Outlook and Policy

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INTERNATIONAL ECONOMIC OUTLOOK IN 2010

Recovery in the global economy, which commenced in the second half of 2009, is expected to remain gradual and uneven in 2010 as economies emerge from the worst post-World War II recession. The strength and pace of the recovery will vary considerably across the economies, depending on the extent of the region-specific structural problems in the aftermath of the global financial crisis. The advanced economies are expected to record modest growth in 2010 given the prevailing high unemployment, the ongoing deleveraging process and the weak financial systems that continue to restrain lending activity to the real sector. The Asian economies are, however, expected to continue to lead the global recovery as sources of growth become broad-based, supported by the further strengthening of both domestic demand and external demand, amid improved intra-regional trade, especially with PR China.

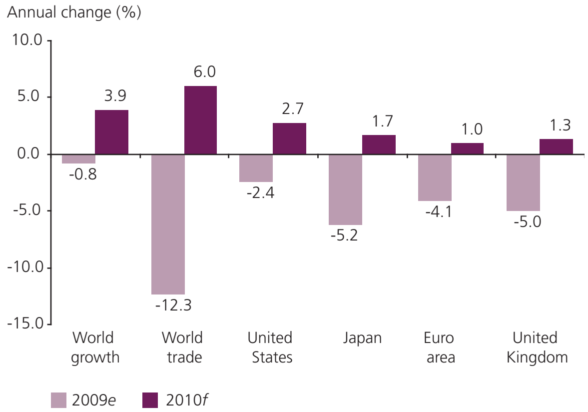
Recovery in the global economy is expected to remain gradual and uneven in 2010, with the Asian economies leading growth

A distinct feature of the ongoing global recovery process, particularly in the advanced economies, is the pervasiveness of the policy support put in place since early last year. The sustainability of recovery in the advanced economies is still dependent on the stimulus and the restoration of financial intermediation in the credit market. However, some of the quantitative easing is expected to be withdrawn beginning early 2010. As the fiscal stimulus wears off towards year-end, the sustainability of the recovery in the advanced economies will need to rely on the resumption of private sector activity. However, given the likelihood of persistently high unemployment, weak private sector balance sheets and fragile financial systems, the prospect is for a very gradual recovery in private sector demand, which will in turn affect the pace of economic recovery.

Notwithstanding the continued improving conditions in the international financial markets, credit conditions particularly in the advanced economies are likely to remain restrictive due to constraints faced by the financial institutions as they continue to grapple with weak balance sheets, tighter capital standards and regulatory changes from the ongoing reforms in the financial system. Hence, bank lending to the economy, in particular to households and small businesses, is likely to remain weak. On the international front, given the less promising prospects in advanced economies and improving investors' risk appetite for high-yielding assets, the magnitude and direction of capital flows to emerging economies with better prospects would result in more volatile capital flows to such economies.

In the **US**, the prospect is for a continued but gradual recovery in economic activity, underpinned by the considerable policy stimuli and gradual revival in private sector demand. The fiscal stimulus, which supported growth strongly in 2009, will provide further impetus to growth this year, especially through tax benefits and infrastructure spending. More than half of the USD787 billion fiscal stimulus package is targeted to be spent in 2010. There will, however, be a gradual withdrawal of monetary stimulus following the expiry of several of the Federal Reserve's liquidity and asset purchase programmes starting early this year. Nonetheless, the net impact of these policies on the recovery process is expected to remain positive, especially through their influence on private sector demand. Private consumption is expected to expand, albeit at a modest pace, following the positive wealth effect from the rise in equity markets and stabilising house prices. Households are also expected to gain from tax benefits for the housing sector. Private consumption will, however, be constrained by continued weakness in the labour market and persistently tight credit conditions. Similarly, private investment is also expected to record anaemic growth during the year due to prevailing excess capacity and very low utilisation rates. Residential investment is expected to be supported by ongoing government policies in the form of lower mortgage rates and tax credit relief. Overall, the US recovery process will continue to be driven by policy stimulus amidst a very gradual recovery in private sector demand.

Chart 4.1
World Growth, World Trade and Growth in Major Advanced Economies (2009-2010)



e Estimate
f Forecast

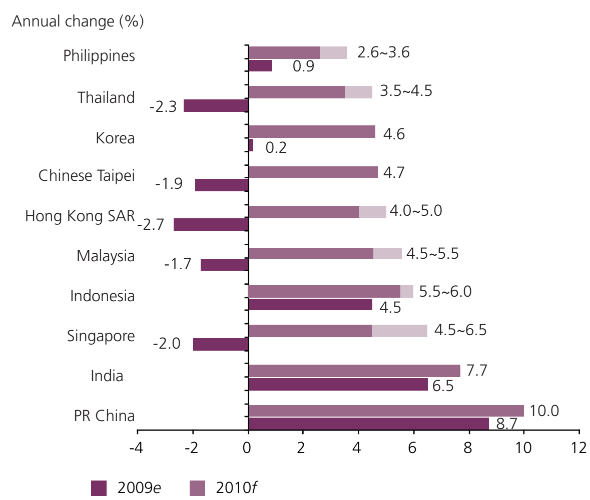
Source: International Monetary Fund and National Authorities

Economic activity in the **euro area** is projected to improve in 2010 but growth will remain modest and below potential. While fiscal stimulus will be less expansionary and fiscal consolidation in a number of countries in the euro area is expected to commence, it will still be a factor driving some growth. At the same time, private sector demand is expected to show a gradual recovery, but remain restrained by a challenging environment of persistent high unemployment and weak financial sectors. Meanwhile, in the **UK**, economic recovery will be supported by the monetary stimulus as well as external demand following the depreciation of the pound sterling. Nonetheless, domestic demand will remain weak due to the restrictive credit conditions and planned fiscal consolidation. For **Japan**, an economy that is highly dependent on trade, the recovery in exports, especially to the Asian region, in particular PR China, is expected to remain the key driver of economic growth in 2010. However, the recovery is expected to be modest, with domestic demand likely to be constrained by weak labour market conditions and subdued capital expenditure plans. Moreover, deflation is expected to persist in the economy, further weighing down on domestic demand, in particular private consumption. Given this scenario, monetary and fiscal policies are expected to remain expansionary to support growth.

