aims to achieve), this rationale no longer holds.

**Malaysia currently has three main social insurance schemes focused on disability and old-age security.** Social insurance in Malaysia comprises three programs: (i) a scheme for pensionable public service workers, funded by the budget; (ii) disability social insurance for private sector employees administered by the Social Security Office (SOCSO), and (iii) mandatory old-age savings plan for private sector workers administered by the Employee Provident Fund (EPF). Only the first one is funded by public resources; the other two are funded by contributions levied on wages (2.25 percent and 23 percent, respectively).

**Since social insurance schemes cover about 60 percent of the labor force, a significant fraction of workers is left unprotected.** About 5.2 million workers are currently contributing to EPF and SOCSO, with another 1.4 million civil servants covered by the PSD pension scheme. In 2010, there were about 950,000 recipients of benefits provided through PSD and SOCSO, of which about 850,000 received a regular monthly pension. Among the pension recipients, about 600,000 are from the public service scheme and approximately 250,000 are disability pension recipients provided through SOCSO. Although Malaysia performs relatively well compared to other countries (Figure 107), at 40 percent, the coverage gap is significant. Those not covered include self-employed, farmers and in general informal sector workers. Nevertheless, evidence indicates that pensions play an important role in poverty reduction in Malaysia: without pensions, the household poverty rate would increase from 3.8 to 5.0 percent. The poverty gap would increase as well: from 0.86 to 1.29.

**Figure 107. Social security coverage around the world (percent labor force)**



Source: Holzmann et al., 2009.

**The largest gap in social insurance in Malaysia is the lack of unemployment insurance.** Increasing flexibility in labor markets and invigorating the forces of competition in product and labor markets also increases the risks of job and income loss for workers and their families. In these circumstances, countries around the world have found it useful to introduce an unemployment insurance system. A system of this kind that covers most or all of the formal labor force can pool risks and cushion the impact of shocks. How expensive such a program will be and how much impact it will have on the amount of effort a recipient is willing to make will depend critically on the level of the benefit and the duration of the eligibility period. Introducing an unemployment insurance scheme such as an Unemployment Insurance and Savings Account (UISA) (Box 10) would obviate the need for large severance payments and other restrictions to hiring and firing workers.<sup>29</sup>

#### **Box 10. Unemployment Insurance and Savings Account**

Many countries are increasingly relying on unemployment insurance savings accounts (UISA). An appropriately designed unemployment insurance scheme can provide adequate protection to workers in the context of a more flexible labor market. Balance between economic efficiency and worker protection could be achieved if the Government set as an overarching goal 'to protect the income of workers as opposed to protecting particular jobs' (often unproductive).

Labor markets characterized by high informality, weak enforcement, and moral hazard issues could benefit from a model of UI that relied on unemployment insurance savings accounts. Traditional UI schemes tend to be abused in developing countries. The general operation of UISAs is straightforward, transparent, and less prompt to abuse, although they allow for only limited risk pooling, as savings in the accounts can be depleted faster than what is needed. Employers deposit some specified fraction of each worker's earnings in a special individual savings account on a regular basis. In Chile, workers are also required to make regular contributions to their accounts. Upon separation workers can make withdrawals from their savings accounts as they deem fit (some programs allow access before separation for health, education, and housing reasons). UISAs are a relatively new program, although Brazil has used them since the 1960s. More recently, several other Latin American countries (Argentina, Chile, Colombia, Ecuador, Panama, Peru, Uruguay, and Venezuela) have introduced UISAs.

Source: Robalino and Sanchez-Puerta(2008).

**Lack of child care is an important obstacle for Malaysian women to join the labor force.** In addition to inflexible work hours and limited opportunities for part-time work, lack of childcare is another important obstacle for women to join the labor force. In 2011 five children died in unlicensed health care centers, which are estimated to comprise as many as two-thirds of the 3,200 child care centers in Malaysia. The Income Tax Act has provisions for tax deductions to be provided to employers for the purpose of establishing childcare centers near or at the workplace (UNDP, 2007), but as of 2009 only 436 registered child care centers were established at workplaces (EPU, 10<sup>th</sup> Malaysia Plan). In addition, child care expenses are not deductible from individual income taxes.<sup>30</sup> The 10<sup>th</sup> Malaysia Plan anticipates increasing the number of community-based nurseries and day care centers under the Social Welfare Department (JKM), and actively promoting CSR programs to sponsor the establishment of licensed day care centers in partnership with NGOs.

