Developments in the Malaysian Economy

HIGHLIGHTS

- The Malaysian economy expanded by 4.5% in the first quarter of 2019.
- Headline inflation turned negative during the quarter due mainly to lower domestic fuel prices, while core inflation remained stable.
- Current account surplus of the balance of payments increased to RM16.4 billion.

The Malaysian economy grew by 4.5% in the first quarter of 2019

Overall GDP growth was moderate at 4.5% in the first quarter of 2019 (4Q 2018: 4.7%), driven mainly by the expansion in domestic demand. On a quarter-on-quarter seasonally-adjusted basis, the economy grew by 1.1% (4Q 2018: 1.3%).

Domestic demand remained the key driver of growth

Domestic demand expanded by 4.4% in the first quarter (4Q 2018: 5.7%), driven by firm household spending amid weaker capital expenditure.

After three consecutive quarters of robust spending, private consumption growth moderated but remained strong at 7.6% (4Q 2018: 8.4%). This mainly reflected the normalisation in spending following the frontloading of purchases during the tax holiday period. Nonetheless, household spending continued to be supported by income and employment growth.

Public consumption expanded at a faster pace of 6.3% (4Q 2018: 4.0%), attributable to higher growth in spending on supplies and services.

Moderate growth in 1Q 2019

Chart 4: Real GDP Growth (at constant 2015 prices)*

Quarterly change (%), seasonally-adjusted (RHS)  
Annual change (%)

* With effect from first quarter of 2019, Malaysia’s GDP in constant terms is rebased to 2015 prices from 2010 prices

Source: Department of Statistics, Malaysia
Gross fixed capital formation (GFCF) contracted by 3.5% (4Q 2018: 0.6%), weighed down by weaker private and public sector investment. By type of assets, investment in structures declined by 1.3% (4Q 2018: 1.3%) amid subdued property market activity. Capital expenditure on machinery and equipment registered a larger contraction of 7.4% (4Q 2018: -1.3%), affected mainly by a decline in transport equipment spending. Investment in other types of assets also declined by 2.2% (4Q 2018: 4.5%) due mainly to lower research and development (R&D) spending.

Private investment growth slowed to 0.4% (4Q 2018: 5.8%). Investment activity was affected by heightened uncertainty surrounding global trade negotiations and prevailing weaknesses in the broad property segment. Nevertheless, spending on large multi-year projects provided some support to investment growth, particularly in the primary-related manufacturing and utilities services sub-sectors.

Public investment declined further by 13.2% (4Q 2018: -5.9%), on account of lower capital spending by the Federal Government and public corporations.
Moderation across most sectors partially offset by a rebound in growth of the agriculture sector

The services sector growth moderated as the wholesale and retail trade subsector registered slower growth following the post-tax holiday normalisation. However, this was partially offset by higher car sales following the release of new models. Growth in the finance and insurance subsector was sustained, supported by higher insurance premiums relative to claims which offset slower financing. The utilities subsector recorded an improvement given higher demand for electricity, particularly from households amid warmer weather conditions. The information and communication subsector remained supported by demand for data communication services.

Growth in the manufacturing sector moderated, mainly driven by the slowdown in the electronics and electrical (E&E) and primary-related clusters. The slower growth in the E&E cluster was due to lower global demand for semiconductors. The implementation of stricter vehicle emission standards in the EU and expiring tax rebates for cars in PR China weighed on demand for automotive semiconductors. Growth in the primary-related cluster also moderated as unplanned closure of gas facilities in Sarawak in February affected the production of refined petroleum products, particularly liquefied natural gas. Meanwhile, recovery in the production of palm-oil based products led to an improvement in the consumer-related cluster during the quarter.

The agriculture sector’s growth rebounded due to the strong recovery in oil palm yields from the adverse weather last year. Additionally, natural rubber production improved as higher rubber prices spurred more tapping activities during the quarter.
Growth in the mining sector declined further as oil production was affected primarily by unplanned facility closures in Peninsular Malaysia and Sabah. Growth was also weighed by weaker natural gas production as operations were affected by unplanned closure of gas facilities in Sarawak.