The gradual recovery in the advanced economies, coupled with strong demand from the emerging economies, will support the resumption of **global trade** in 2010. Notably, the composition of global trade will shift from the advanced economies to the emerging economies, particularly Asia, as domestic demand in the region strengthens further. The changing pattern of global trade is likely to shift the global flows of foreign direct investment, as multinational companies become more region-specific in managing their global production and investment networks to take advantage of the favourable growth prospects in the emerging economies.

In line with the anticipated improvements in the global economy and trade, the **Asian economies** are poised for a more robust growth in 2010. As a major anchor of growth for the region in 2009, **PR China** is expected to continue to support intra-regional trade through the sustained expansion of its domestic demand. Besides the continued broad-based improvements in external demand for the region, domestic demand conditions in the regional economies are also expected to strengthen further. Private consumption is likely to be bolstered by better employment prospects, while private investment can be expected to rebound in view of higher capacity utilisation. This will be further reinforced by the continued implementation of fiscal stimulus packages, especially in the area of infrastructure spending.

Chart 4.2
Regional Economies: Real GDP Growth



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Source: International Monetary Fund and National Authorities

Global inflation is expected to rise in 2010 in tandem with the recovery of the global economy and higher commodity prices. Prices of oil and other commodities are expected to be higher, but not to the levels seen in early 2008, reflecting more underlying real demand conditions, particularly in the emerging economies. To some extent, the anticipated rise in commodity prices will also be driven by market expectations of a recovery in global demand as well as the excess liquidity in the global financial system. However, further increases in the prices of commodities are likely to be limited by the availability of spare capacity in the production of most commodities and in some cases by large stock of inventories.

Headline inflation in the advanced economies is expected to rise to 1.3% in 2010 from a record low of 0.1% in 2009. Meanwhile, inflation in emerging and developing economies is expected to rise to 6.2% in 2010 from 5.2% in 2009[1]. Against this backdrop, these central banks are expected to gradually exit from the very low interest rate regime in addition to the reversal of quantitative easing in the advanced economies. The speed at which central banks will exit will take into consideration a broad range of factors, ranging from conditions for the sustainability of recovery and the outlook for inflation.

Several downside **risks** remain in the outlook of the global economy. The timing and magnitude of the withdrawal of the stimulus measures could pose considerable risk to the growth and inflation outlook. If there was a significant premature withdrawal of these measures, it could increase the risk of a double-dip recession, particularly in the advanced economies. If the measures are, however, withdrawn too late, this could lead to financial imbalances and heightened inflationary pressures, and in some cases, unsustainable asset price inflation. Another major risk is the fiscal health of the advanced economies that have embarked on large fiscal stimuli and financial rescue packages. This is reflected in increasing concerns on sovereign risk, particularly in Europe. If these economies are unable to outline a clear strategy to return to a sustainable fiscal position, markets would impose high risk premiums on these economies, resulting in sharper fiscal consolidations that could harm the recovery process. The advanced economies also continue to face significant challenges from their fragile financial system and structural unemployment. In the case of emerging economies, the positive growth differentials could attract large capital inflows and pose complications in the conduct of monetary policy and managing exchange rate volatilities.

[1] IMF World Economic Outlook Update, January 2010

MALAYSIAN ECONOMY IN 2010

The Malaysian economy is projected to grow by 4.5% to 5.5% in 2010, underpinned by strengthening domestic demand and an improving external environment. While the public sector will remain supportive, growth is expected to be driven by greater private sector activity and robust external demand from the regional countries. The underlying strong macroeconomic fundamentals, the healthy private sector financial position and the strong financial system will provide support to a private sector-led recovery. A supportive monetary environment, including continued access to competitive financing will remain in place to foster recovery in the private sector activity.

Real GDP is expected to expand by 4.5% to 5.5% in 2010, supported by strengthening domestic demand and an improving external environment

The main contribution to growth in 2010 would come from the expected strengthening in domestic demand, driven mainly by the private sector. Favourable domestic conditions, including the improvements in the labour market, rising disposable incomes and sustained consumer confidence, will support the further expansion in private consumption. In line with strengthening external demand and increasing domestic activity, private investment is expected to gradually recover in 2010. In addition, higher capital spending by the NFPEs and the accelerated implementation of the remaining projects under the second stimulus package, will further reinforce domestic demand. The recovery in the

Potential Output of the Malaysian Economy

Potential output is the trend level of output that is consistent with the aggregate productive capacity of an economy. It traces the sustainable growth path of the economy and is primarily determined by the expansion and non-inflationary utilisation of the available physical capital and labour force, as well as total factor productivity (TFP) growth. TFP growth captures productivity increases arising from improvements in the utilisation of factor inputs due to technological progress and overall economic efficiency. The output gap is the difference between the levels of actual output and potential output. It is a measure of the cyclical deviation from the non-inflationary trend of output, and thus provides an assessment of the position of an economy in the economic cycle.

Amidst a challenging global environment, the latest estimates indicate that the growth rate of potential output of the Malaysian economy moderated to 2.5% in 2009, the slowest pace since the Asian financial crisis. This was mainly due to the decline in investment activity and moderation of TFP growth, consistent with the experience during previous economic downturns. Given a sharper decline in actual gross domestic output (GDP), the output gap[1] was a negative 1.4% of potential output, indicating that the economy was operating below its potential in 2009.

However, with the expected recovery of the Malaysian economy going forward, driven by the strengthening of domestic activity and an improving external environment, the output gap is projected to narrow in 2010, and potential output is expected to return to its trend growth of about 5% over the medium term with the expected recovery in investment and continued improvement in productivity.

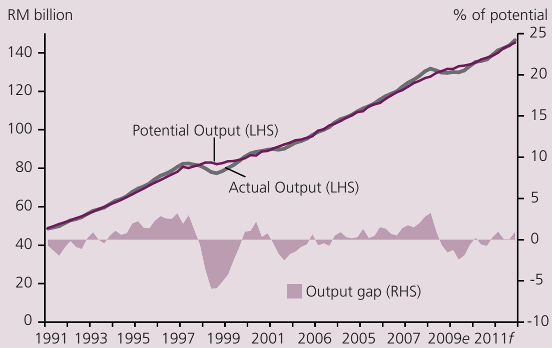
Table 1
Actual Real GDP and Potential Output