#### **Options to modernize the existing social insurance and assistance schemes would include:**

- (a) As part of the overall social protection development strategy, adopt a strategy for the development of an integrated social insurance system.
- (b) Introducing adequately designed unemployment benefits to replace severance pay in its current form so as to facilitate labor market transitions.

<sup>29</sup> As part of the Human Capital SRI, the Government has commissioned a study to the International Labor Organization in preparation for implementing unemployment insurance in 2013.

<sup>30</sup> Women, Business and the Law Database (accessed at: <http://wbl.worldbank.org>).

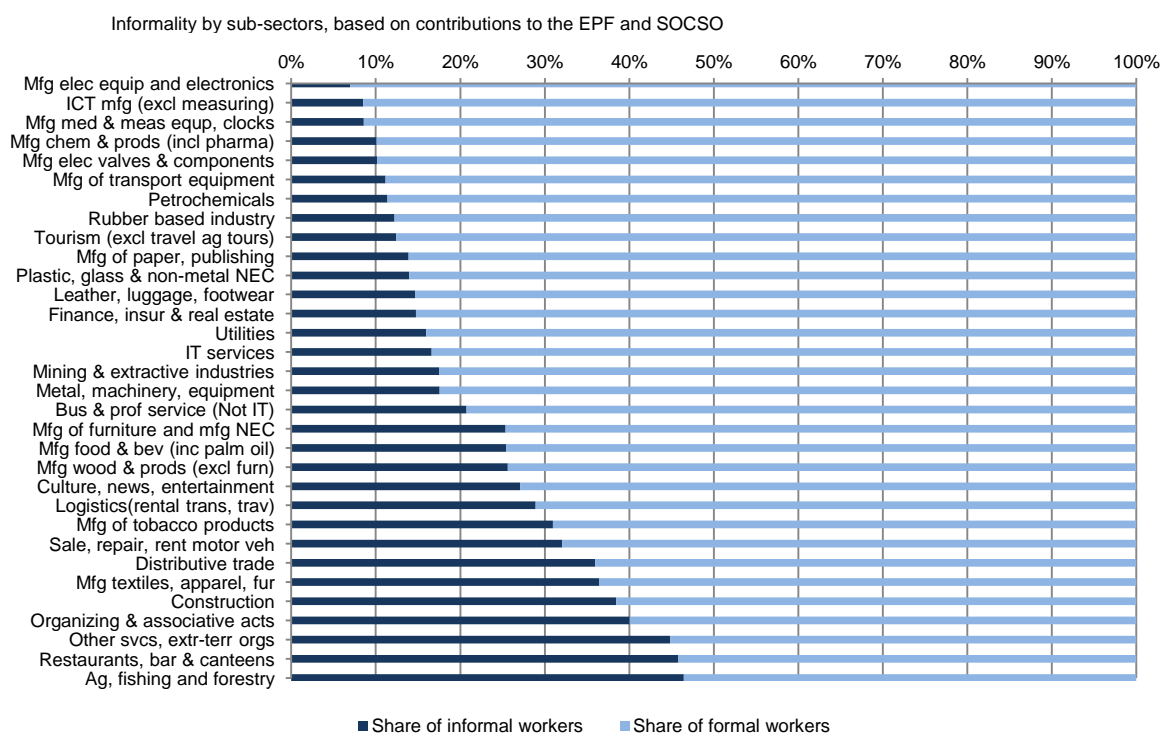
- (c) Search for innovative approaches to extend affordable and sustainable social insurance coverage to farmers, self-employed and informal sector workers.

