

ISSUES AND CHALLENGES IN THE MALAYSIAN ECONOMY

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Towards Inclusive Growth

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LIST OF ABBREVIATIONS

ASEAN	Association of Southeast Asian Nations
ATP	Autonomous Technical Progress
BCBS	Basel Committee on Banking Supervision
BNM	Bank Negara Malaysia
DTP	Domestic Technical Progress
ES	Expected Shortfall
EVI	Economic Vulnerability Index
EWS	Early Warning System
FDI	Foreign direct investment
FTP	Foreign Technical Progress
GDP	Gross Domestic Product
HCI	Human Capital Index
HDI	Human Development Index
IPR	Intellectual Property Rights Protection
ITP	Innovation Technical Progress
MDG	Millennium Development Goals
MIGI	Malaysia Inclusive Growth Index
NEAC	National Economic Advisory Council of Malaysia
R&D	Research and Development
SC	Scale effect
SFA	Stochastic Frontier Analysis
TEC	Technical Efficiency Change
TFPG	Total Factor Productivity Growth

VaR	Value at Risk
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Program
WTO-TRIPS	World Trade Organization-Trade Related Aspect of Intellectual Property Rights Agreement

INTRODUCTION

INCLUSIVE GROWTH IN MALAYSIA: ISSUES AND CHALLENGES

1.1 INTRODUCTION

The Malaysian economy has enjoyed rapid economic growth in recent years with a 5.4% average annual growth rate for gross domestic product from 2010 to 2018 (Economics Intelligence Unit, 2019). By 2018, Malaysia's GNI per capita according to Atlas method has almost reached the high income level at around USD\$10,460 from just USD\$370 in 1970 making it the third most highest income per capita nation in ASEAN after Singapore and Brunei. Indeed, Malaysia has drawn considerable attention due to its strong sustained economic growth and efforts to reduce poverty. Consequently, the country's economic and political standing has improved suitable of an emerging market economy.

At the same time, Malaysia has the highest income inequality in Asia according to the Gini coefficient method which is one of indication of less inclusive growth. It is widely understood that high economic growth in Malaysia would result in widening economic disparity in various dimensions

such as regional inequality and income group's gaps. This indicates that less developed states and disadvantaged income groups do not enjoy from high economic growth compared to the developed states and high income groups, in term of economic growth at the national level.

However, it is crucial to ensure that economic growth would benefits all sections of the society and increase their overall quality of life. There is evidence to support that income inequality would result in rising social-economic issues (Peterson, 2017). Income inequality is defined as measurement of the gap of the distribution of income of the highest individuals or households with income of the lowest individuals or households (OECD, 2019). This rising income inequality would then result in lower GDP per capita especially for the high income economy (Brueckner, Dabla-Norris, Gradstein, & Lederman, 2017).

If the gap of the income inequality keep widening, there is a possibility of political dissatisfaction among the lower income groups or less developed states which could become a political issues that need to be addressed. In Malaysia, addressing the issue of rising cost of living has become one of the main agenda of the Government which is partly contributed to the widening income gap between the high income and low income. This has caused the low or even middle-income households unable to afford basic needs such as housing and healthcare. To foster the sense of economic growth and equity, the World Bank has come up with the agenda of Shared Prosperity (World Bank, 2018). This is important to ensure that the public would have belief in the current system and thus sustaining the functioning of democracy and economic system.

Malaysia has always emphasized growth with equity in its various economic plans through reducing the poverty levels by providing jobs for all Malaysians irrespective of race (Nixon,

Asada, & Koen, 2017). In same path, the present central government, the Pakatan Harapan government has adopted inclusive growth as its main economic agenda through the revised 11th Malaysian Plan which aims to drive uplift the bottom 40% (B40) income group to the middle-income group (M40) (Wan Sulaiman, 2018). This would eventually able to distribute the benefits of economic growth to all sections of the society.

In addition, according to the definition of inclusive growth given by World Bank, inclusive growth is a growth that allows all sections of the society to contribute and gain benefit from economic growth. Nevertheless, this could only be achieved through policy goals and programmes such as improving income and purchasing power of B40 income group through increasing marketability and productivity of this group. The government will be focusing on invigorating the entrepreneurship programme and enhancing the human capital capability of the B40 income group.

Various academic researchers have been conducted on inclusive growth in Malaysia recently, particularly on the various economic plans to achieving economic growth with equity. Some studies discuss on the success of this plans on achieving quality economic development (Rosli & Hwa, 2012). Other studies discuss issues related to inclusive growth such as labour market, social protection, tax system, pension system and healthcare (Nixon et al., 2017).

