

EXECUTIVE SUMMARY

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

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

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

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

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

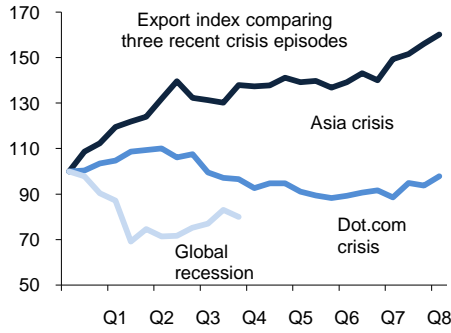
Managing the economy's recovery will be a delicate balancing act. Withdrawing policy support too early runs the risk of choking off the recovery. But extending support for too long may hamper the credibility of medium-term fiscal consolidation, reduce the room for future stimulus, increase the risk of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

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

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

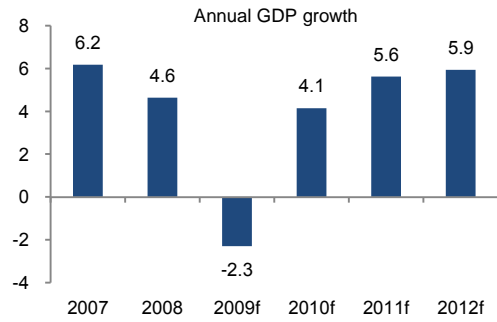
- **Specializing the economy further.** Given limited resources—both public and private—and the need to achieve agglomeration economies, it is important to focus on a few high value-added, innovation-based sectors with strong potential. Improvements to the enabling environment can facilitate this through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

The export slump and recovery ...



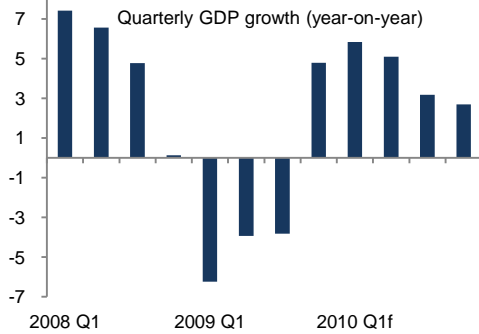
Source: CEIC and World Bank staff calculations
 Note: Export index equals 100 for Jul 1997 (Asia crisis), Mar 2000 (Dot.com crisis) and Sep 2008 (current global recession)

... will drive expected growth next year



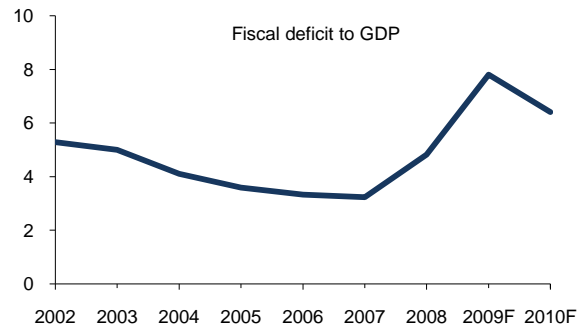
Source: CEIC and World Bank staff projections.

As quarterly growth resumes ...



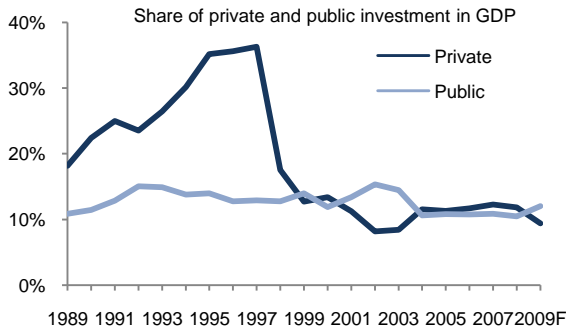
Source: CEIC and World Bank staff projections.

... the withdrawal of policy support requires careful management



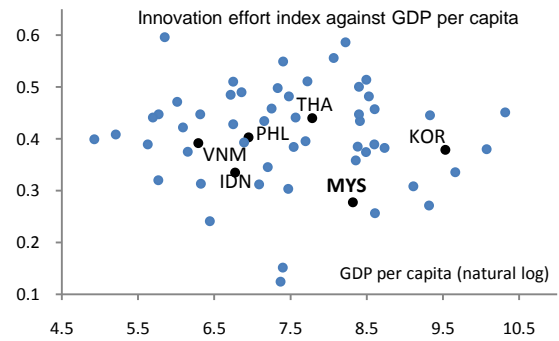
Source: CEIC and World Bank staff projections.

Sustained growth requires a pick-up in private investment



Source: CEIC and World Bank staff calculations.

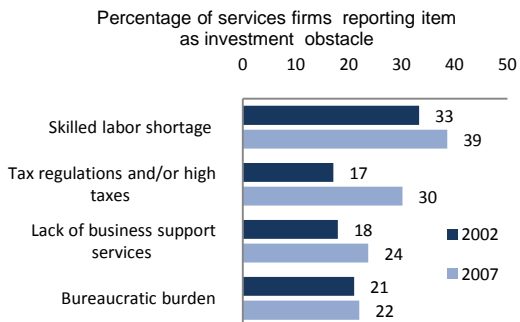
... and greater innovation efforts by firms



Source: WDI and World Bank staff calculations.

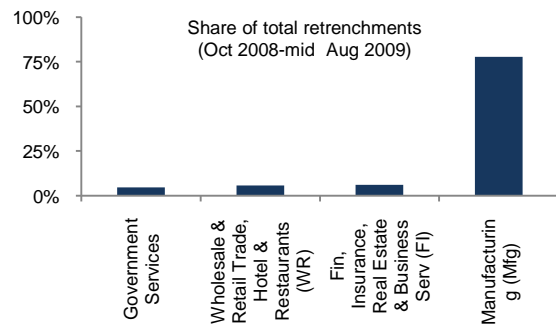
Note: Index captures efforts on product development, product upgrading, process improvement, and foreign joint ventures.

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



Source: World Bank (2005 and 2009b).

... and targeting safety nets to protect against adversity



Source: Department of Labor.