Period	Actual	Potential	Investment	Labour	Gap
	Annual change (%)				% of potential output
1993-1999	6.5	6.5	4.3	4.1	0.1
2000	8.9	4.2	26.0	4.4	1.1
2001	0.5	4.6	-2.1	1.5	-1.6
2002	5.3	4.0	0.6	1.9	-0.6
2003	5.8	6.1	2.8	3.6	-0.4
2004	6.8	5.5	3.6	1.0	0.4
2005	5.3	5.0	5.0	0.6	0.8
2006	5.8	5.6	7.5	2.1	1.0
2007	6.2	5.2	9.6	2.5	2.1
2008	4.6	4.0	0.8	1.3	0.7
2009*e*	-1.7	2.5	-5.5	2.7	-1.4

e Estimate

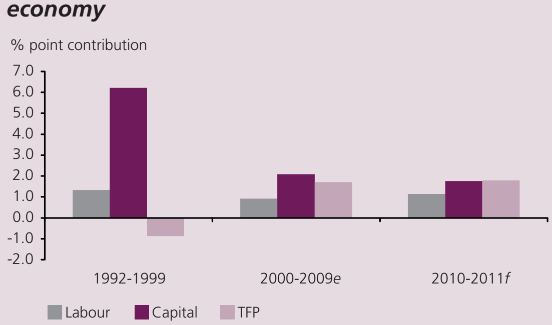
Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

Chart 1
Actual and Potential GDP



e Estimate
f Forecast

Chart 2
Factor contributions and TFP growth
Shift from a factor-driven to a productivity-driven economy



e Estimate
f Forecast

[1] The output gap is the difference between the levels of actual and potential output and the gap is measured as a percentage of potential output. A positive output gap indicates that actual output is above potential output, while a negative output gap indicates the reverse.

global economy will provide a further impetus to growth in 2010, particularly from the more robust expansion in the regional economies. Given the relatively large external sector in the economy, the strengthening of external demand will have positive spill-over effects on the broader economy, in terms of employment, production and overall sentiments, thus supporting greater private consumption and investment.

From the supply side perspective, most economic sectors are expected to record better performance in 2010, supported by strengthening domestic demand and a further improvement in external demand. The manufacturing and mining sectors are expected to record positive growth as external demand for major products such as electronics, crude oil and natural gas, recover. The services sector remains the key contributor to overall GDP growth, with growth expected to be broad-based. Both the trade and manufacturing related sub-sectors and the domestic-oriented sub-sectors are expected to improve amid the recovery in both global and domestic demand. The agriculture sector is also projected to register higher growth as demand from the major export markets for industrial crops improves with better economic prospects in 2010. Meanwhile, the construction sector is expected to sustain growth, benefiting from the continued implementation of the remaining projects under the second stimulus package and the Ninth Malaysia Plan.

Labour market conditions are projected to improve further in 2010, with the unemployment rate expected to decline to 3.6% of the labour force. Based on a survey conducted by Bank Negara Malaysia, most firms in the manufacturing, services and construction sectors plan to increase employment and provide a higher salary increment in 2010, in line with the expected recovery in global and domestic economic activity.

Headline inflation is expected to remain modest at an average of 2% to 2.5% in 2010. The price increase reflects the improving economic conditions and the possible adjustments to the administered prices following the Government's plan to revise the subsidies for petroleum products as well as to review the existing subsidies on other essential items.

On the external front, the current account surplus is projected to be lower at 14.3% of GNI in 2010. The lower current account surplus reflects the lower trade surplus, higher income account deficit, sustained current transfer outflows as well as a small services account deficit. Gross exports are projected to expand further in 2010, in line with the stronger external demand and higher commodity prices. However, the trade surplus is expected to be lower as higher exports will be partly offset by the expansion in gross imports, in tandem with the recovery in the manufacturing sector and the strengthening of domestic demand. On the financial account, foreign direct investment inflows and direct investment abroad by Malaysian companies are likely to increase given the improving global and domestic economic conditions.

The projected growth of the Malaysian economy of between 4.5% and 5.5% in 2010 is based on the expectation of a gradual and uneven global economic recovery. It is recognised that the global economy is still facing several downside risks. These risks, mainly in the advanced economies, include the effect on recovery once fiscal spending begins to diminish, the still weak and fragile financial system, the continued de-leveraging process amongst the private sector and the fiscal stress in some large advanced economies pose considerable uncertainties to the outlook for the global economy. Under these circumstances, domestic demand will be a key factor in driving growth in 2010. In this environment, policies will remain supportive of growth, in particular to ensure that private sector activity strengthens further and that the recovery is firmly established.

In addition to ensuring the timely implementation of projects, the Government has announced several measures to revive private investment, including the liberalisation of the economy, the privatisation of Government-owned corporations, the provision of incentives to high growth sectors and further improvements in the Government's delivery system. On the monetary front, monetary policy will remain accommodative while attention will continue to focus on ensuring that the private sector, in particular the small and medium enterprises, have access to financing. At the same time, there will be heightened vigilance to ensure that financial imbalances do not develop in the economy, which would threaten macroeconomic stability and the sustainability of the economic recovery. The strong economic and financial fundamentals of the Malaysian economy place the domestic economy in a better position for a stronger recovery as the global conditions improve further.

Domestic Demand Conditions

Domestic demand is projected to expand by 3.2% in 2010 as private sector activity strengthens in line with the resumption of global economic growth. The private sector is expected to be the main driver of domestic demand as the Government consolidates its expenditure in 2010.

Domestic demand will record higher growth in 2010, driven mainly by private spending as the Government consolidates

Favourable domestic conditions, in terms of an accommodative monetary policy, continued access to financing and improved labour market conditions, will help to support the further expansion of household consumption, while private sector capital spending is projected to increase gradually during the year. In addition, higher capital spending by the NFPEs will provide a further boost to domestic demand.

Private consumption is projected to increase by 3.8% in 2010. The higher expansion in consumer spending will be supported largely by improvements in the labour market, a steady increase in disposable income and sustained consumer confidence. Employment prospects will be more favourable with stronger labour demand in various sectors of the economy, in line with the recovery in economic activity. Consequently, the average private sector salary is expected to increase by 4.1% while the unemployment rate is projected to be lower at 3.6% of the labour force. The rise in income levels following the gradual recovery of the export and manufacturing sectors will benefit almost one third of the labour force in the domestic economy, and will support higher consumption spending. In addition, households in the rural area are expected to enjoy favourable income growth as commodity prices are expected to remain firm in 2010.