The construction sector registered lower growth reflecting slower activities in the non-residential, civil engineering and special trade subsectors. The near completion of large petrochemical projects resulted in a lower growth for the civil engineering subsector. The special trade subsector’s growth moderated due mainly to declining early works from transportation projects transitioning to mid-phase. In the non-residential and residential subsectors, growth remained weak due to the oversupply of commercial properties and a high number of unsold residential properties.
Headline inflation turned negative due mainly to lower domestic fuel prices

Headline inflation, as measured by the annual percentage change in the Consumer Price Index (CPI), declined to -0.3% in the first quarter of 2019 (4Q 2018: 0.3%).

The decline was primarily due to lower domestic fuel prices, arising from the resumption of the managed float fuel pricing mechanism from 5 January 2019 amid lower global oil prices during the quarter. The lower price ceiling on RON95 petrol at RM2.08/litre effective 2 March 2019 also helped contain the increase in domestic fuel prices in March.

The negative inflation during the quarter was not broad-based, with 81% of consumer items not experiencing price declines.

Core inflation, excluding the impact of consumption tax policy changes, was unchanged at 1.6%. While the steady expansion in economic activity was supported by continued employment and income growth, demand-driven inflationary pressures in the economy remained contained in the absence of excessive wage pressure and some degree of spare capacity in the capital stock.

The decline in headline inflation reflected the lower domestic fuel prices

Chart 9: Contribution to Headline Inflation by Components

The share of consumer items recording price declines remained small

Chart 10: Quarter-on-Quarter Change in CPI

Note: The larger share of consumer items recording price declines in 2Q 2018 and 3Q 2018 was largely due to the zero-rated GST rate. The chart is based on the quarter-on-quarter change in CPI for 125 expenditure classes.

Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates
Stable labour market conditions

Labour market conditions remained supportive of economic activity. Employment continued to expand albeit at a more moderate pace of 2.2% (4Q 2018: 2.4%), amid stable unemployment rate (3.3%; 4Q 2018: 3.3%). Strong net employment gains were recorded in the services sector.

Manufacturing sector wage growth remained firm at 7.0% (4Q 2018: 9.8%). Wage growth in export-oriented industries (7.7%; 4Q 2018: 10.8%) continued to outpace that of domestic-oriented industries (5.2%; 4Q 2018: 6.6%).

Employment continued to grow albeit more moderately

### Chart 11: Employment Growth

<table>
<thead>
<tr>
<th>Year/Quarter</th>
<th>1Q 2017</th>
<th>2Q 2017</th>
<th>3Q 2017</th>
<th>4Q 2017</th>
<th>1Q 2018</th>
<th>2Q 2018</th>
<th>3Q 2018</th>
<th>4Q 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual Change (%)</td>
<td>2.4</td>
<td>2.2</td>
<td>3.0</td>
<td>2.0</td>
<td>1.0</td>
<td>2.0</td>
<td>2.0</td>
<td>3.0</td>
</tr>
</tbody>
</table>

Source: Department of Statistics, Malaysia

Firm manufacturing sector wage growth

### Chart 12: Aggregate Manufacturing Sector Wages

<table>
<thead>
<tr>
<th>Year/Quarter</th>
<th>1Q 2017</th>
<th>2Q 2017</th>
<th>3Q 2017</th>
<th>4Q 2017</th>
<th>1Q 2018</th>
<th>2Q 2018</th>
<th>3Q 2018</th>
<th>4Q 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual Change (%)</td>
<td>10.8</td>
<td>9.8</td>
<td>12.0</td>
<td>14.0</td>
<td>2.0</td>
<td>7.0</td>
<td>9.8</td>
<td>7.0</td>
</tr>
</tbody>
</table>

Note: Manufacturing sector wages were sourced from the salaries and wages data published in the Monthly Manufacturing Statistics by the Department of Statistics, Malaysia.

Source: Department of Statistics, Malaysia and BNM estimates
Higher current account surplus

The current account surplus of the balance of payments widened to RM16.4 billion in the first quarter (4Q 2018: RM10.8 billion), the highest since the first quarter of 2014 (RM19.8 billion). This was due to a higher goods surplus and smaller income and services deficits.

The goods surplus increased to RM33.8 billion (4Q 2018: RM32.7 billion) amid lower imports of production inputs and capital goods. This had offset lower exports in both manufacturing and commodity sectors.