As a continuation of previous research on inclusive growth which address selected income inequality issues in Malaysia (Rosli & Hwa, 2012), the present volume mainly focuses on how Malaysia can achieve inclusive growth through economic areas such as trade, innovation, efficiency and fiscal policy. An attempt is also made to understand selected areas of development contribution to inclusive

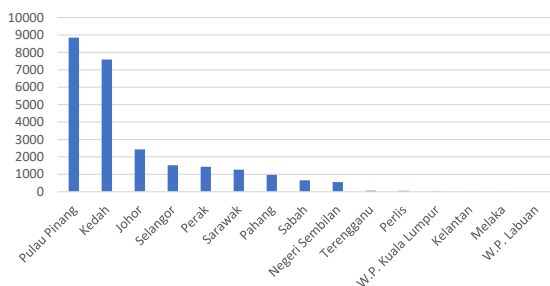
growth such as FDI and rural community economy by which certain community or areas are left behind. In doing so, this study aims to identify how inclusive growth could be achieved in those areas.

1.2 INCLUSIVE GROWTH IN MALAYSIA

1.2.1 Income Inequality by States

In Malaysia, which practiced a federal system, whereby the Federal government is responsible for planning economic and social development policies. In term of attracting private investment an important ingredient for economic growth, certain states are able to better attract investment due to partly the legacy from colonialism resulting in regional disparity among states in Malaysia in term of economic and social development.

Fig. I.1, above shows the capital investment by states in Malaysia for the period from January until March 2019. As can be seen, Pulau Pinang has the largest proposed capital investment at almost RM9 billion followed by Kedah at



Source: Malaysian Industrial Development Agencies (MIDA).

Fig. I.1. Total Proposed Capital Investment by States in Malaysia for January Until March 2019.

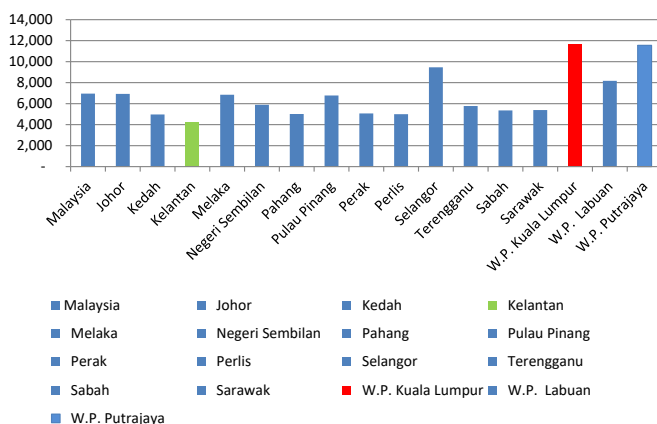
almost RM8 billion while the third largest state, Johor has only around RM2 billion. This can be partly due to the ability of these two states to attract private investment especially in high technology sector.

In addition, Fig. I.2 clearly shows income inequality between states in Malaysia in 2016, with rich states such as Kuala Lumpur has an average household income of almost RM12,000 almost three times higher than the poorest state, Kelantan which has an average household income of just RM4,000.

1.2.2 Income Inequality by Ethnicity and Income Groups

According to Saari, Dietzenbacher, and Los (2015), Malaysia registered income inequality between ethnicity that are

Average Household Income by States in 2016 (RM)



Source: Department of Statistics Malaysia.

Fig. I.2. Household Income by States.

Bumiputera, Chinese, India and others due to the different economic sector each ethnic mostly participated in. Fig. I.3 below clearly shows that the income gap between Chinese and other ethnic has been widening since 2009. In 2009, the income gap between Chinese and Bumiputera was RM1,400 and this has increased to RM2,473 in 2016.

According to the study done by Kazanah Research Institute (2018), the income gap between the top 20% of income earners with other income groups has doubled in two decades. Figure I.3 below of household income by income groups



Source: Department of Statistics Malaysia.

Fig. I.3. Household Income by Ethnic and Income Class.

clearly demonstrate that the income gap between top 20% (T20) with middle 40% (M40) and bottom 40% (B40) has increased from 2014 to 2016. In 2014, the income gap between the T20 and M40 was RM8,700 and increased to RM9,500 in 2016. While, the income gap between the T20 and B40 increased from RM11,763 in 2014 to RM13,240 in 2016. The increasing income gap can be attributed to the increasing level of income of the top earners due to increasing skills and productivity of this group compared to other groups.