### Modern social insurance also replaces informality as a shock-absorber

**Modern social safety nets also replace another risk absorber in low-income contexts: the informal economy.** In the absence of social safety nets and when the firm-based income protection fails them, workers often find themselves in the informal economy. On the other hand, well-designed social safety nets with moderate tax wedges and flexible labor markets reduce the incentives for firms to remain in the informal economy. Informal workers are less productive, earn lower wages and enjoy limited (usually family-based) income protection in case of shocks. Therefore, modernizing jobs requires understanding the informal economy and ensuring that reforms create incentives for formalization of firms and businesses.

**Many Malaysian workers are either employed in informal firms or in formal firms that offer them informal contracts** (thus avoiding having to pay mandatory pension contributions). While the informal economy in Malaysia is not particularly large for its income level or within East Asia, about 40 percent or more informal workers work in agriculture, fishing, forestry, and restaurants and bars (Figure 108). Similarly, more than 30 percent of workers in the distributive trades, retail, sales, construction, and textile, apparel, and furniture manufacturing are informal. On the other hand, less than 10 percent of workers in ICT, electronic manufacturers, medical equipment manufacturers, and chemical product producers are informal.

**Figure 108. Social security coverage around the world (percent labor force)**

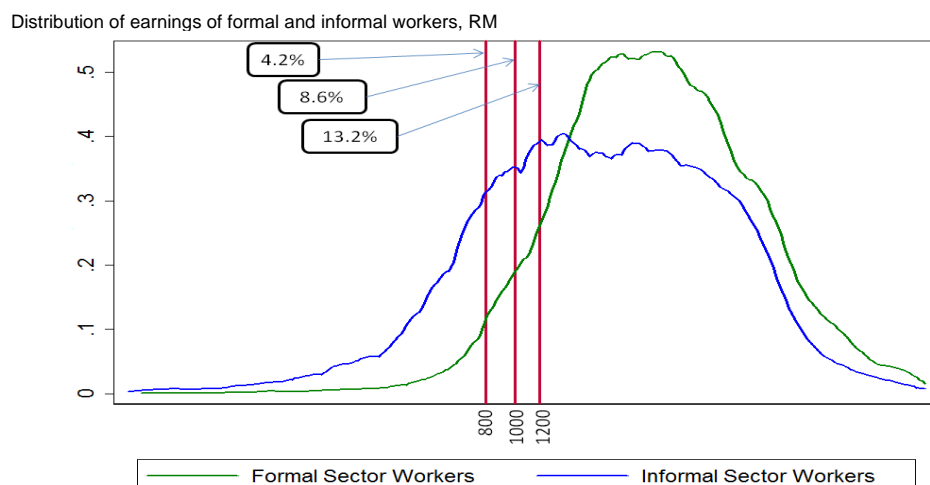


Source: DOS – Household Income Survey, 2009.

**Informal workers earn significantly less than formal workers, especially in manufacturing.** About 4.2 percent of formal workers earn total monthly compensation of less than RM800 while almost one-third of all informal workers earn less than that each month (Figure 109). The average monthly wages of formal and informal workers also differ within sectors, especially in manufacturing. About half of all informal workers in the manufacturing sector have average total compensation of less than RM1,200 per month, while 14 percent of formal workers in the sector earn that amount or less (Figure 110). The difference in the wages of formal and informal workers within the service sector

is smaller though still significant (Figure 111). About 12 percent of workers in the formal sector currently earn RM1,200 or less, slightly fewer than in the manufacturing sector.

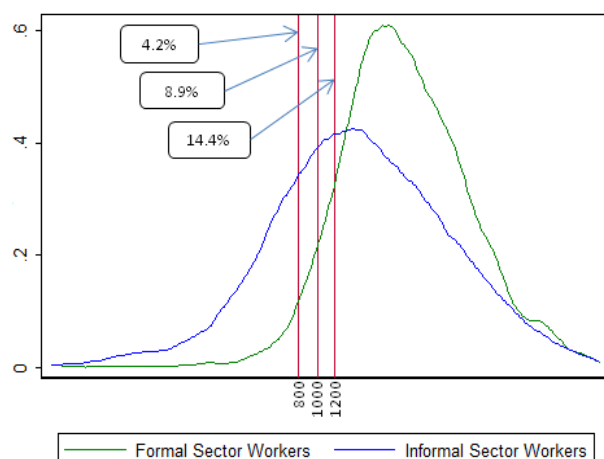
**Figure 109. Informal workers earn less than formal-sector workers...**



Source: DOS – Household Income Survey, 2009.