The services account registered a smaller deficit of RM1.8 billion (4Q 2018: -RM3.8 billion) owing mainly to lower net payments for foreign transportation services in tandem with more moderate trade activity. The travel account also recorded a higher surplus (RM7.9 billion; 4Q 2018: RM7.7 billion) due to lower outbound travel payments.

In the income accounts, the smaller primary income deficit (-RM10.1 billion; 4Q 2018: -RM12.9 billion) was mainly attributable to lower portfolio investment payments (RM4.7 billion; 4Q 2018: RM7.3 billion). The secondary income deficit amounted to RM5.5 billion (4Q 2018: -RM5.2 billion), on account of continued outward remittances by foreign workers.

Chart 13: Current Account Balance

 SOURCES: Department of Statistics, Malaysia
The financial account registered a net outflow of RM13.8 billion (4Q 2018: net outflow of RM6.1 billion), due mainly to the repayment of interbank borrowings by domestic financial institutions. Net inflows of direct and portfolio investments during the quarter partially offset higher net outflows in the other investment account.

The direct investment account registered a higher net inflow of RM16.3 billion (4Q 2018: net inflow of RM2.1 billion), supported by larger FDI inflows of RM21.7 billion (4Q 2018: net inflow of RM12.9 billion). This partly reflected the divestment of a private healthcare company to a Japanese investor and the formation of a joint-venture in the oil and gas sector. By sector, FDI was channeled mainly into the services sector, particularly the healthcare sub-sector, and the manufacturing sector. Direct investments abroad (DIA) by Malaysian companies recorded a lower net outflow of RM5.5 billion (4Q 2018: net outflow of RM10.8 billion). DIA outflows were channeled primarily into the financial services sub-sector and the mining sector.

The portfolio investment account registered a net inflow of RM2.1 billion (4Q 2018: net outflow of RM5.8 billion). During the quarter, investor sentiments in the region improved, following the signaling by the US Federal Reserve (the Fed) for a pause in monetary policy normalisation, and signs of positive developments on trade negotiations between the US and PR China. This was reflected in the turnaround in non-resident portfolio investments (1Q 2019: net inflow RM13.5 billion; 4Q 2018: net outflow RM2.5 billion), due mainly to higher purchases of domestic debt securities. Non-resident portfolio inflows were partially offset by residents’ continued asset acquisition, amounting to a higher net outflow of RM11.4 billion (4Q 2018: net outflow RM3.3 billion).

The other investment account recorded a net outflow of RM31.9 billion (4Q 2018: net outflow of RM1.8 billion). This was attributable mainly to the repayment of inter-bank borrowings. Net errors and omissions amounted to +RM2.9 billion, or +0.7% of total trade. The international reserves of Bank Negara Malaysia amounted to USD103.0 billion as at end-March 2019, compared to USD101.4 billion as at end-December 2018.
Manageable external debt

Malaysia’s external debt stood lower at RM903.7 billion, or 59.5% of GDP as at end-March 2019 (end-December 2018: RM924.9 billion or 63.9% of GDP). The decline was due mainly to net repayment of interbank borrowings and trade credits, and a reduction in non-resident deposits. There was also revaluation adjustment from the stronger ringgit against regional and major currencies during the first quarter of 2019. These were partially offset by a net issuance of bond and notes and higher non-resident holdings of domestic debt securities and intercompany loans.

The country’s external debt remains manageable, given its currency and maturity profiles, and the presence of large external assets. Close to one-third of external debt is denominated in ringgit (32.7%; end-December 2018: 31.1%), mainly in the form of non-resident holdings of domestic debt securities (63.2% share) and in ringgit deposits (17.6% share) in domestic banking institutions. As such, these liabilities are not subject to valuation changes from the fluctuations in the ringgit exchange rate.

The remaining external debt of RM607.9 billion or 67.3% of total external debt is denominated in foreign currency (FC) and comprised mostly offshore borrowings. As at end-March 2019, offshore borrowings declined to RM546.9 billion or 36.0% of GDP (end-December 2018: RM566.9 billion or 39.2% of GDP). The corporate sector accounted for slightly more than half of the FC-denominated external debt and is largely subject to prudential and hedging requirements.