I.3 OVERVIEW OF INCLUSIVE GROWTH: FOUR SELECTED ISSUES

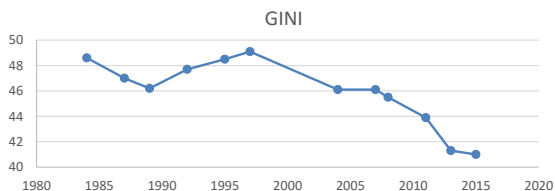
With a population of around 31 million, Malaysia is considered to be among the most dynamic economies in ASEAN region. Its income per capita is among the highest compared to regional peers. However, the issue of income inequality among states as well as income groups needed policy makers to understand the role of economic areas mainly trade and innovation, financial development, human capital and commodity prices as well as fiscal policy in addressing this issue.

I.3.1 Trade and Innovation

Increasing trade is expected to contribute to the growing income inequality especially in advanced economies due to the loss of middle-income jobs and low-income jobs in manufacturing as many jobs will be exported to low cost country such as China and India and trade mostly will benefit the high income jobs (Barusman & Barusman, 2017). For Malaysia, on the other hand currently external trade is a very important aspect of the economy as it contributes to more

120% to the GDP in 2018. Fig. I.4 below clearly shows that Gini coefficient is on declining trend since 1997 from 49.1 in 1997 to 41.0 in 2015. At the same time, external trade is also on the growth path from RM684 billion in 2010 to RM1.9 trillion in 2018 (Fig. I.5). Study done by Ahmed and Masih (2017) has shown that trade openness would reduce income inequality for Malaysia.

Furthermore, studies have shown that innovation can increase income inequality by increasing the income of top earners (Aghion et al., 2018). On the other hand, innovation can also assist in reducing the income inequality brought by globalisation and technology through implementing policies



Source: World Development Indicators.

Fig. I.4. Gini Coefficient for Malaysia (1980–2015).



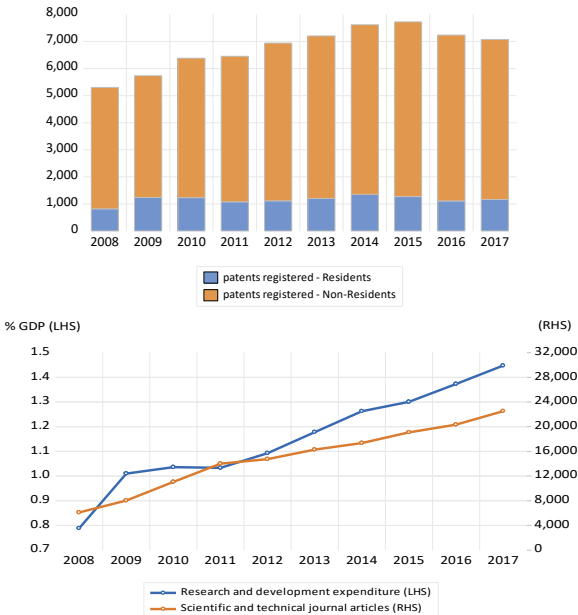
Source: Department of Statistics.

Fig. I.5. External Trade for Malaysia (2000–2018) RM Million.

that promote inclusive innovation such as encouraging patenting innovation by small companies (De Palo, Stylianos, & Roman, 2018). Fig. I.6 below indicates that innovation activities in Malaysia is improving with R&D spending increasing from just 0.8% of GDP in 2008 to 1.3% of GDP in 2018.

1.3.2 Financial Development and Income Inequality

Financial development can become a tool to reduce income inequality (Haffejee & Masih, 2008) and poverty levels as well (Zhang & Ben Naceur, 2019). This is because a more



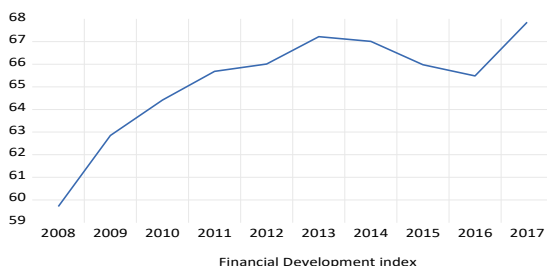
Source: World Development Indicators.