In view of the recovery in economic activity and improved labour market conditions, consumer confidence is likely to be sustained in 2010. Other factors providing support to private consumption growth include continued access to credit with accommodative interest rates and a relatively low inflation environment. The balance sheet of households is expected to remain strong as reflected

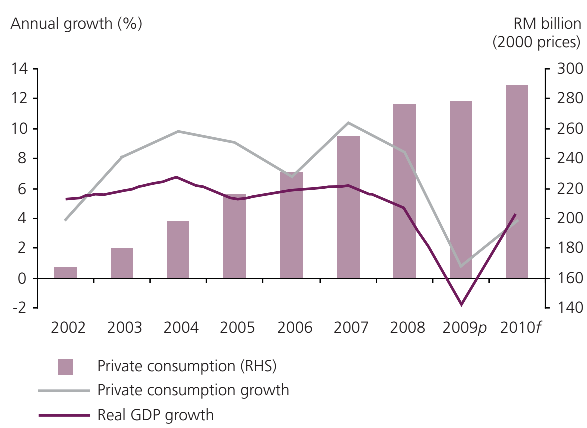
Table 4.1
Real GDP by Expenditure (2000=100)

	2009*p*	2010*f*	2009*p*	2010*f*
	Annual change (%)		Contribution to real GDP growth (percentage point)	
Domestic Demand[1]	**-0.4**	**3.2**	**-0.3**	**2.8**
Private sector expenditure	-3.4	3.3	-2.2	2.1
Consumption	0.8	3.8	0.4	2.0
Investment	-21.8	0.7	-2.6	0.1
Public sector expenditure	7.7	2.7	1.9	0.7
Consumption	3.7	-2.7	0.5	-0.4
Investment	12.9	9.3	1.3	1.1
Change in stocks			**-2.5**	**4.5**
Net exports of goods and services	**8.4**	**-18.6**	**1.1**	**-2.7**
Exports	-10.1	7.7	-12.0	8.3
Imports	-12.5	11.7	-13.1	11.0
Real Gross Domestic Product (GDP)	**-1.7**	**4.5~5.5**	**-1.7**	**4.5~5.5**

[1] Excluding stocks
p Preliminary
f Forecast
Note: Figures may not necessarily add up due to rounding

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

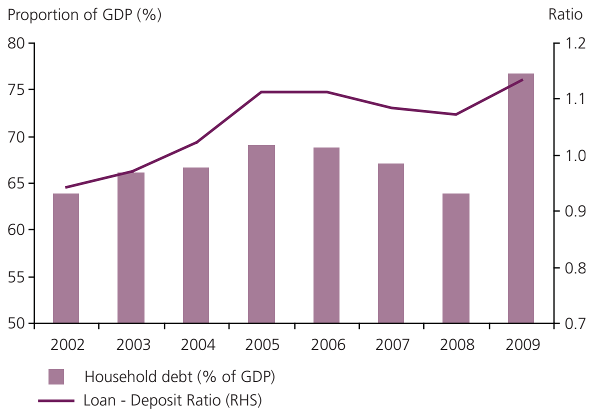
Chart 4.3
Real GDP and Private Consumption



p Preliminary
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 4.4
Household Debt Indicators



Source: Bank Negara Malaysia

by the stable debt levels of households and low level of non-performing loans. In addition, the continued implementation of projects from the second economic stimulus package is expected to also benefit the household sector.

Private investment is expected to register a marginal growth of 0.7% in 2010. Capital spending by businesses is likely to expand gradually from the second half of 2010, in line with the strengthening of domestic and external demand amid improving global economic conditions. The modest recovery in private investment will be supported by higher activity from the manufacturing sector. Furthermore, a faster improvement in capacity utilisation since the second half of 2009, supported by the increase in manufacturing production will encourage firms to embark on capacity expansion. The rebound in business optimism due to the improvement in external demand and increasing domestic economic activity will also encourage firms to resume investment projects that have been deferred.

In the services sector, the consumer-oriented business segments will continue to expand in view of the higher consumption activity during the year. Firms in the wholesale and retail trade industry are projected to expand their operations through the establishment of new outlets. Investment in the communications sector will be higher as companies intensify the network upgrading exercise to widen broadband service coverage. Meanwhile, investment in the transportation sector will be supported mainly by capacity expansion in air travel services. Capital spending in the mining sector is also anticipated to increase, supported by an expansion in upstream oil and gas production capacity as well as additional development expenditure for new discoveries located offshore in Peninsular Malaysia and Sarawak. In addition, capital expenditure in the construction sector is likely to benefit from the ongoing Ninth Malaysia Plan (9MP) civil engineering projects as well as continued implementation of the second stimulus package.

Although expenditure on emoluments will be higher, **public consumption** is projected to decline by 2.7% in 2010 as expenditure on supplies and services is reduced. This is in line with the Government's policy to be more efficient in its spending, without affecting the effective delivery of Government services.

Public investment is expected to expand by 9.3% in 2010, mainly on account of higher capital spending by NFPEs. Government development expenditure during the year will continue to be channelled towards improving the economic and social sectors of the economy. Capital outlay in the economic services sector will mainly be for providing transport and industrial infrastructure, improving public utilities and agricultural productivity as well as for enhancing rural development. The implementation of various projects under the 9MP as well as the second stimulus package will also be accelerated during the year. Of significance, Government direct spending consisting of RM5 billion worth of projects from the second stimulus package will be implemented in 2010. In the social services sector, a large proportion of the allocation will be utilised to improve the provision of essential public services such as education and health care, and the development of low-cost housing and quarters for civil servants.

Besides the large capital expenditure in the upstream oil and gas sector, higher investment by NFPEs is projected in the areas of transport, communication and utilities. Investment in the communication and utilities sectors will focus on upgrading the broadband network and improving power supply respectively. In the transportation sector, higher capital outlay has been committed to the implementation of rail expansion projects in 2010.

Table 4.2
Real GDP by Sector (2000=100)

	2009*p*	2010*f*
	Annual change (%)	
Agriculture	0.4	3.1
Mining & quarrying	-3.8	2.5
Manufacturing	-9.3	6.5
Construction	5.7	3.7
Services	2.6	4.9
Real Gross Domestic Product (GDP)	**-1.7**	**4.5~5.5**

p Preliminary
f Forecast

Source: Department of Statistics, Malaysia
Bank Negara Malaysia

Sectoral Outlook

Better performance is expected in most economic sectors as domestic demand strengthens and external demand continues to improve in 2010. The manufacturing and mining sectors are expected to return to growth as external demand for major products such as electronics, crude oil and natural gas recovers. The recovery in external conditions will also raise demand for trade-related services, contributing favourably to the services sector. In addition, the revival of domestic-oriented activity, which has been on a firm recovery path since the second half of 2009, will further enhance growth in all sectors. Growth will be underpinned by strengthening domestic demand, particularly private consumption, amidst continued policy support. Furthermore, the anticipated improvement in labour market conditions, together with higher business and consumer confidence, will provide incentives for private sector activity in the domestic-dependent sectors. Meanwhile, the construction sector is expected to sustain its growth, benefiting from the continued implementation of the various projects under the second stimulus package and the Ninth Malaysia Plan.

