Revisiting the New Economic Model (NEM) – Lags and Prospects

A Joint Seminar Series by the Jeffrey Cheah Institute on Southeast Asia (JCI) and the Malaysian Economic Association (MEA)

"The Malaysian Economy: Where are We?"

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Nurturing the Seeds of Wisdom

Malaysia's economy grew at an annual average rate of 7.7% in the 1970 - 1997 period, and so the official expectation in 2001 was that the economy would grow an average of 7.5% in the 2001-2010 period. The outcome has been disappointing as growth only averaged 4.6% annually in 2001-2016.

According to Professor Woo Wing Thye, President of the Jeffrey Cheah Institute on Southeast Asia, the good news is that there exist straightforward policy actions that the Government could implement effectively to put the economy back on course to realise *Wawasan 2020.* Using the terminology of the IT age, there are three kinds of threats to Malaysia's ability to catch up with the standard of living in the developed countries: hardware failures, software failures, and power supply failures. Hardware failures refer to mistakes in economic management. Software failures refer to mis-governance in socio-political spheres leading to instability. Power supply failures refer to systemic crisis resulting from geopolitical conflict and environmental catastrophes. Success in economic catching up requires Malaysia not only to manage its economy well but also to promote social harmony, and cooperate with the rest of the world to maintain global peace and to protect the natural environment.

In the opening address, the President of the MEA -- Tan Sri Dr. Sulaiman Mahbob, who is former Director-General of the Economic Planning Unit, emphasised the importance of good economic management and strong institutional governance to tackle the challenges of the Malaysian economy:

- Contemporary issues include the budget deficit, lower value of currency, increasing prices, the weakening quality of investments and labour reform; and
- Longer term objectives to raise economic value add also need to be considered, even as the fourth industrial wave of new technologies and the digital economy drive future growth.

"Whatever we decide today will have implications on the future generation – how will we pass on the legacy?" Tan Sri Dr. Sulaiman Mahbob

While policy measures are undertaken to improve the real economy, focus needs to be given on the softer side of economic management – this is what the nation currently lacks and collective action is required to achieve the outcomes of good productivity and policymaking.

Is the Malaysian Economy Fundamentally Strong?

Tan Sri Dr. Lin See Yan, the former Deputy Governor of Bank Negara Malaysia, saw the present synchronised growth of the world to be the product of the advanced economies being artificially propped up by abnormally low interest rates. He summarised the world economy as follows:

- the US is achieving robust growth at full employment; Europe is improving but slowing down; Japan is inching in the right direction; and China and India are progressing steadily;
- the economies of Mexico, Indonesia and Turkey require significant reforms; and
- the economies of Russia, Brazil, South Africa and Nigeria are in serious trouble.

Tan Sri Dr. Lin pronounced Malaysia to be caught in the middle-income trap as the real economy has lost its edge and recent growth masks underlying economic fatigue. Furthermore, policies are implemented to stimulate short term growth rather than to undertake structural reforms to restore economic dynamism. Tan Sri Dr. Lin acknowledged that his assessment of the Malaysian economy stood in contrast to the more favourable ones in the IMF and the World Bank reports, which he described as "polite talk".

"There is a need to reclaim the loss of confidence in the Ringgit…we deserve better and it is a fallacy to keep on arguing for a weak ringgit to boost exports." Tan Sri Dr. Lin See Yan

The key issues raised for the Malaysian economy identified by Tan Sri Dr. Lin were:

- Reliance on the growth in consumption, which is systemically weaker than other drivers of economic growth[1]. The growth in consumption builds up imbalances and raises the level of debt, which in turn becomes a drag on future demand and economic growth.
- Weakening fundamentals including investment slow-down; absence of upgrading in the manufacturing sector; virtual zero improvement in technological innovation (0.1% increase in Total Factor Productivity (TFP) from 2011 to 2015[2]); and insufficient competition due to State-Owned Enterprises (SOEs) crowding out the private sector.
- High rates of youth and graduate unemployment (even in fields such as engineering) due to labour market mismatches, limited job creation and inadequate supply of industry-ready graduates[3]. Concomitantly, the process of '*Schumpeterian creative destruction'* presents concerns with the looming effects of robotics, artificial intelligence and automation on Malaysia's workforce.
- Present weakness of the Ringgit against the USD, particularly when compared with most regional currencies.