**Figure 110. ...especially in Manufacturing...**

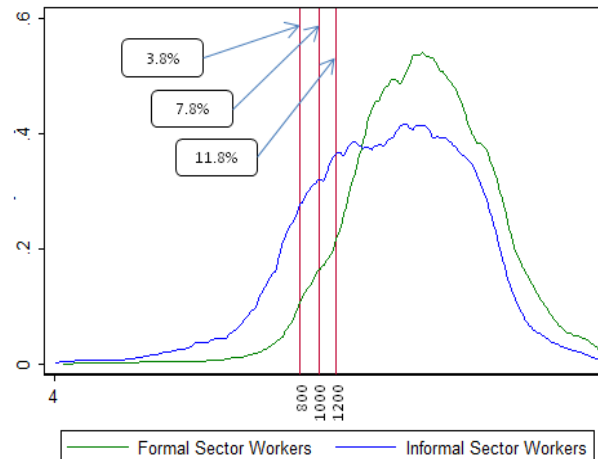
Distribution of earnings of formal and informal workers, RM per month



Source: DOS – Household Income Survey, 2009.

**Figure 111. ...but also in services**

Distribution of earnings of formal and informal workers, RM



Source: DOS – Household Income Survey, 2009.

## Implications of a higher wage structure

**Firms can remain competitive in a higher-wage environment as long as productivity rises and non-wage labor costs decline.** The agenda of creating modern, highly paid jobs and raising incomes of most Malaysians is not incompatible with maintaining Malaysia's competitiveness as it is unit labor costs that matter and unit costs need not rise with wages. This will be the case if productivity increases (from increased skills and competition in the economy) and if other employment costs decline due to greater flexibility in employment contracts. It is important to emphasize that reforms aimed at increasing productivity and lowering labor costs must be pursued as the same speed as other reforms to pull up wages. Similarly, it would not be socially sustainable to pursue the reduction labor costs through greater flexibility ahead of reforms to expand the social protection system: both should be pursued in parallel.

**The agenda of moving up the value chain and innovation-led growth is very much linked to the agenda of creating modern jobs.** Moving up the value chain essentially means performing more complex tasks within firms. The requirements for moving up the value chain include the provision of more and better skills and improved regulations

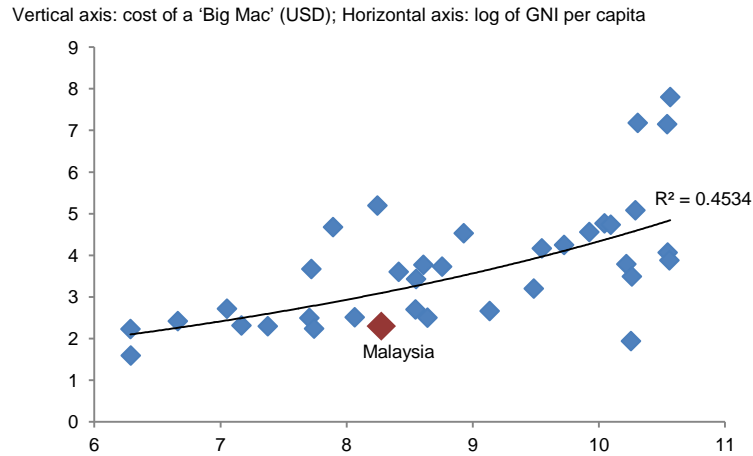
in labor markets, but skills alone will not suffice. As noted in the April 2010 Malaysia Economic Monitor, other requirements include upgrading home-grown technological capabilities, improving access to finance for innovation, enhancing competition (the driving force for innovation), and facilitating the fluid entry and exit of firms. All of these elements must be in place to create the demand for modern jobs and ensure the sustainability of the higher wage structure.

