Observer

Can Malaysia become a high-income country by 2020?

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If you are scanning today's uncertain global economy for stories of encouragement, then look no further than Malaysia. For just as the famous Petronas Towers shine above its capital, Kuala Lumpur, this diverse, federal Southeast Asian country of over 31 million people stands out for its resilient and robust economic performance. Can the country keep up this promising performance and achieve its ambitious goals?

Indeed, since independence in 1957 Malaysia has not looked back. It has notched up nearly half a century of rapid and inclusive economic growth, with real GDP expanding by 6.4% per annum on average since 1970. Once dependent on agriculture and commodity exports, this growth has allowed it to become a more diversified, modern economy. It is open and competitive too, with strong links to global value chains, particularly in manufacturing electronic goods, machine equipment, medical goods and so on.

These links helped Malaysia recover swiftly after the 1997-98 Asian financial crisis. The resilience of its economy was further demonstrated by a domestic demand-driven recovery following the global financial crisis in 2007-08. Recently, Malaysian has consistently outperformed most of its regional peers in the convergence race.

Indeed, GDP per capita not only exceeds the ASEAN average but is now higher than in some OECD member countries. And as the OECD's first ever *Economic Assessment of Malaysia*, issued in November, underlines, poverty and income inequality have declined markedly at the same time, to wit the emergence of a rather large and growing middle class.

The Malaysian government's 11th Malaysia Plan (2016-20) emphasises the need for greater inclusiveness . In particular, it seeks to raise the living standards of the bottom 40% of the population by income, to reduce the income and infrastructure gaps between richer and poorer states, and to increase the participation of women in the economy.

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Another key objective is to continue with gradual fiscal consolidation, following the reduction of the headline fiscal deficit from a peak of 6.4% of GDP in 2009 to a projected 3.1% in 2016. This progress owes much to major structural reforms. On the revenue side, the government introduced a consumption-based goods and services tax (GST) in April 2015, which led to better and more transparent tax collection, and has helped broaden an overly narrow tax base. Malaysia is one of Asia's main oil and gas exporting countries, and GST implementation helped offset the sharp decline in oil prices, with the share of fiscal revenue from oil and gas halving between 2014 and 2016, to one sixth. On the expenditure side, the authorities embarked on a far-reaching energy and food subsidy rationalisation programme in 2009, which has now been largely completed.

To cushion the political and economic impact of the GST and subsidy removals, especially on lower incomes, the government introduced an income support programme in 2012, called BR1M, which involves income transfers to households in the bottom 40%. In addition, the government has provided substantial (arguably too broad) GST exemptions on various items, such as fruits, vegetables, cooking oil and petrol, which these low income groups have a larger propensity to consume.

On top of this inclusive strategy, Malaysia's economic success story has also been underpinned by prudent monetary and financial policy, led by its independent and authoritative central bank. Malaysia has the third largest bond market in Asia and is a global proponent of Islamic finance. A salutary lesson the Malaysian authorities drew from the 1997-98 Asian crisis was the need for macroprudential measures, such as stringent reserve requirements on financial institutions and leverage caps on residential purchases, and these have helped the country cope with the volatility of capital flows and asset prices in recent years.

Nevertheless, a lacklustre and uncertain global environment means choppy waters remain ahead, with subdued global trade growth, spillovers from rebalancing efforts in China and low commodity prices. Clearly, for convergence towards higher income countries to be achieved by 2020 as is the government's aspiration, Malaysia will have to engage in tough reforms, particularly in two areas.

First, productivity growth needs to be reinvigorated, and durably so. One lever to bring this about would be to step up efforts in improving education levels, not least proficiency in English, and to increase the supply of job-ready graduates, especially through technical vocational education and training. Though an open economy, further liberalisation of trade and investment would help Malaysia, backed by stronger competition policies, particularly in telecommunications. Meanwhile, the antiquated bankruptcy law needs to be revamped, to align it with international best practice, as this would spur service sector activity and bolster small and medium enterprises. Productivity in the public sector also has room to improve, in particular by reducing duplication among government agencies, decentralising more functions, and overhauling public procurement policies to improve transparency and encourage competitive bidding.

The second area of focus is for Malaysia to foster more inclusive growth. This chiefly means addressing informal employment and the absence of an integrated and targeted social safety net. A more comprehensive social protection system is needed, especially the long-delayed implementation of an employment insurance scheme. Labour participation rates of women and older people could be raised too, through more flexible work arrangements and investment in early childcare, as well as lifelong learning and reskilling programmes. Boosting digital connectivity, especially broadband access, would also help reduce the gaps between the richer and poorer Malaysian states.

Ageing is another challenge that Malaysia must address. The retirement age has been raised, but at 60 remains low by OECD standards. A higher retirement age, reductions in withdrawal exemptions in the Employees Provident Fund for private sector employees, and a move towards defined contributions for future public sector hires, should be considered to help the country prepare for rising pension costs. Malaysia has achieved much, and has set itself ambitious objectives as well. By pushing ahead with structural reforms to boost productivity and foster more inclusive growth, those goals could, like the Petronas Towers, become a shining reality.

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