By instrument, 35.4% (or RM215.3 billion) of FC-denominated external debt is accounted by interbank borrowings and FC deposits in the domestic banking system. 80.7% of the interbank borrowings are in the form of largely stable intragroup borrowings from related banks overseas, namely parent banks, regional offices and subsidiaries, reflecting banks’ centralised liquidity and funding management practices. During the quarter, banks’ FC-denominated short-term external debt declined by RM30.7 billion following net repayment of interbank borrowings. This primarily reflected lower funding needs of several foreign banks, including banks operating in Labuan International Banking and Financial Centre. Foreign-currency risk, measured in net open position of FC-denominated exposures remained low at 5.1% of banks’ total capital, reflecting banks’ continued vigilance in managing risks arising from their external borrowing.

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Chart 16: Changes in External Debt

<table>
<thead>
<tr>
<th>Net change</th>
<th>RM billion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interbank borrowings</td>
<td>-25.4</td>
</tr>
<tr>
<td>Exchange rate valuation effects</td>
<td>-8.8</td>
</tr>
<tr>
<td>NR deposits</td>
<td>-3.9</td>
</tr>
<tr>
<td>Others</td>
<td>-2.5</td>
</tr>
<tr>
<td>Loans</td>
<td>-0.4</td>
</tr>
<tr>
<td>Intercompany loans</td>
<td>6.1</td>
</tr>
<tr>
<td>NR holdings of domestic debt securities</td>
<td>6.6</td>
</tr>
<tr>
<td>Bonds and notes</td>
<td>7.2</td>
</tr>
</tbody>
</table>

1 Changes in individual debt instruments exclude exchange rate valuation effects
2 Comprises trade credits, IMF allocation of SDRs and other debt liabilities
Note: NR refers to non-residents
Figures may not add up due to rounding
Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

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3 Refers to the aggregated sum of the net short or long foreign currency positions for all currencies across banks.
Long-term bonds and notes issued offshore stood at RM157.6 billion as at end-March 2019, accounting for 25.9% of total FC-denominated external debt. These were mainly by non-financial corporations and channeled primarily to finance asset acquisitions abroad. The Federal Government also issued a Samurai bond amounting to RM7.4 billion during the quarter. Intercompany loans, which amounted to RM105.6 billion and accounted for 17.4% of FC-denominated external debt, are typically on flexible and concessionary terms. About 80% of these intercompany loans were obtained by multinational corporations (MNCs) from parent or affiliate companies abroad.

From a maturity perspective, 59.2% of the total external debt is skewed towards medium- to long-term tenure (end-December: 56.2%), suggesting limited rollover risks. Short-term external debt accounted for the remaining 40.8% of external debt. As at 30 April 2019, international reserves stood at USD103.4 billion, sufficient to finance 7.4 months of retained imports, and is 1.1 time the short-term external debt.

Of significance, reserves are not the only means for banks and corporations to meet their external obligations. The progressive liberalisation of foreign exchange administration rules has resulted in significant increase in non-reserves external assets. In particular, banks and corporations held roughly three-quarters of Malaysia’s RM1.7 trillion external assets, which can be drawn down to meet their RM698.6 billion external debt obligations, without creating a claim on international reserves. While the flexible exchange rate remains the first line of defense, adequate international reserves and availability of substantial foreign currency external assets by banks and corporations continue to serve as important buffers against potential external shocks.
Is Malaysia Experiencing Premature Deindustrialisation?

Authors: Tengku Mohamed Asyraf, Devendran Nadaraja, Afif Shamri, Rubin Sivabalan

HIGHLIGHTS

- Malaysia appears to have prematurely deindustrialised since the early 2000s, mainly due to the increased global competition and the slow progress in moving up the value chain.

- The deindustrialisation process has, however, recently slowed down, due to productivity gains in the E&E sub-sector as a result of horizontal diversification and increased high skilled employment.

- Ensuring further economic development requires a balanced development strategy targeting both manufacturing and modern services sectors.

The process of industrialisation is a critical step for a country to achieve a high level of income. This was the path followed by most Western countries during the First and Second Industrial Revolution, as well as by the more recent Newly Industrialised Economies (NIEs) such as South Korea, Chinese Taipei and Singapore. Upon attaining this high income status, it is then a common pattern for countries to start deindustrialising, as they begin to adopt labour-saving technologies on a massive scale. More recently, however, developing countries have begun prematurely deindustrialising due to reasons that are vastly different, as their manufacturing sector faced intense competition from global markets. This box will explore the nature of Malaysia’s deindustrialisation and compare the underlying drivers for this process vis-a-vis the advanced economies. It will also discuss the current thinking on the policy strategies in tackling the issue of premature deindustrialisation.