**Most jobs will be created in services sectors – to ensure these are modern jobs Malaysia needs to emphasize growth in knowledge-intensive services.** Given the experiences of other countries, the structural change towards a higher income economy includes a relatively higher growth rate in services. Accordingly, the weight of the services sector in Malaysia's GDP is expected under the 10<sup>th</sup> Malaysia plan to increase from 58 percent of GDP in 2010 to 61 percent by 2015. Not only will services grow faster than manufacturing, but manufacturing growth will come from deepening of both human and physical capital, and therefore the sector is unlikely to generate the large number of high-income jobs required to drive robust domestic demand. Therefore, most new jobs will be in services, but which services jobs will be created? Services sectors are diverse and service jobs range from the least to the most skilled. The challenge for Malaysia will be accelerate the growth of services jobs that entail the performance of non-routine tasks. Most of these sectors are knowledge-intensive and creative sectors, which have high skills requirements but also high wages.

**Foreign firms can adapt to higher wages.** A survey of Japanese firms (see Box 11) finds that only one-third of respondents are concerned with the introduction of the minimum wage policy. In contrast, more firms are concerned about employees' low retention rates, the difficulty in hiring Malaysian workers, high litigation risk and difficulty in recruiting technicians, specialized workers, and managerial employees. Because globally competitive foreign firms can choose in which country to perform higher-value-added tasks, they will respond to the endowments in the economy rather than try to change the economy's comparative advantage. But if Malaysia successfully transforms its economy, foreign firms will remain interested in investing even with higher wages, as is the case in Korea, Singapore, or other higher income countries.

**Higher labor costs may bring about somewhat higher inflation that will require careful management.** As economies grow, their price levels tend to increase, a phenomenon known as the Balassa-Samuelson Effect (see Figure 112 for a non-rigorous demonstration). This effect is partly caused by higher wages, which drive up the costs of non-tradable goods and services, and unlike 'Dutch disease' can take place in the presence of economy-wide productivity gains. Although this effect only prevails in the long-run, it should be kept in mind, since Malaysia has been actively managing prices and wages (as evidenced by Malaysia falling below the regression line in Figure 112) whereas economic transformation implies allowing prices to adjust and wages to rise. In other words, Malaysia may face more, and more imminent, pressures on prices from structural sources compared to other economies. The implications for monetary policy are that it will be therefore important to differentiate between structural and cyclical inflation. There are also important implications for social policy since the distribution of the beneficiaries from higher wages likely will not entirely overlap with the groups affected by higher prices, with the latter group larger than the former. Policies to support low-income groups that may not immediately benefit from higher wages will be important to help them cope with any increases in inflation. Support should be targeted, suggesting that direct transfers such as the recently implemented BR1M scheme should be preferred to consumer price subsidies.

**Figure 112. Prices rise with income**



#### **Box 11. Results from a JETRO survey on challenges experienced by Japanese firms in Malaysia**

##### **Japanese Investment in Malaysia**

Japanese firms are the second largest investors in Malaysia after Singaporean investors. In 2010, Japanese FDI stood at RM4.02 billion (13.9 percent of total FDI) with 61 investments, out of which 44 investments (3.25 billion, 80.8 percent of the total) were expansion and diversification of current projects while 17 investments (0.77 billion, 19.2 percent of total) were new projects. These Japanese investments are mostly concentrated in the sectors of non-metal mining, food manufacturing, transportation equipments, and electronics. As of January 2011, 1,407 Japanese firms were operating businesses in Malaysia, out of which 730 firms were engaged in manufacturing.