Fig. I.6. Indicators for Innovation, 2008–2017.

developed banking sector especially that implements financial inclusion would provide financial resources to people from lower income level as well as poor people to engage in economic activities such as setting up a business that could increase their income level or even uplift them from the poverty trap (Anwar, Uppun, Tri, Reviani, & Park, 2015). The Financial Development Index which measures how the financial sector in the country is developed also measures the easiness to gain access to financial resource which is an important aspect of financial inclusion. Fig. I.7 below shows that Financial Development Index is on an increase from just an index of 59 in 2008 to 68 in 2017. Focus should be given in insuring wider financial inclusion to improve income equality in the economy through measures such as banks given target loan given to low-income groups.

1.3.3 Human Capital and Inclusive Growth or Development Index

Improved human capital through lower inequality in education has been identified as one of the approach to achieve



Source: IMF Database.

Fig. I.7. Indicators of Financial Development.

inclusive growth by reducing income inequality and poverty levels (Lee & Lee, 2018; Oluwadamilola, Akinyemi, & Adediran, 2018). Lower inequality in education can be seen through better education attainment throughout cross section of the society which increased in public spending on education could achieve that goal. A study done by Mahmood, Noor, and Law (2014) has also found out that for developing countries by increasing the number of years in school could reduce human capital inequality and as a result the gap in income between class in society will be smaller.

For Malaysia, from Fig. I.8 below the public spending on education has been on an increasing trend from just RM27

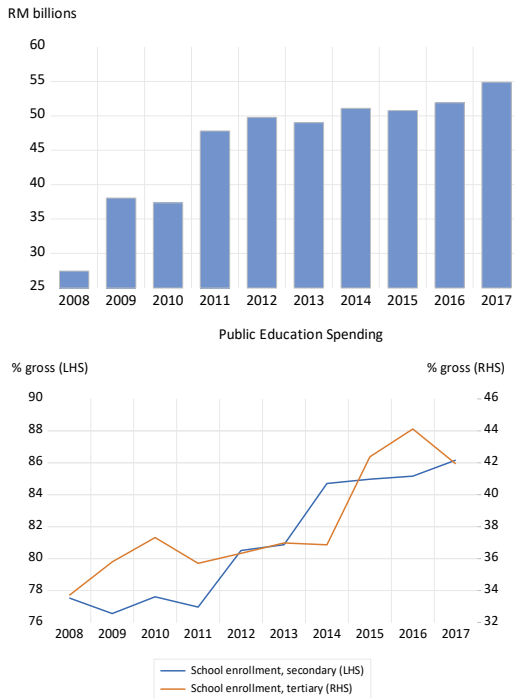


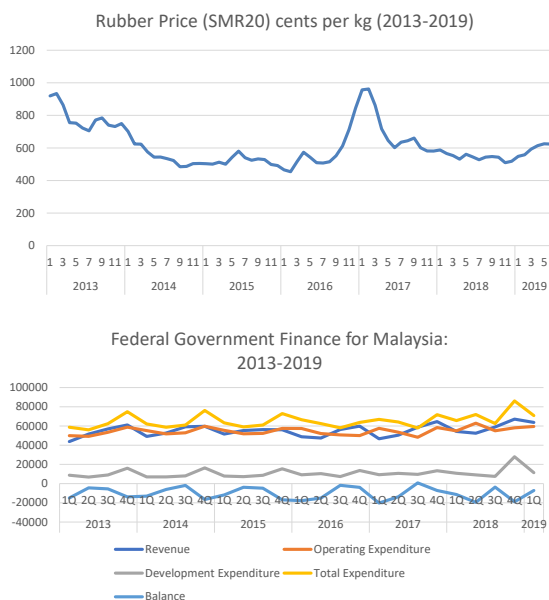
Fig. I.8. Indicators of Education in Malaysia.

billion in 2008 to almost RM55 billion in 2017. The increased spending is reflected from the higher percentage of tertiary school enrolment from just 34% in 2008 to 42% in 2017. As such, the government of Malaysia need to ensure that the education inequality between income class, ethnicity or region need to be reduced through policy action such as giving tuition assistance to students in rural areas as well as from lower income groups.

In addition to human capital, Inclusive Development Index can assist towards a more inclusive economy by providing an economic policy framework as well as performance metric of a country towards achieving a higher economic growth with shared benefits to all members of the society (World Economic Forum, 2018). In the 2018 Inclusive Development Index, Malaysia is ranked 13th place among 70 emerging economies. Malaysia needs to improve its economic policy framework as well as implement its action plan towards a more inclusive economy to improve its future ranking.