What are the different paths of deindustrialisation?

Deindustrialisation represents a natural stage of economic development, as economies start to shift their resources away from manufacturing to services as a result of high manufacturing productivity growth and increased consumption for services as society becomes wealthier. This is part of an economic structural transformation path (IMF, 2018), where economies typically move from agriculture, to manufacturing and on to services as they develop. This path of deindustrialisation represents a positive development as the high manufacturing productivity growth, typically due to adoption of labour-saving technologies, implies that the manufacturing workers have become highly productive that the economy requires less of them to meet overall demand. It is measured by a sustained decline in the manufacturing employment share, accompanied by a more moderate decrease in the manufacturing output share of the economy (IMF, 2018). Examples of economies that have experienced this path of deindustrialisation include the US, EU and Japan as their manufacturing employment shares have fallen much faster than their manufacturing output shares since the 1970s.

Premature deindustrialisation, however, is a less desirable path of deindustrialisation when it is attributable to declining manufacturing competitiveness as opposed to high manufacturing productivity. This form of deindustrialisation will typically result in economies experiencing a faster contraction in their manufacturing output share compared to the manufacturing employment share. Rodrik (2016) finds that economies that are currently experiencing premature deindustrialisation are mostly from Latin America and Sub-Saharan Africa, such as Brazil, Argentina, South Africa and Ghana. This deindustrialisation path is detrimental to countries’ economic development as the manufacturing sector is an important source for the creation of high quality, high productivity, high income employment and technological adoption and development.
Malaysia: Positive Deindustrialisation or Premature Deindustrialisation?

Based on the criteria laid out in Table 1, it appears that Malaysia has been exhibiting signs of premature deindustrialisation. The Malaysian economy began to deindustrialise from the year 2000 onwards, where it attained its peak employment share in manufacturing at 23.5%, at an income level of Intl $9,500 GDP per capita\(^1\). This is much lower than the peak employment share attained by the advanced economies when they began to deindustrialise (30% employment share), and far behind the level of GDP per capita income (Intl $18,000) (Kirsh, 2018). Further evidence of the economy experiencing a less desirable form of deindustrialisation are the twin decline in employment as well as the output share of manufacturing, indicating that the process of falling employment was not an outcome of rising productivity, but rather from lower competitiveness.

**Table 1: Symptoms of positive deindustrialisation vs. premature deindustrialisation**

<table>
<thead>
<tr>
<th>Symptoms</th>
<th>Deindustrialisation</th>
<th>Premature</th>
</tr>
</thead>
<tbody>
<tr>
<td>Causes</td>
<td>Adoption of labour-saving technologies</td>
<td>Falling manufacturing competitiveness</td>
</tr>
<tr>
<td>Peak manufacturing employment share*</td>
<td>~30%</td>
<td>~15%</td>
</tr>
<tr>
<td>GDP per capita at peak manufacturing employment share*</td>
<td>Intl $18,000</td>
<td>Intl $14,000</td>
</tr>
<tr>
<td>Relative fall in employment vs output shares</td>
<td>Fall in employment share greater than fall in output share</td>
<td>Fall in employment share less than fall in output share</td>
</tr>
</tbody>
</table>

* Note: refers to results for a sample of advanced and middle income economies in Kirsh (2018)

\(^1\) Refers to income level measured in constant 2005 international dollars on purchasing power parity (PPP). This is taken from the Penn World Table 7.1 (2012).
The loss of competitiveness is partly attributable to PR China’s ascension into the World Trade Organisation (WTO), which coincided with the timing of the reduced significance of Malaysia’s manufacturing employment share (Chart 2). The loss of competitiveness to PR China is, however, not unique to Malaysia as other Asian economies have also shed employment in the low skill sectors. What differs, however, is that other countries such as South Korea and Chinese Taipei² appear to have prevented premature deindustrialisation by creating employment in other high value added segments of the manufacturing value chain, a situation that is less apparent in Malaysia (Chart 3).