[1] E Kharroubi and E Kohlscheen (2017): "Consumption-led expansions", BIS Quarterly Review
[2] Productivity Report 2016/17 (2017), Malaysia Productivity Corporation, p.13
[3] Dian Hikmah, Mohd Zaidi Mahyuddin (2017): "Youth Unemployment in Malaysia: Developments and Policy Considerations", Bank Negara Malaysia Annual Report 2016, pp.101-104

Tan Sri Dr. Lin stated that economic reform could raise Malaysia's GDP growth to be above the current target of 4.5 – 5.0%. He recommended the pursuit of structural reforms in the areas of labour, fiscal and education policies. These imperatives include a modern labour market that is designed for improvements in productivity and a tax system that reduces the incidence of indirect taxes on the middle class. The highest priority should be on increasing innovation through better education, talent retention and a creative ecosystem.

The Policy Goal to Re-Focus on Manufacturing

Datuk Dr. Awang Adek Hussin, a former Deputy Minister of Finance, hailed Malaysia as one of the better performing economies in Southeast Asia and globally, and he emphasized the difficulty of doing significantly better than the current global norm of low growth.

"Malaysia is caught in the wrong idea that in order to be a developed nation, it needs to expand the services sector and move away from manufacturing." Datuk Dr. Awang Adek Hussin

Nevertheless, Datuk Dr. Awang acknowledged that the service sector is plagued by low labour productivity, technological backwardness and significantly lower training expenditure compared to the manufacturing industry. It is ominous that labor productivity growth in Malaysia has halved to 1.9% for the 1998 - 2015 period compared to 3.8% for the 1971 - 1997 period. This presents a major challenge as Malaysia seeks to adopt the path taken earlier by advanced countries by shifting from manufacturing to the services sector. Datuk Dr. Awang stated that the new policy goal should be a large expansion in manufacturing activities.

Datuk Dr. Awang cited a Growth Diagnostic analysis of the Malaysian economy[4] that recommended the government to improve risk financing (e.g. venture capital); minimise the impact of macroeconomic volatility; and manufacture new export products. South Korea stood out for its success to boost local technology creation, which resulted in the successful transition in its growth driver from the Electrical and Electronic (E&E) sector to the Machinery and Equipment (M&E) sector from 1990 to 2010. South Korea's Research and Development expenditure was 4% of GDP in 2011 compared to 1.1% in Malaysia.

[4] Noor Azlan Ghazali, Mpumelelo Nxumalo and Jared Glanz-Berger (2017), "Malaysia at a Crossroads: Diagnosing the Constraints to High-Income Status", PNB Research Institute Sdn Bhd, p.24

Governance is Key to Unlock the Potential of Innovation in Malaysia

Professor Rajah Rasiah of the University of Malaya concurred with other speakers that Malaysia is now caught in the Middle-Income Trap. He posited that Malaysia is facing premature de-industrialisation by highlighting the decline in value-added share in gross output in manufacturing from 29% to 23% from 1990 to 2005 juxtaposed against the high equivalent proportions in South Korea (40%) and the US and Germany (close to 50%).

“Policy-induced rents to spur innovation cannot succeed with inadequate oversight in weeding out non-performers.” Professor Rajah Rasiah

Malaysia remains highly dependent on importing intellectual property. According to Professor Rajah, governance is the key challenge to improving innovation. Drawing from the experiences of Korea, Taiwan, Japan and Singapore, he called upon the Malaysian government to set up a strong appraisal mechanism for its funding of innovation-promotion programs, given the significant amount of disbursements already made. Two particular examples were instructive: firstly, the stringent reviews of Multinational Corporations (MNCs) in Singapore to ensure that local players were upgrading; and secondly, the hard approach by South Korea to remove non-performing entrepreneurs and penalise abusers through means such as incarceration. These actions ensured that subsidised credits by the state yielded its desired results.

The OECD’s comprehensive review of Malaysia’s innovation policy in 2016 had also unveiled challenges in the areas of governance, education and skills shortages. In particular, the national governance structure for innovation involves a complex array of actors and needs to be further streamlined and co-ordinated well for more effective implementation.

While lesser known, the Malaysian construction industry deserves plaudits for its ability to evolve and climb the trajectory of innovation. The smart tunnel is an exemplar of radical innovation which provides solutions to ease traffic jams and tackle flash floods. According to Professor Rajah, in 2016 Malaysian firms were involved in 47 overseas construction projects in the US, Japan and other countries.

The New Economic Model – A Lost Decade

Dato' Latifah Merican Cheong, former Assistant Governor of Bank Negara, surmised that Malaysia remains caught in the Middle-Income Trap even after 5 years of implementing the NEM. The diagnosis of the NEM remains valid today as evidenced amongst others, in the top talent leaving Malaysia; restrictions on foreign skilled workers to protect locals; and the high level of centralised planning in government.