Broad-based recovery is expected in 2010 with improved performance in most sectors

The **services** sector is projected to register a higher growth of 4.9% in 2010, and will remain the key contributor to overall GDP growth. Growth will be broad-based, with most sub-sectors recording better performance compared to 2009. The trade and manufacturing-related sub-sectors, which were adversely affected by the economic downturn in 2009, are expected to improve, in line with the anticipated recovery in the global economy. Meanwhile, the more domestic-oriented sub-sectors are expected to record higher growth, benefiting mainly from strengthening domestic demand.

Within the services sector, the **finance and insurance** sub-sector is expected to register higher growth, mainly supported by the finance segment, which would benefit from increased bank lending and higher fee income as the economic recovery gathers momentum. In the insurance segment, the improvements in salaries and wages and enhanced financial literacy would contribute to increased demand for life insurance products, while the anticipated increase in the sales of motor vehicles would benefit the general insurance business.

After being adversely affected by the economic downturn in 2009, the **transport and storage** sub-sector is projected to return to positive growth in 2010. Growth will emanate from higher demand for cargo-related transportation services, following the anticipated improvement in trade and manufacturing-related activities. Growth will be further supported by improved demand in the passenger segment, in line with the expected higher tourist arrivals and improvement in domestic tourism activity. Similarly, the **utilities** sub-sector, which weakened considerably in 2009, is expected to expand favourably in 2010. Growth will be contributed by increased demand for electricity from the industrial users, in line with the improvement in manufacturing activity, as well as steady demand from the commercial and household sectors.

The services sub-sectors that are dependent on domestic consumption, such as the **wholesale and retail trade** and **accommodation and restaurant** sub-sectors, are projected to register enhanced growth rates. The anticipated increase in tourist arrivals will also contribute favourably to these sub-sectors. Outlook for the **communication** sub-sector is also positive, spurred by increasing demand for mobile data and broadband services. Intense competition among the service providers, commercial roll-out of the high speed broadband project in selected urban areas and continued expansion of WiMAX services will further contribute to the growth of the sub-sector.

The **manufacturing** sector is poised for strong growth in 2010, based on the observed momentum of recovery since the end of 2009. Broad-based expansion is expected across all clusters, reflecting improved external demand and strengthening domestic demand. The electronics and electrical (E&E) cluster is projected to turn around with the pick-up in global demand for electronics, particularly with the return of corporate IT spending, where upgrade and replacement of software and equipment were held back during the global downturn. Likewise, growth in the primary-related cluster will be driven by external demand and higher commodity prices. The chemical industry is expected to improve in tandem with the E&E, automotive and household markets, while demand for hygiene and medical products will continue to support the rubber products industry. Meanwhile, the consumer-related cluster is expected to move in line with the strengthening of domestic demand, particularly private consumption. Also, the performance of the construction-related cluster will be influenced by anticipated higher domestic construction activity and infrastructure projects in the region.

The **agriculture** sector is expected to register a higher growth of 3.1% as demand from major export markets for industrial crops, especially palm oil and rubber, improves with better economic prospects in 2010. In addition, the reduction in import duties on rubber by the PR of China as of 1 January 2010 will further boost its demand for the commodity. In terms of production, higher palm oil output is expected during the year following the recovery in yield of fresh fruit bunches and an increase in planted area ready for production. In the case of rubber, besides a continuing increase in productivity from areas replanted with high yielding clones, higher rubber prices since the second half of 2009 will continue to encourage increased tapping.

The **mining** sector is projected to expand by 2.5%, reflecting higher output of both crude oil and natural gas following the recovery in demand. The increase in LNG output will also partly reflect the first full-year of shipment under an export contract with PR China.

The **construction** sector is expected to maintain a growth of 3.7% in 2010. The civil engineering segment will be supported by the continued implementation of projects under the second stimulus package. Furthermore, apart from additional progress on projects under implementation, several other major projects identified under the Ninth Malaysia Plan are also expected to take off during the year. Meanwhile, improved business and consumer sentiments and continued access to financing will support expansion in both the residential and non-residential sub-sectors.

Balance of Payments

On the external front, improvements in exports and capital inflows, which were evident in the second half of 2009, are expected to continue in 2010 as the global economic recovery gathers strength. The expected stronger external demand, particularly from the region, and higher commodity prices is projected to contribute to a further expansion in gross exports in 2010. However, the trade surplus is expected to be lower as imports are projected to expand faster than exports. While imports of intermediate goods will increase in tandem with the expansion in manufactured exports, the stronger recovery in the domestic economy will also lead to higher imports of consumption and capital goods. The lower trade surplus, together with a higher income account deficit, sustained current transfer outflows and a small services account deficit, are expected to lead to a narrowing of the current account surplus to RM103.8 billion or 14.3% of GNI in 2010. On the financial account, foreign direct investment inflows and direct investment abroad by Malaysian companies are likely to increase given the improving global and domestic economic conditions.

Gross exports are projected to recover from a low base, registering a growth of 11.2% in 2010. This projection of export growth is based on the assumption that the global economic recovery will be gradual, with sluggish growth in the advanced economies but stronger activity in the emerging economies, particularly the regional economies. Export recovery is expected to be broad-based, as exports will be supported by a recovery in the manufacturing and commodity sectors. This broad-based recovery will continue to be led by intra-regional trade and the gradual pick-up in exports to G-3 economies. The recovery in manufactured exports is projected to emanate from both electronics and electrical (E&E) and non-E&E exports. The stronger growth in the E&E exports is expected to be in both electronics and electrical segments, attributable to the continued strong demand for personal computers, smart phones and new electronics gadgets, as well as the expected recovery in IT spending by the corporate sector. The outlook for commodity and resource-based manufactured exports is expected to improve, with the higher commodity prices and stronger regional demand likely to be sustained.