Chart 2: PR China’s entry into the WTO in 2001 coincided with the decrease in Malaysia’s manufacturing employment share and reduced competitiveness of regional economies’ E&E exports

Chart 3: Unlike other regional economies, Malaysia’s manufacturing sector has generated less employment in high value added segments

² Chinese Taipei’s successful positive deindustrialisation arose from adoption of the strategy of “keeping the roots planted in Chinese Taipei while letting the branches and leaves expand abroad” (Chen, 2005). This entailed retaining production of higher value added products in the country, while offshoring labour-intensive activities. Critically, both Chinese Taipei and South Korea also kept innovation-based functions such as developing new products domestically, while moving production-based manufacturing jobs abroad.
Two explanations in the literature have been put forth to account for the slow progress of Malaysia’s manufacturing sector in moving up the value chain. First is the less-than-desirable policy landscape and the lack of industry-government coordination which has led to a lack of technology upgrading in the manufacturing sector (see Rasiah (2011) and Menon and Ng (2015)). The second view posits that industrial upgrading in Malaysia is slow due to the large concentration of micro-, small- and medium-sized firms in the manufacturing sector. These smaller firms suffer from low production volume or do not have consistency in the demand for their products. As a result, they are unable to embrace automation solutions, which are costly, capital intensive and have a longer payback period. For export-oriented firms, the difficulty in upgrading is also due to the limited ability to embark on product innovation as they are mainly involved in production-related activities on behalf of international clients, with limited ownership of the final product itself (Khazanah Research Institute, 2017). This, however, has not stopped local firms from undertaking process innovation, as the percentage of Malaysian firms that embarked on this is comparable to our regional peers (World Bank Enterprise Survey, 2016).

Notwithstanding these developments, there are several important nuances about Malaysia’s deindustrialisation that are worth highlighting:

1. While the output and employment shares of manufacturing declined up to 2010, they have been relatively steady thereafter (Chart 4). Though it may be too early to conclude that Malaysia has stopped deindustrialising, the process appears to have slowed considerably over the past decade.

2. Sector-specific trends also appear to play an important role in explaining Malaysia’s deindustrialisation. Most of the decrease in the overall manufacturing share as well as the subsequent stabilisation tracks closely the trend of the E&E sub-sector (Chart 5a). Meanwhile, other manufacturing sectors experience more muted changes in their output and employment shares.

3. Comparing the period before and after 2010, the E&E sub-sector showed an improvement in productivity in the latter half compared to the previous decade (Chart 5b). An increasing rate of productivity is an important attribute towards a more positive long-term industrial process.

**Chart 4: Although Malaysia’s manufacturing output and employment shares have declined since its peak in 2000, the pace of the decline have been more gradual from 2010 onwards**

![Chart showing share of manufacturing value added and employment from 1995 to 2017](chart_url)
These developments appear to be rooted in several recent shifts taking place in the manufacturing sector. First, although the broader manufacturing sector has been slow in moving up the value chain, the E&E sub-sector has considerable success in reversing its fall in output share as it engaged in horizontal diversification towards a new set of end-product segments. This was enabled by a large presence of multinational corporations (MNCs) in Malaysia with vendor linkages with domestic E&E firms as well as the emergence of public-listed homegrown E&E companies. As the MNCs responded to the major shifts in the global E&E markets, Malaysian firms moved in tandem to diversify away from personal computers (PC), which had been on a structurally declining trend towards and after 2010, into fast-growing end-product segments such as smartphones, automotive electronics and cloud computing. Consequently, Malaysia’s E&E sub-sector was able to record improved output share and productivity from 2010 onwards. These are in spite of the lack of functional upgrading in terms of activities within the E&E sub-sector, as its primary activity remains predominantly assembly and testing.

Second, employment within the E&E sub-sector has also become increasingly skilled-biased. Data from the Labour Force Survey between 2010 and 2015 indicate a shift in the E&E sub-sector’s worker composition away from the use of direct labour, typically associated with the labour-intensive methods of production (Chart 6). This has been replaced with a higher share of engineers and technicians who can operate machines and automated equipments. Despite this positive trend, the E&E sub-sector still faces an acute shortage of high-skilled labour amid the increasing need to automate and innovate.

Chart 6: E&E’s shift towards high skilled employment

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\(^3\) The declining E&E output share in the late 2000s reflects the adverse impact of the emergence of smartphones and tablets technology to the global PC market as Malaysia’s E&E sub-sector was highly plugged into the PC production chain.
Where should Malaysia go from here?