"Malaysia has regressed in many areas because of the interference of vested interests and the lack of political will to reform." Dato' Latifah Merican Cheong

According to Dato' Latifah, the failure to implement the NEM is attributable to institutional and governance weaknesses. The NEM started well but has yet to achieve its strategic outcomes due to the intervention of vested interests. Instead of the project-based orientation adopted by the Performance Management and Delivery Unit (PEMANDU), Dato' Latifah called for a holistic programmatic approach and that the National Development Policy Council should be reinstated to drive the implementation of challenging policies to reform the Malaysian economy. Going forward, Dato' Latifah asserted that the private sector must be the main driver of economic growth and warned against allowing the Government Linked Corporations (GLCs) to crowd out private firms. The civil service should be leaner and less bureaucratic, and comprehensive policies are needed to address Malaysia's weakening fundamentals manifested in cost of living issues (low wages and disposable incomes) and the fiscal drag on economic growth (high operational budget and rising contingent liabilities).

Moving Forward

During open discussion, the panel generally agreed that policy actions going forward must be underpinned by the appropriate types of institutions. Good governance institutions are needed to overcome the growth barriers erected by vested interests, and to create a competitive environment. Here, it is instructive that countries which have successfully escaped the middle trap to achieve high-income status exhibited improvements in the accountability of institutions and in tackling corruption[5].

The panel also agreed that what is urgently needed is strong political will and resolve to implement critical policy actions for the immediate and longer term horizon. These will not only restore confidence in Malaysia's economic and political environment, but also ensures that the Malaysian economy reaches its full potential. Only then can the NEM's hallmarks of high-income, inclusive and sustainable growth be elevated to a truly transformative agenda and new vision for Malaysia in 2050.

[5] World Bank. 2017. World Development Report 2017: Governance and the Law. Washington, DC: World Bank, p.161

ABOUT THE JCI-MEA ECONOMIC SEMINAR SERIES

The Jeffrey Cheah Institute on Southeast Asia at Sunway University (JCI) and the Malaysian Economic Association (MEA) are co-organising a series of four seminars to discuss key economic issues and identifies the specific policy measures needed to accelerate economic growth; to distribute more of the income growth to the poorest 40 percent of the population; and to ensure compatibility between economic growth and the health of the natural environment. The JCI-MEA seminar series is also a constructive forum to help inform the present efforts by the Government to formulate the *Transformasi Nasional 2050* (TN50) blueprint. Top economists will discuss the state of the Malaysian economy, important lessons from the reform experiences of foreign countries, and about the new policy directions and new implementation mechanisms that should be adopted in order to restore Malaysia's economic dynamism.

Malaysia initiated the *Wawasan 2020* project in 1991 to bring Malaysia to "developed nation status" by 2020. The *Wawasan 2020* project made good progress until the 1997-1998 Asian Financial Crisis (AFC). The alarming subsequent development was that the economic performance of Malaysia in the post-AFC growth has been anaemic, keeping Malaysia substantially below the growth trajectory that would make *Wawasan 2020* a reality.

The government adopted the NEM agenda in 2010 to put the Malaysian economy back on track to realise *Wawasan 2020*. Many readers of the NEM report interpreted it to mean the implementation of comprehensive, radical reforms to break Malaysia free from the middle-income trap. The implied policy changes included cracking down on rent seeking (i.e. cronyism), restructuring of Government Linked Companies (GLCs), deregulation of markets to spur competition, increasing the supply of skilled workforce, promotion of technological innovation, transformation of the public sector into lean and task-focussed agencies, reorientation of the inclusiveness policies to work through market-friendly and transparent affirmative actions, supporting the Small and Medium-Sized Enterprise (SME) sector, and protection of the environment. Since 2010, the NEM policies have been embodied in many new government programs such as the Malaysia Plans (10th and 11th); Blueprints for Education, the Services Sector and Productivity; the SME Master Plan; and Transformation Plans for the Economy, and the Government.

With 2020 closing in, the joint JCI-MEA Seminar Series on the New Economic Model provides a timely assessment of the progress towards achieving the 2020 goals of a high income society that is inclusive and environmentally friendly and sustainable. Where are we now? In what areas have successes been registered and progress stagnated, fallen behind or even gone off the rail? How relevant are the reform experiences of other countries including China, Indonesia and Thailand to the discourse? And what is to be done? How should the new *Transformasi National 2050* (TN50) program help bring Malaysia to a "developed economy status" and become a model that other developing and emerging economies can emulate? This reports presents a summary of key discussion points from the first seminar entitled "The Malaysian Economy: Where are We?" held on 1 August 2017 at Sunway University. For more information on the entire JCI-MEA seminar series, please refer to www.jci.edu.my