Exports and capital inflows are expected to continue improving in 2010 as the global economic recovery gathers strength. The current account surplus, while still sizeable, will be reduced, as imports are expected to expand faster than exports

With the anticipation of a recovery in exports and domestic demand, the recovery of **gross imports** is expected to be more pronounced, increasing by 14.6% in 2010. As the bulk of Malaysia's gross imports are intermediate goods, intermediate imports will increase and contribute the most to the import recovery, in tandem with the strengthening demand for manufactured exports. Imports of capital goods are expected to increase as the corporate sector gradually revives investment activity and undertakes new capital investments to increase production capacities. Imports of consumer goods are also expected to increase with the improvement in consumer spending.

The **services account** is projected to record a marginal deficit of RM0.7 billion in 2010, as higher deficits in the transportation and other services accounts are expected to more than offset the higher surplus in the travel account. With global trade, investment and tourism activities improving, payments for transportation, construction, communication and professional services, are also anticipated to increase.

Meanwhile, tourism earnings are expected to continue to increase with the anticipated improvements in global and regional tourist arrivals and well targeted tourism promotional activities. The **income account** deficit is projected to widen to 2.7% of GNI as a recovery in exports is expected to translate into higher repatriations of profits and dividends by MNCs operating in Malaysia, particularly in the E&E industries as well as the oil and gas sector. Meanwhile, profits and dividends accruing to Malaysian companies with investments abroad are expected to remain large, mainly from the oil and gas, and services sectors, supported by higher commodity prices and the improving regional economic outlook.

On the financial account, gross inflows of **foreign direct investment (FDI)** are anticipated to increase in 2010 amid improving global growth prospects and corporate profitability. As global FDI inflows are expected to recover only moderately in 2010, the improvement in FDI in Malaysia is thus projected to be moderate with inflows mainly into the manufacturing, services and oil and gas sectors. In the manufacturing sector, the bulk of the FDI is likely to continue to be in the form of reinvestment by the MNCs for capacity expansion in tandem with the recovery in the E&E industries. In addition, investment is also expected in the new growth areas such as renewable energy and medical devices. Higher FDI flows are also expected in the services sector, particularly in the financial services sector following the further liberalisation in April 2009, which included the issuance of new licenses to foreign financial institutions, increasing foreign equity limits and allowing greater operational flexibility to locally-incorporated foreign financial institutions. Meanwhile, FDI in the oil and gas sector will be supported by rising prices and increasing demand for crude oil as global activity rises.

Direct investment abroad (DIA) by Malaysian companies is expected to increase and remain large in 2010 as companies continue to expand regionally and globally. The higher DIA is expected to be channelled mainly into the services, oil and gas, as well as manufacturing sectors with the focus being on regional and other emerging economies. Regional and global expansion represents opportunities for

Table 4.3
Balance of Payments

	2009*p*	2010*f*
	RM billion	
Goods	141.5	141.6
Trade account	118.4	116.7
Exports (% annual change)	*-16.6*	*11.2*
Imports (% annual change)	*-16.6*	*14.6*
Services	3.2	-0.7
Balance on goods and services	**144.7**	**140.8**
Income	-12.6	-19.9
Current transfers	-19.4	-17.1
Balance on current account	**112.7**	**103.8**
% of GNI	**17.0**	**14.3**
Capital account	-0.2	
Financial account	-82.9	
Balance on capital and financial accounts	**-83.1**	
Errors and omissions	-15.8	
of which:		
Foreign exchange revaluation gain	*10.7*	
Overall balance	**13.8**	

p Preliminary
f Forecast
Note: Numbers may not necessarily add up due to rounding
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Table 4.4
External Trade

	2009*p*		2010*f*	
	RM billion	Annual change (%)	RM billion	Annual change (%)
Gross exports	**553.3**	**-16.6**	**615.1**	**11.2**
of which:				
Manufactured	430.4	-12.5	474.0	10.1
Agriculture	53.4	-21.6	60.3	12.8
Minerals	59.3	-32.2	70.8	19.4
Gross imports	**434.9**	**-16.6**	**498.4**	**14.6**
of which:				
Capital goods	65.8	-5.9	70.7	7.6
Intermediate goods	297.3	-21.6	348.8	17.3
Consumption goods	31.4	-2.7	33.2	5.7
Trade balance	**118.4**	**-16.6**	**116.7**	**-1.4**

p Preliminary
f Forecast
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Malaysian companies to access a larger consumer market, to increase their scale of operations, and to increase their global competitiveness. This would, over a medium term, benefit the country through having more competitive and globalised Malaysian companies, and also increase the potential for greater income repatriation.

Labour Market Outlook

Conditions in the labour market are expected to improve further in 2010, in line with the recovery in global and domestic economic activity. The improvements in business confidence and economic activity since the second half of 2009 are expected to gain traction during the year, and this in turn will underpin recruitment and salary decisions. Based on a survey conducted by Bank Negara Malaysia, most firms in the manufacturing, services and construction sectors plan to increase employment by about 5% in 2010. With the expected stronger labour demand, the unemployment rate is projected to decline to 3.6% of labour force in 2010 (2009: 3.7%). In addition, about 70% of companies surveyed indicated that they would unwind the freeze on salary increases in 2010. Overall, the average salary increment in the private sector is expected to be higher by 4.1% in 2010 (2009: 3.4%).

Inflation Outlook

Headline inflation is expected to remain modest at an average of 2 – 2.5% in 2010. This projection reflects the improving economic conditions and takes into account the possible adjustments to administered prices and subsidy restructuring by the Government. In the absence of further price revisions and inflation related external developments, inflation in Malaysia will remain contained.

Demand prospects for economic growth in the region and the global economy have improved. The cautious attitude of businesses and households, lingering excess capacity and the withdrawal of Government stimulus measures, however, would in varying degrees affect economic activity across countries. Hence, despite the expected improvement in economic activity, demand conditions are not expected to exert pressure on global inflation in 2010.

Similarly, demand pressures on domestic prices are expected to be manageable. Sustained consumer confidence, the accommodative monetary conditions and the Government's stimulus packages will likely support consumption and investment activity by households and businesses. The output gap will narrow as domestic demand increases. Nevertheless, as output is recovering from low levels, the impact on price pressures is likely to be limited.