1.3.4 Commodity Prices and Fiscal Policy for Inclusive Growth

The volatility of commodity price has caused macroeconomic instability and increase in income inequality due to its impact on trade and government revenue as well as rural income such as farmers that produces the commodity (Fynn, 2013). Wee and Singaravelloo (2018) has stated for Malaysia, in 2013 census there were 283,683 rubber smallholders and any drop in prices of natural rubber would have an adverse impact on the government income target for rural households. Fig. I.9 below signifies that rubber price has greatly fluctuated from 2013 to 2019, from 933 cents per kg in February 2013 to 454 cents in February 2016 or 51% drop in just three years. The government needs to address the volatility in rubber prices by



Source: BNM website.

Fig. I.9. Commodity Price and Fiscal Policy in Malaysia.

increasing demand for rubber prices or coordinating the price of natural rubber with other major rubber producer such as Thailand and Vietnam.

In term of fiscal policy, according to IMF (2014) fiscal policy plays an important role in term of achieving a more equal income distribution through taxation and spending policy. Furthermore, Agnello and Sousa (2014) has found out fiscal consolidation in advanced economies arising from increasing budget deficit would increase income inequality due to budget cuts to programmes that assist lower income group. Fig. I.9 below has shown that for the quarterly period from 2013 to 2019, the Federal Government Finance has always been in deficit except for in quarter 3, 2017. The Federal

Government need to find ways to increase future revenue to have adequate fiscal space for measures to mitigate future economic crisis as well to fund effective programmes to assist the poor and low income people to increase their income and provide social protection assistance.

1.4 MAJOR FINDINGS AND FUTURE CHALLENGES

This section outlines some major findings in accordance of the issue outlines and their policy implications for inclusive growth.

First, inclusive growth or sustainable development is delayed by a lack of innovation in the economy (Chapter 1). Innovation either from foreign or local source can be used to increase productivity and efficiency in the economy. One of the approaches is to promote innovation through protection of intellectual property right (IPR) especially on small business. The findings show that innovation has a higher impact on economic growth when there is IPR protection.

In Chapter 2, the extent of benefits of banking on financial inclusion and specifically on the benefit of banking sector on inclusive growth depends on ability of the banks to absorb more risks as financial inclusion is deemed having higher risk. The central bank need to adequately address the issue of high market risk for higher financial inclusion initiatives to the banking sector.

Third, it seems that human capital mainly in term of capital flight cannot dramatically reduce income inequality. It can be inferred from Chapter 3 and 4 of the present volume that human capital plays an important role in reducing capital flight risk as well as inclusive growth with the support of Foreign Direct Investment (FDI) and Financial Development in an economy.

In other aspects, it was found out that in Chapter 4 that FDI and financial development could increase the income gap if workers did not upskill their level of working skill to increase productivity. While Chapter 5 indicates that level of inclusivity in Malaysia has increased through assessing the Malaysian Inclusive Growth Index especially in term of Human Capital Index (HDI) which is in line with the focus of the government to achieve inclusive and sustainable economic growth.

Policy makers need to mitigate the impact of commodity price shocks and volatility on economic growth, financial resources and income distribution especially on the poverty level (Chapter 6). Importantly, fiscal policy can play an important role to mitigate the impact of price shocks as well as ensuring sustainable and inclusive growth through taxation and spending policy that is pro-poor and safeguarding social protection in the economy (Chapter 7).

1.5 CONCLUDING REMARKS

This introduction has briefly summarized the issue of inclusive growth in Malaysia through several economic areas such as trade, financial development, commodity and fiscal policy. This introduction has been based on upon existing literature and data, as well as findings of own studies. In general, Malaysia has been progressing well in achieving inclusive growth while income inequality existed between states, ethnics and income groups.

With the focus on economic areas, we have attempted (1) to examine the impact of innovation on inclusive growth (2) to investigate how banking risk, trade and financial development could impact inclusive growth (3) to explore the role of human capital in capital flight and inclusive growth 4) to illustrate the impact of commodity price shocks on income

inequality and the role of fiscal policy in ensuring inclusive growth.

The main findings are summarized as follows. First, the importance of innovation as a factor explaining the slower economic growth is emphasized. Second, the benefits of assessing bank market risk tend to increase financial inclusion. Third, higher human capital development tends to reduce capital flight risk and ensure inclusive growth. Fourth, lack of fiscal space could increase income inequality in an economy.

Some policies are suggested to achieve inclusive growth; the promotion of intellectual property right for small business to spur innovation, ensuring strong banking sector for wider financial inclusion, upskilling the skill of low-income workers to reduce impact of globalisation, to ensure stable commodity price through increasing domestic demand and to strengthen fiscal policy through increasing source of revenue and effectiveness of pro-poor spending programmes.

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