

Transitioning into a High Income Economy: Policy Considerations

From Past to Present: Development of the Malaysian Economy

Malaysia has achieved significant economic progress since attaining Independence in 1957, developing from a low income to an upper middle income economy over a half-century. Income per capita has risen by approximately twenty fold in the last four decades, while the incidence of poverty has been reduced by more than ten fold. Major structural changes have also occurred in the economy. The predominantly primary commodity-based economy with a heavy reliance on rubber and tin in the 1960s was transformed by the rise of the manufacturing sector as the main contributor to growth in the late 1980s, and subsequently, by the services sector becoming the main driver of growth since 2000. Throughout this development process, Malaysia has strengthened and deepened its integration with the global economy.

Malaysia is currently confronted with a global economic environment that is changing significantly. While the global landscape has been gradually shifting in this recent decade, the current global financial and economic crisis has accelerated this shift. Of significance, two distinct developments stand out. First, the global economic landscape is increasingly multi-polar with the rising economic importance of the emerging market economies, especially the economies of Brazil, Russia, India and PR China (BRIC). Importantly, the significant rise of PR China has changed the dynamics of growth in Asia. Favourable structural factors in the emerging market economies, including a large and growing middle class, will support domestic demand and thus the continued growth of these economies post-crisis. The crisis has, however, revealed several structural weaknesses in the advanced economies, all of which will limit the growth potential of these economies in the medium term. Second, the rise of the relatively large emerging market economies, such as the BRICs, Vietnam and Indonesia, will also intensify competition in the global economy, not only among businesses, but also among countries in attracting investment and human capital.

In this more challenging environment, strategic initiatives are being taken to strengthen the flexibility of the Malaysian economy in adapting to the changing circumstances, so as to effectively benefit from new opportunities while addressing potential challenges. The existing economic model is being reviewed and policies that support greater competitiveness, a faster pace of innovation and the elevation to more knowledge-intensive industries are the strategies to transition Malaysia to a high income economy.

The Future: Characteristics of the High Income Malaysian Economy

A high income country is defined by the World Bank as a country with an income per capita of more than US\$11,905. Therefore, from its current level of US\$6,634, Malaysia needs to approximately double its income per capita to become a high income country. Beyond the level of income, an assessment of the existing high income countries highlights five key economic characteristics, namely:

1. Knowledge and innovation-intensive economic activity

A high income economy is knowledge and innovation-driven as opposed to investment-driven. All sectors of the economy are involved in high value economic activity, where knowledge, innovation and productivity are central to value creation.

For Malaysia, given the existing strong manufacturing base, movement towards higher value activity will be driven by the existing industries moving up the value chain. Firms in these industries will increasingly rely on niche strategies as well as continuous improvements, higher sophistication and greater specialisation. Some of the potential areas include advanced electronics, solar panel manufacturing, medical equipment and downstream palm oil. This movement towards higher value activity will be complemented by the development of

the knowledge-intensive services sub-sectors. These modern services include computing, information and communication technology (ICT), research and development (R&D), health and education, and entertainment. Alongside these knowledge-intensive services, established manufacturing-related services, such as logistics, marketing and branding, will also provide strong support to industrial growth.

In addition, while multinational and large domestic corporations remain important, small and medium enterprises (SMEs) will form the backbone of the economy. Of significance, a strong base of highly dynamic, innovative and competitive SMEs will be a critical feature of a high income Malaysian economy.

2. Competition-driven private sector-led economy

Economic activity in a high income economy is led by the private sector in a competitive environment. Competition will contribute to the efficient allocation of resources and the creation of vibrancy and dynamism in economic activity. For markets to function effectively and efficiently, the absence of market distortions, particularly those that result in inappropriate price signals, is a necessary precondition. Nevertheless, a strong institutional framework needs to be in place to address the potential for market failure and to ensure a competitive and fair business environment.

3. Government as a facilitator of economic growth

As the economy will be private sector-led, the role of the Government has to shift to become a key facilitator of growth. In this role, the focus of the Government is on providing a competitive enabling environment for the efficient functioning of the private sector. This will primarily involve the provision of enabling infrastructures, including public transportation and modern internet-related infrastructure, as well as the provision of security and basic social services, such as health and education. In addition, a comprehensive technology and innovation policy would encourage high value activity and knowledge creation. Close collaboration between the public and private sectors is necessary to effectively achieve these objectives.

4. Greater balance between domestic and external demand

Consistent with the ongoing trend, a high income economy needs to have a more balanced model of development. Whilst competitive advantage in the external sector can remain key, the domestic sector needs to have a greater role in contributing to growth. First, a higher and larger middle income group will support even higher and more sophisticated private consumption. Second, an increase in the quality of private investment will contribute to a more sustainable growth of high income and high value-added employment. Private investment will need to increasingly shift away from being predominantly in construction and low value machinery towards advanced automation and R&D to facilitate movement up the value chain as well as to support innovation. High productivity, meanwhile, will complement this rise in capital sophistication to deliver high value products and services.