On the supply side, the improvement in economic activity since the second half of 2009 is likely to lead to an upturn in global commodity prices. The IMF WEO update in January 2010 projected that crude oil prices could trade higher at around USD76 per barrel in 2010 (USD62 per barrel in 2009). This increase is significantly less compared to the sharp increase in July 2008 when oil prices peaked at USD147 per barrel. Other non-fuel commodities such as food and metals are broadly expected to follow similar trends. The December 2009 edition of the Food and Agriculture Organisation of the United Nation's (FAO) Food Outlook maintained that the overall improvement in the global supply and demand balance would keep price increases for food commodities at moderate levels. Rice prices however, are expected to rise due to lower production amid adverse weather conditions. The price of sugar is also expected to remain firm although lower than the August 2009 peak, as the relatively tight supply conditions are counterbalanced by recovery in production and reserve drawdown.

It should be noted that while the underlying demand for commodities is expected to remain modest, the environment of prolonged low interest rates and excess liquidity could encourage greater speculative activities in the commodity markets. Consequently, non-fundamental factors could periodically push global commodity prices to higher levels. Producers could face higher and more volatile input costs. More subdued demand conditions and above-average inventory levels could moderate the price increases. Nevertheless, the ample global liquidity conditions, if prolonged, would pose heightened risk of higher commodity prices.

On the domestic front, the Government has announced its intention to revise the subsidy for petroleum products. A comprehensive review on the existing subsidies on other essential items is also being undertaken. This could generate some upward adjustment on domestic headline inflation. However, given that demand conditions are not expected to exert strong pressures on consumer prices, the impact is likely to be transitory and contained. Core inflation is likely to exhibit a benign trend and is not expected to be a source for concern.

MONETARY POLICY IN 2010

The global economy entered 2010 on a recovery mode compared to the height of the global crisis in early 2009. Global GDP growth picked up greater momentum in the final quarter of 2009, underpinned by stronger activity, particularly in emerging economies. While there were significant elements of policy support in driving the expansion in economic activity, there were also signs of recovery in private demand, notably in private consumption. The expectation is for private sector demand to strengthen further in 2010.

Monetary policy in 2010 will focus on promoting the sustainability of economic recovery

The recovery process nevertheless appears to be uneven across countries, which implies that the timing and magnitude of the exit from the extraordinary policy measures implemented during the crisis may vary across countries. Emerging economies however, are leading the recovery process in the world economy. The better fundamentals of the emerging markets, especially in Asia, imply that these economies will have an important role in supporting global demand over the next few years.

The emerging markets' better fundamentals could also make these economies vulnerable to large scale capital inflows driven by the combination of low global interest rate, excess liquidity and the rising appetite for risks and search for yields. Given the still uncertain international economic outlook, such capital flows are likely to react suddenly to shifts in global developments and changing expectations. As a consequence, the inflows of funds are equally susceptible to be interrupted by episodes of reversals. The resulting higher volatility in the financial markets could complicate policymaking in the emerging economies where the financial markets are less developed. The challenges to intermediating the large and volatile capital inflows could create financial imbalances and misallocation of resources while the sudden and rapid withdrawals of such funds could disrupt financing and real economic activity. Therefore, the economic and financial environment will remain challenging for emerging economies.

Domestically, the Malaysian economy is expected to strengthen. The ongoing improvement in consumption and investment activities will boost domestic demand and raise national output closer to the productive potential of the economy. Sustained consumer confidence and the accommodative monetary conditions will support consumption and investment activity by households and businesses. The Government has announced plans for a gradual consolidation in its fiscal position in 2010. Nevertheless, the overall fiscal policy remains expansionary and will continue to lend support to the recovery process. External demand, particularly from regional economies, will also sustain trade and economic activity. Accordingly, the prevailing negative output gap will narrow as domestic demand increases.

Inflation is expected to rise in line with the recovery in economic activity. Nevertheless, given that output is recovering from low levels, the resultant pressure on inflation from the narrowing output gap is expected to be limited. Core inflation is likely to exhibit a modest upward trend and is not expected to be a source for policy concern. On the supply side, the Government has announced its intention to undertake a comprehensive review of the subsidy delivery system. The restructuring of subsidies and the reemergence of rising global energy and food prices could generate some upward pressure on domestic inflation. However, the assessment is that the potential impact on consumer prices is likely to be transitory and manageable.

With the threat of a fundamental recession having now diminished, the Monetary Policy Committee (MPC) raised the OPR by 25 basis points in March 2010 towards normalising monetary conditions. A very high degree of monetary stimulus was considered no longer warranted following the robust recovery and improved economic outlook. The concern was that maintaining interest rates at too low a level over an extended period could encourage excessive risk taking behaviour, and the unhealthy build up of leverage. At the same time, it could also result in disincentives to save, and lead to disintermediation, causing savers to move into risky investments. Such developments can undermine the recovery process, while reducing the longer term growth potential of the economy. Thus, while monetary policy remains accommodative and supportive of the economy, the normalisation of interest rates is meant to reflect the improving economic environment and to prevent financial imbalances from developing in the economy.

With price pressures expected to be modest going forward, monetary policy in 2010 will focus on promoting the sustainability of economic recovery and ensuring that financing continues to be available to the private sector at a reasonable cost. Given the lingering uncertainties surrounding the future growth path of the global economy, an accommodative monetary policy stance will be maintained to support and strengthen private investment and consumption demand and thus overall economic growth.

FISCAL POLICY IN 2010

Fiscal policy was significantly expansionary in 2009 to prevent the Malaysian economy from sliding into a fundamental economic downturn as the global financial and economic crisis drove the global economy into a deep recession. Along with accommodative monetary policy and pro-active measures to support access to financing by the private sector, these measures were successful in mitigating the recessionary impact of the crisis on the Malaysian economy. As a result, the economic contraction begun to stabilise as early as the second quarter of 2009. As the economy continues to recover in 2010, fiscal policy will remain geared towards preparing the foundation for a stronger recovery of private sector demand. Key to a sustained economic recovery is a strong resumption of private consumption and investment. Thus, fiscal policy has accorded significant priority towards enhancing the role of the private sector as the driver of economic growth.