##### **How Japanese firms assess investment opportunities in Malaysia**

According to the 'Survey of Japanese Firms Business Activities 2011' conducted by The Japanese Chamber of Trade and Industry, Malaysia (JACTIM) and the Japan External Trade Organization (JETRO), the top three reasons that Japanese firms regard Malaysia as an attractive investment destination are (i) a stable political situation, (ii) high safety and security, and (iii) well-developed infrastructure (see Table 20). Compared to regional peers such as Thailand, China, Vietnam and Indonesia, Japanese firms value Malaysia's political stability and predictability with regards to long-term investments due to low political risk. Although many firms feel the need for further improvements in internet and telecommunications systems in Malaysia, more than half of Japanese firms regard power systems to be well-developed and improving over the past years.

Although safety and security are considered a major attraction for investing in Malaysia, and increasingly so over recent years, more than half of the Japanese survey respondents have encountered business related theft and crimes. Incidents include theft of raw materials and products from factories and warehouses (31 percent); theft of cash and office equipment (17 percent); and carjacking on highways (7 percent). One of the reasons for the increase in theft and crimes may lie in the soaring price of metal products in recent years.

Other major disincentives for investing in Malaysia are the Government's role in the private sector (2 percent), especially with a view on tedious administrative procedures. In particular, businesses feel that customs clearance procedures are cumbersome and take too long; they contend that it takes too much time to issue Certificates of Origin, and that HS codes are altered frequently, which makes it difficult to anticipate the cost of imports.

**Table 20. Reasons for Japanese firms to invest in Malaysia**

Reasons	%
Political stability	63%
Safety and security	57%
Infrastructure	54%
Employees' language skills	51%
Favorable living condition	36%
Labor cost	23%
Government investment preferential policy	17%
Inexpensive energy resource	15%
Concentration of mechanical parts industry	13%
Favorable market	12%
Ethnic diversity	11%
Quality of technical labor	10%
Natural resources	6%
Quality of low-skill labor	5%
Gateway to Islamic countries/markets	5%
Government business attitude	2%

Source: JACTIM/JETRO, Survey of Japanese Firms Business Activities 2011.

### What investment challenges do Japanese firms face?

According to the 'Survey of Japanese Firms in Asia and Oceania 2011', administered by JETRO, major challenges Japanese firms in Asian countries face in their investment and business management are:

- (i) cost increases, including procurement and wages;
- (ii) pressures from cost reductions including competition with other firms, cost reduction requests from major business partners; and
- (iii) the quality of labor, including human capacity of local employees, quality of workers, and difficulty in recruiting workers for managerial positions.

Japanese firms in Malaysia face similar challenges to Japanese firms in neighboring countries. They perceive significant challenges in (i) procurement cost increases; (ii) competition with other firms in terms of cost reduction; (iii) wage increases; (iv) exchange rate fluctuations; and (v) the quality of labor. Japanese firms anticipated adverse effects from the minimum wage policy that the Government is intent to introduce as it would increase the labor cost. 70 percent of all the firms surveyed indicated that this policy would affect their business negatively.

On the other hand, Japanese firms are also confronted with challenges in securing high quality labor, which appears to be a larger concern than the minimum wage (Table 21). Challenges include a low retention rate (62 percent), difficulty in finding low-skill labor (42 percent), high litigation risk (40 percent), and difficulty in recruiting technicians, specialized workers, and managerial employees. The domestic labor market has been at a full employment and the employees actively move across companies depending on conditions offered.

**Table 21. Challenges Japanese firms face in securing high quality labor**

Challenges	%
Employees' low retention rate	62%
Difficulty in hiring Malaysian workers	42%
High litigation risk	40%
Difficulty in recruiting technicians, specialized workers, managerial employees	40%
Introduction of minimum wage policy	33%
Difficulty in hiring non-Malaysian labors	32%
Employees' low attendance rate	24%
Trade unions	15%
Long litigation period for dismissal	14%
Difficulty in making changes to labor contract	10%
Labor issue is not a problem	5%

Source: JACTIM/JETRO, Survey of Japanese Firms Business Activities 2011.