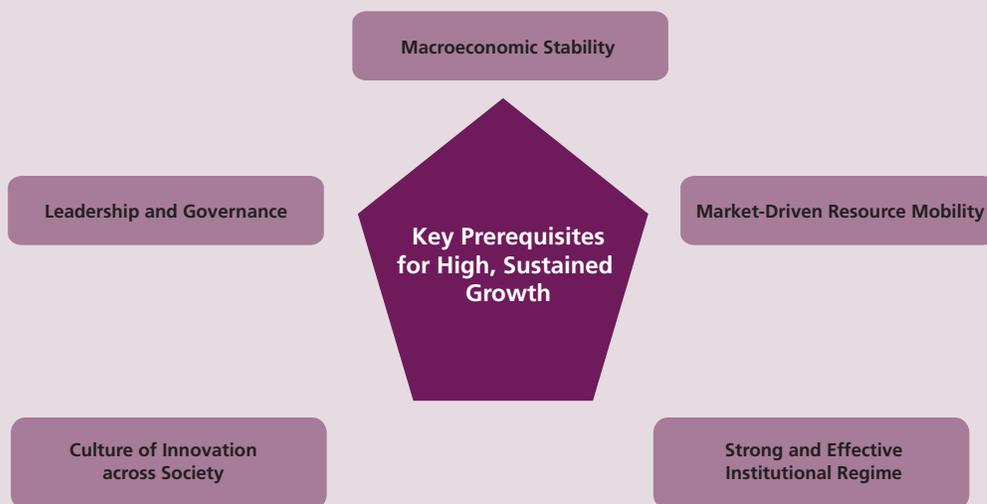
5. Deeper global and regional integration

Given that the domestic market in Malaysia is small, firms will, as they grow in size and strength, increasingly integrate with the region and the rest of the world for greater access to larger markets. Deeper integration with the international markets will encompass both final demand and the supply of factor inputs. For Malaysia, further integration with the regional economies and other emerging economies will be a key characteristic of the transition to becoming a high value-added economy. In particular, the recent rising trend of investment abroad by Malaysian companies can be expected to continue and over the medium term will bring increased benefits to Malaysia as new opportunities and markets are gained.

Strategies for a Sustainable and Dynamic Malaysian Economy

Despite relatively distinct views as to the characteristics of a high income economy, there is no consensus on the requirements to successfully become a high income economy. The experiences of the high income countries do, however, offer some indication that five factors are particularly important (Figure 1). First is macroeconomic stability, which provides an environment conducive for high savings and business investment in an environment of reduced uncertainty. Second, market-driven resource mobility across all markets is essential for the efficient allocation of resources in the economy. Third, there must exist a strong institutional regime with adequate enforcement, encompassing, amongst others, an effective regulation of competition, the prevention of market failures and an effective protection of property rights. Fourth, a culture of innovation needs to

Figure 1
Five Pillars for Sustained Economic Progress

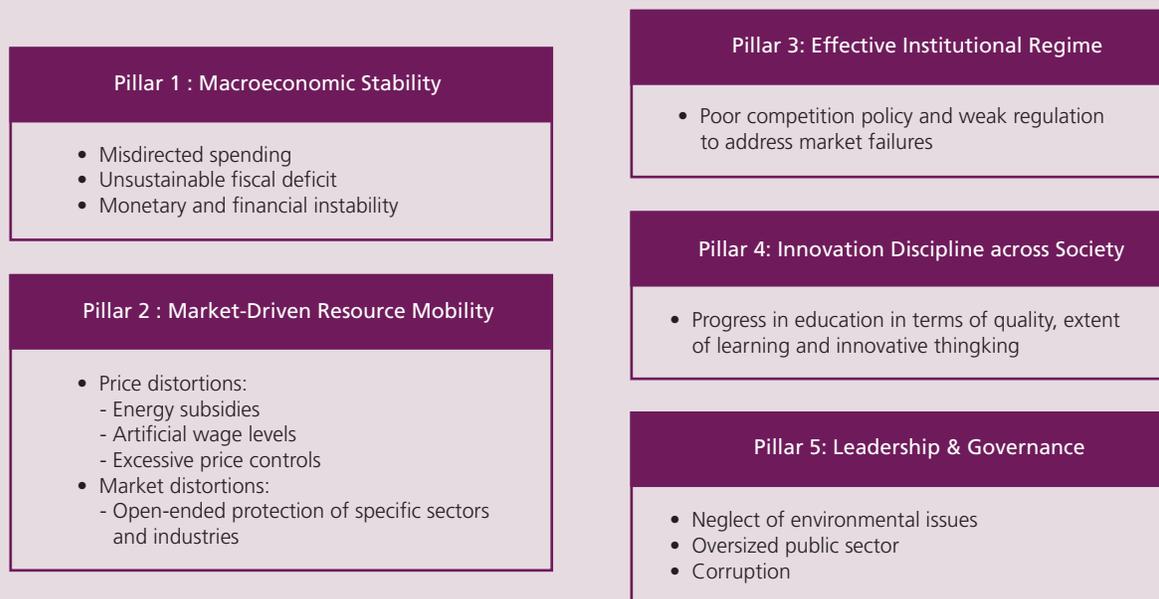


be instilled nationwide, with collaborative efforts within and between the private and public sectors as well as academia. Fifth is that strong leadership and governance must continue to have an important role, particularly in ensuring stability, developing a competitive environment and providing the enabling infrastructure.