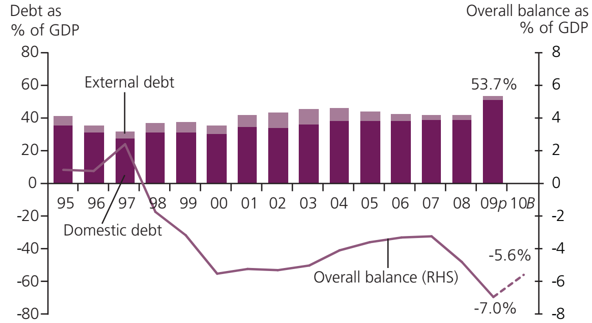
Table 4.5
Federal Government Finance

	RM billion		% change	
	2009*p*	2010*B*	2009*p*	2010*B*
Revenue	158.6	148.4	-0.7	-6.4
Total expenditure	206.6	189.5	5.2	-8.3
Operating expenditure	*157.1*	*138.3*	*2.3*	*-12.0*
Gross development expenditure	*49.5*	*51.2*	*15.6*	*3.4*
Loan recoveries	0.5	0.6		
Overall balance	**-47.4**	**-40.5**		
% of GDP	**-7.0**	**-5.6**		
Sources of financing:				
Net domestic borrowing	56.9	-		
Net external borrowing	-6.3	-		
Realisable assets[1] and adjustments	-3.2	-		

[1] A positive (+) sign indicates a drawdown in the accumulated realisable assets
p Preliminary
B Budget
Note: Numbers may not add up due to rounding

Source: Ministry of Finance

Chart 4.5
Federal Government Fiscal Balance and Debt



p Preliminary
B Budget
Source: Ministry of Finance

Government efforts to strengthen private investment and increase the participation of the private sector in the economy were reflected in the measures announced in the 2010 Budget. These include privatization initiatives, and measures that provide a more conducive business environment. Moreover, to encourage private sector involvement in the economy, the Government is also providing incentives to several high growth sectors. Among the sectors identified are tourism, information technology and communication (ICT), finance and Islamic banking, halal products and green technologies. To further support growth of private consumption, the Government has reduced the personal income tax, and raised individual tax relief to increase the disposable income of consumers.

In response to the contractionary influences on the domestic economy as the global economy slipped into a recession, the Government implemented a sizeable fiscal stimulus in 2009, resulting in a higher deficit of 7% of GDP (2008: 4.8% of GDP) and a higher Federal Government debt of 53.7% of GDP (2008: 41.5% of GDP). For 2010, whilst remaining largely accommodative, fiscal policy has taken into account the need to ensure that it will not exert undue strain on the Government's finances. Specifically, the large Government support introduced at the height of the global economic crisis would be gradually scaled back.

With a view towards a phased consolidation of the fiscal position, the 2010 Budget placed emphasis on measures to improve the effectiveness and efficiency of the Government's revenues and expenditures. To enhance the efficiency of Government expenditures, the measures that will be implemented and prioritised include the restructuring of the fuel subsidy system which accounts for a significant portion of the Government's annual outlays as well as a review of the whole system of subsidies and price controls. To maintain a sustainable fiscal position without compromising the overall growth and development objectives, the Government will also intensify its public-private partnership programme for several high impact projects. Some of these projects include the high speed broadband, regional development corridors and public transportation infrastructure projects.

To strengthen its revenue streams, the Government has undertaken a study on the feasibility of implementing the goods and services tax (GST). With the GST, the Government revenue base will be broadened and thus better insulated from the adverse cyclical swing in oil prices. Currently, the revenue base is too narrow, depending mainly on direct taxes and petroleum-related revenues. In addition, it is significantly exposed to the swings in the business cycle that has a large impact on government finance. The Government has also announced plans to review the tax assessment system, especially for petroleum related activities, which are currently assessed with a lag of up to a year.

With the implementation of these measures, the Federal Government fiscal deficit is expected to narrow to 5.6% of GDP in 2010. Operating expenditure will be lower by 12% from RM157 billion in 2009 to RM138 billion. Meanwhile, development expenditure will remain high at RM51.2 billion. Most of the development expenditure will be channeled towards the economic services and education services sectors.

Given the ample liquidity in the domestic market, the Government has financed its fiscal deficit mainly from the domestic bond market. Apart from raising funds through the issuance of government securities, the Government will also issue an RM3 billion retail bond known as 1Malaysia Sukuk. The issuance will also serve as an alternative investment avenue for Malaysians to receive better returns in an environment of low domestic interest rates.

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.

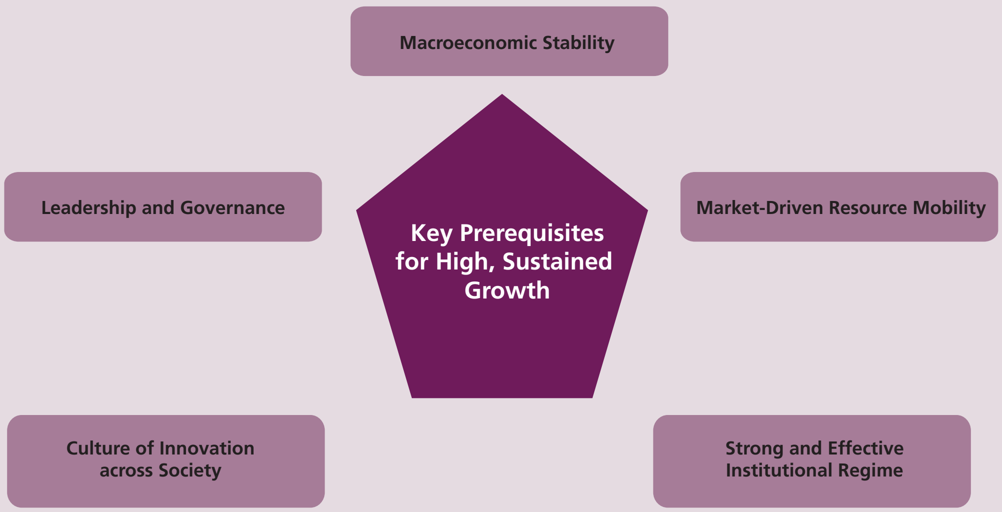
5. Deeper global and regional integration

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

Pillar 1 : Macroeconomic Stability
• Misdirected spending • Unsustainable fiscal deficit • Monetary and financial instability

Pillar 2 : Market-Driven Resource Mobility
• Price distortions: - Energy subsidies - Artificial wage levels - Excessive price controls • Market distortions: - Open-ended protection of specific sectors and industries

Pillar 3: Effective Institutional Regime
• Poor competition policy and weak regulation to address market failures

Pillar 4: Innovation Discipline across Society
• Progress in education in terms of quality, extent of learning and innovative thingking

Pillar 5: Leadership & Governance
• Neglect of environmental issues • Oversized public sector • Corruption

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.