These recent trends suggest Malaysia is already making some progress towards a more positive path of development. Replicating the E&E sub-sector’s experience in other parts of the manufacturing industry can accelerate productivity improvements across the entire sector, which is critical to overcoming premature deindustrialisation. Improvement should not be confined to the manufacturing sector alone. In particular, the services sector, being the largest sector, will need to play a more significant and complementary role to manufacturing in creating good quality, high productivity and high paying jobs that are the hallmark of more developed economies.

The lesson from the E&E’s diversification process presents a pragmatic way forward for other sectors in the economy to improve productivity and arrest their respective “premature output deindustrialisation”. Producing more complex and sophisticated products can be a viable strategy to increase each sector’s competitiveness. A strong case can be made for the resource-based industries to potentially produce more complex downstream products, such as specialty chemicals and oleo-chemicals. Similarly, transport manufacturers may also find means to produce more complex types of passenger vehicles such as hybrid and electric vehicles.

It is noteworthy, however, that even if these industries were able to move horizontally and produce more complex products, it may not necessarily prevent the decline in manufacturing employment share as the nature of advanced manufacturing inherently requires more automated equipments and machines while reliance on labour as a factor of production diminishes. This explains the reason that advanced economies are still experiencing a declining share of manufacturing employment to this day. Despite this lower reliance on labour, there will be a potential for an increase in high skilled and thus higher paying jobs in order to cater for the more technologically advanced manufacturing sector.

Given these trends, recent developments in the literature also suggest that the services sector is able to take on a more significant role in providing high quality employment to complete the process of transitioning towards a high income economy. It is essential that employment creation be targeted towards the modern services sub-sector as opposed to the traditional services sub-sector. This is because the modern services sub-sector closely resembles the manufacturing sector in terms of productivity, tradability and technological diffusion (Nayyar et al., 2018). This modern services sub-sector is typically defined as the ICT services, finance as well as transport, storage and communications sectors. In addition, Gollin (2018) argues that modern services will also yield technological and knowledge spillovers, which will provide an opportunity for technological transfer and capital investments, akin to the manufacturing sector.

However, a balanced development strategy targeting both manufacturing and modern services is needed as there are several limitations in solely relying on the modern services sub-sector in economic development. Firstly, despite the increasing tradability of the modern services sub-sector, its share in global trade is still relatively low compared to manufacturing trade, which implies there might be limited gains to the economy’s export performance if it were to focus solely on modern services. Secondly, despite the similarities in the characteristics of the manufacturing and modern services sectors, the modern services sub-sector will not be able to absorb the displaced low and mid-skilled manufacturing workers in the short run due to its demand for high-skilled labour, which is a key feature of modern services. This reinforces the urgency for effective and comprehensive labour upskilling programmes to accelerate the development of the modern services sub-sector to ensure a smoother employment transition.

To facilitate a more balanced development strategy, several policy imperatives ought to be prioritised. Firstly, there is a need for a principle-based investment approach that focuses on high skilled job creation, high value added activities and high product complexity. This will ensure the economy attracts investments that will move all the sectors up the value chain and into modern and advanced activities that are fast growing with high productivity. Secondly, the capability of domestic firms, talent and infrastructure must be further strengthened in order to capitalise on opportunities as a result of
the changing global economic landscape. Industrial automation, advanced robotics and digitalisation are transforming processes in both the manufacturing and services sectors. While Malaysian firms are already actively pursuing process innovation, there is still a need to nurture domestic firms and talent to be agile in dealing with new forms of process innovation. National strategies and roadmaps will play a critical role in steering this transformation. Infrastructure-wise, digital connectivity using high-speed broadband has become equally important as the deployment of physical infrastructure.

**Conclusion**

While Malaysia has been experiencing premature deindustrialisation since the early 2000s, recent trends suggest that certain industries are progressing towards a more positive path of industrial development. To further sustain the progress of the Malaysian economy, a balanced development strategy that targets and upgrades both manufacturing and modern services is needed. Recent experience also underscores the principle that the most effective outcomes are achieved when government and private sector efforts work hand-in-hand, and new forms of industrial policies will have a key role to play in facilitating structural transformation and economic development.

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4 Examples of these strategies and roadmaps include Industry4WRD, National Internet of Things Strategic Roadmap and the eCommerce Strategic Roadmap.