Although the broad development literature does not provide a single clear recipe for economic development, experiences do, however, give examples of factors that should be resisted (Figure 2). Of significance are market distortions that are put in place to artificially sustain cost competitiveness. Across many developing economies, market distortions have ranged from price controls and energy subsidies, to the open-ended protection of specific sectors and industries. While there may be circumstances to justify the temporary adoption of some of these measures, such policies over a prolonged period of time usually involve high costs.

For Malaysia going forward, established strengths and foundations will provide the support for continued economic development. To successfully transition into a high value-added economy, Malaysia has the potential to capitalise on existing comparative advantages and develop deeper capabilities and expertise. It has been recognised that fundamental reforms will be required in several areas of the economy. In this regard, three key strategic priorities have been identified, namely to nurture a quality workforce, foster a competitive environment and develop an efficient enabling infrastructure.

Figure 2
Global Experience in Common Constraints to Growth



1. Quality workforce with an instilled culture of innovation

A knowledgeable, innovative and entrepreneurial workforce is essential to drive the value creation necessary in a high income economy. Therefore, world-class education and training are critical for developing skills and creative talent.

Malaysia is, therefore, embarking on the reform of its education system into one that is capable of developing human talent equipped with the relevant skills and competencies required to enhance productivity and economic development. In this regard, strong emphasis is being placed on strengthening the learning institutions in order to ensure top-quality teaching. Relating to this, the salary and reward schemes for university lecturers and teachers are currently being improved to better attract and retain quality educators. In addition, a technical education system is being enhanced to successfully provide the skilled talents required for the advanced manufacturing and services sectors. To ensure that quality is continuously upheld, performance of the premiere polytechnics will be benchmarked against renowned technical institutions, including those in Germany, Austria and Sweden. There have also been ongoing efforts to engage with the private sector in ensuring the relevance and effectiveness of the education system in meeting the needs of the industry.

While reform of the education system is a critical priority, flexibility is being given to draw on the global flow of talent. In this regard, a series of measures has been undertaken to increase the flexibility to employ expatriates, while initiatives are being put in place to reduce brain drain.

2. Competition-driven and efficient markets

Sophisticated high value economic activity requires well-functioning market mechanisms, guided by undistorted price signals, to efficiently allocate the scarce resources. Market distortions would potentially lead to considerable inefficiencies and wastage, while protectionist policies undermine the fundamental incentive structure needed for a thriving entrepreneurial society.

At present, a number of market distortions exist in several areas of the Malaysian economy. These market distortions are highly intertwined in nature, with the measures in place impacting various industries and sectors in the economy. Such subsidies heavily burden the Government and divert resources away from other investment activities. The removal of such distortions should, however, be gradual and sequenced to avoid disruptions to the economy. Equally important is for the savings from the removal of the existing broad-based distortions to be reallocated as more targeted subsidies and direct income transfers to support the low and middle income groups.

3. Extensive and efficient enabling infrastructure

Both traditional and modern infrastructures have a key role in enabling the transition towards a high value-added economy. As Malaysia already has in place high quality physical infrastructure including roads, ports and utilities, the focus is now on the development of an efficient public transportation system, modern internet-related infrastructure and energy efficiency-related infrastructure, which are important in enabling high value activity and improving overall economic productivity. In an effort to expand broadband services nationwide, the Government, in partnership with Telekom Malaysia, has embarked on a RM11.3 billion High Speed Broadband initiative.

As Malaysia adopts these changes, policy implementation needs to take into account three important considerations. First, policies should be gradual and sequenced in order to allow businesses and households to adjust to the new environment. Second is the importance of transparency to allow for public awareness on the new opportunities and constraints. Third, support needs to be provided to the low income group to minimise the negative impact during the transition, as well as to enhance the necessary skills and capabilities required to take advantage of the new opportunities.

Conclusion

The Malaysian economy is currently positioned at a critical juncture of its development and future progress will be confronted with many challenges. Throughout Malaysia's development process of more than 50 years, the economy has exhibited the ability and flexibility to move to new areas of comparative advantage and to new areas of growth. Similarly, in this current process of transitioning into a high value-added economy, Malaysia needs to develop new growth areas and adopt a new economic model for development. With the development of an enabling and competitive economic environment comprising of a quality workforce and an efficient infrastructure, Malaysia will be ready with the necessary foundations to take advantage of the emerging and rapidly changing regional and global trends in order to transition into a high value-added economy.