### Where do Japanese firms place Malaysia in a regional context?

The JETRO survey compares the concerns of Japanese companies in Asia across six major challenges (i) cost increase in procurement, (ii) competition with other firms, (iii) wage increase, (iv) quality of labor, (v) quality control, (vi) difficulties in procuring raw materials and parts at host country. Table 22 shows the comparison of concerns of Japanese firms in Malaysia with those of Japanese firms in regional peers, including China, Korea, Singapore, Vietnam, Thailand, and Indonesia. According to Table 22, wage increases are a major concern for most Japanese firms in Asian countries. Japanese firms in other Asian countries such as China (84.9 percent) and Vietnam (83.3 percent) perceive it as a serious problem. In Malaysia this concern is less pronounced in relative terms (55.1 percent). Rising procurement costs are a major concern for Japanese firms in Malaysia (61.5 percent) more than in other Asian countries except China. Japanese firms in Malaysia are also facing severe competition from other firms in reducing their cost of production and business management (57.4 percent). Although quality of labor and quality control are not as important problems as wage increases overall, Japanese firms in Malaysia regard it as a challenge and more so than in other countries such as Singapore, Indonesia, and Thailand. Obtaining raw materials in Malaysia does not appear to be a considerable problem.

**Table 22. Top Six Challenges Japanese Firms Face in Asian Countries**

Percentage of firms identifying issues as significant obstacles to operate, percent

	Wage increase	Cost increase in procurement	Competition with other firms	Quality of labor	Quality control	Obtaining raw materials and parts at the host country
<b>Malaysia</b>	<b>55.1</b>	<b>61.5</b>	<b>57.4</b>	<b>44.7</b>	<b>41.0</b>	<b>32.8</b>
China	84.9	64.1	53.3	47.6	43.4	41.3
Korea	60.2	50.0	48.9	27.3	19.4	19.4
Singapore	65.7	55.8	56.0	31.4	19.2	13.5
Vietnam	83.3	53.6	38.5	48.7	39.3	61.6
Thailand	68.3	56.7	55.4	40.9	40.7	36.3
Indonesia	75.2	51.9	57.8	42.2	28.7	44.4
Sri Lanka	41.9	61.5	55.2	38.7	23.1	38.5

Source: JETRO, Survey of Japanese Firms in Asia and Oceania 2011.

Sources: JACTIM/JETRO, Survey of Japanese Firms Business Activities 2011 and JETRO, Survey of Japanese Firms in Asia and Oceania 2011

## Conclusions

**The challenge of creating modern jobs is closely related to the challenges for Malaysia's overall economic transformation.** The strong link between productivity and wages means that the structural factors that have suppressed Malaysia's wage growth—inadequate skills, an inefficient regulatory environment, and insufficient social safety nets—are the same forces that threaten to suppress Malaysia's transformation into an inclusive and sustainable high-income economy. Hence, transforming the shape of Malaysia's labor force from one that is 'traditional' to one that is 'modern', and therefore productive, requires the same structural reforms that will drive Malaysia's economic transformation. While direct measures to increase Malaysia's wage rates such as well-designed minimum wage can help, they must be implemented in tandem with efforts to shift Malaysia's production frontiers for wage increases to be sustainable in the long-term.

**Nurturing, attracting and retaining skills lie at the core of creating modern jobs.** Nurturing skills will require an overhaul of the education system towards more autonomy and accountability, and towards more non-routine cognitive and other soft skills. This is in line with the NEM recommendation mentioned earlier that the education system needs to be reviewed and the educational approach shifted from 'rote-learning' to 'creative and critical thinking.' Once skills are nurtured, they need to be retained, by pursuing transformational reforms to increase competition and update inclusiveness policies. Finally, skills can also be brought from abroad to complement Malaysia's talent base. One example raised in the previous *Malaysia Economic Monitor* that is worthy of

consideration is extending a nearly automatic work permit for foreign graduates of Malaysia's universities, as it is done in the United States with "optional practical training."

**Labor markets can be modernized to be more dynamic while creating greater inclusiveness and providing protection for workers.** Malaysian's labor regulations appear reasonably flexible, but they can be modernized in two directions. First, by reducing redundancy costs and introducing unemployment and other social insurance to protect workers, not jobs. Second, by promoting flexible work arrangements, complemented by adequate childcare, to tap on women – a great untapped source of skills in Malaysia.

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