Malaysia Economic Monitor

Boosting Trade Competitiveness

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MALAYSIA ECONOMIC MONITOR
JUNE 2014
BOOSTING TRADE COMPETITIVENESS

World Bank Office—Bangkok
Country Director: Ulrich Zachau
Sector Director: Sudhir Shetty

Comments to:
Mathew A. Verghis
mverghis@worldbank.org
Frederico Gil Sander
fgilsander@worldbank.org

30th Floor, Siam Tower
989 Rama I Road, Pathumwan
Bangkok 10330, Thailand
+66 (0) 2 686-8300
www.worldbank.org/my

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ABBREVIATIONS

AANZFTA	ASEAN-Australia-New Zealand Free Trade Agreement
AEC	ASEAN Economic Community
AFTA	ASEAN Free Trade Agreement
ASEAN	Association of Southeast Asian Nations
ATIGA	ASEAN Trade in Goods Agreement
AVE	Ad-valorem equivalent
BEC	Broad Economic Category
BNM	Bank Negara Malaysia
BP	British Petroleum
BR1M	Bantuan Rakyat 1 Malaysia
CAGR	Compounded annual growth rate
CCC	City College of Chicago
CEPT	Common Effective Preferential Tariff
CUSFTA	Canada-United States Free Trade Agreement
DECPG	Development Economics Prospect Group
DOSM	Department of Statistics Malaysia
DPO	Development Policy Operation
DRUID	Danish Research Unit for Industrial Dynamics
E&E	Electrical and Electronics
EA	East Asia
EAP	East Asia and Pacific
EPP	Entry-Point Project
ETP	Economic Transformation Programme
EU	European Union
FDI	Foreign direct investment
FTA	Free Trade Agreements
G&S	Goods and Services
G3	Group of 3 advanced economies
GATS	General Agreement on Trade in Services
GATT	General Agreement on Trade and Tariffs
GDP	Gross Domestic Product
GEMS	Graduate Employment Management Scheme
GFC	Global Financial Crisis
GFCF	Gross fixed capital formation
GNI	Gross National Income
GST	Goods and Services Tax
GTA	Global Trade Atlas
GVC	Global Value Chains
HDD	Hard Disk Drive
HS	Harmonized System
I2E	Import 2 Export
ICT	Information and Communication Technology
IES	Institute of Economic Studies
ILMIA	Institute for Labor Market Intelligence and Analysis
ILO	International Labour Organization
IMF	International Monetary Fund
IPR	Intellectual Property Rights
IPTS	Institut Pengajian Tinggi Swasta
ISDS	Investor-State Dispute Settlement
ISIC	International Standard Industrial Classification
IT	Information Technology
ITC	International Trade Commission
ITS	Industrial Training Scheme
JETRO	Japan External Trade Organization
JMEPA	Japan-Malaysia Economic Partnership Agreement
LNG	Liquefied Natural Gas
LPI	Logistics Performance Index
MAC	Migration Advisory Committee
MDeC	Multimedia Development Corporation
MIC	Middle Income Countries
MIDA	Malaysia Industrial Development Association
MIDF	Malaysian Industrial Development Finance Berhad
MNC	Multinational Corporation
MOF	Ministry of Finance
MoHE	Ministry of Higher Education

MRT	Mass Rapid Transit
MSC	Multimedia Super Corridor
M&TE	Machinery and Transport Equipment
NAFTA	North America Free Trade Agreement
NBER	National Bureau of Economic Research
NBFIs	Non-Bank Financial Institutions
NFPE	Non-Financial Public Enterprises
NKEA	National Key Economic Area
NTM	Non-Tariff Measure
ODM	Original Design Manufacturing
OECD	Organization for Economic Cooperation and Development
OPR	Overnight Policy Rate
PC	Personal Computer
PDR	People's Democratic Republic
PEMANDU	Performance Management and Delivery Unit
PIC	Pengerang Integrated Complex
PISA	Program for International Student Assessment
PITA	Petroleum Income Tax Act
PMI	Purchasing Managers' Index
PPP	Public-Private Partnership
q/q	Quarter-on-Quarter
R&D	Research and Development
RAPID	Refinery and Petrochemicals Integrated Development
RCA	Revealed comparative advantage
RCEP	Regional Comprehensive Economic Partnership
RM	Ringgit Malaysia
RMB	Renminbi
RON	Research Octane Number
RTA	Regional trade agreements
SAAR	Seasonally adjusted annualized rate
SIP	Structured Internship Program
SME	Small and Medium Enterprise
SOC	Standard Occupational Classification
SOEs	State-Owned Enterprises
TiVA	Trade in Value Added
TPPA	Trans Pacific Partnership Agreement
TRIMs	Trade Related Investment Measures
TRIPs	Trade-Related aspects of Intellectual Property rights
UGRAD	Malaysia Undergraduate Apprenticeship and Development Programme
UK	United Kingdom
UN	United Nations
US	United States
USAID	United States Agency for International Development
USD	United States Dollar
VA	Value-added
VS	Vertical Specialization
WDI	World Development Indicators
WEO	World Economic Outlook
WIOD	World Input-Output Database
WITS	World Integrated Trade Solution
WTO	World Trade Organization
y-o-y	Year-on-Year

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EXECUTIVE SUMMARY

RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

Malaysia's economy overcame a weak start to the year and GDP grew by 4.7 percent in 2013. The economy expanded vigorously in the last three quarters of the year after a soft patch early on. This better-than-expected performance was mainly due to a recovery in exports: after contracting in 2012 and the first half of 2013 (-1.8 and -3.9 percent), exports expanded by 5.2 percent in the second half. This offset weaker domestic demand. As the Government implemented fiscal and credit tightening measures, domestic demand growth decelerated from 7.3 percent in the first half to 5.5 percent in the second half of 2013.

Better export performance led to a higher current account surplus. The recovery in exports was broad-based, including the long-ailing electrical and electronics (E&E) sector. The current account surplus hit a 15-year low of 0.8 percent of GDP in mid-2013, before improving to 7.9 percent in early 2014. This partly offset negative flows of 14.9 percent of GDP in the financial account in the first quarter. Global portfolio reallocation led to outflows in the financial account for the three quarters through March 2014.

Growth slowed in early 2014, but the outlook remains favorable given the positive external backdrop. Due to base effects, GDP is expected to grow by 5.4 percent and 4.6 percent in 2014 and 2015, respectively. The outlook for 2014 and 2015 will benefit from better conditions in advanced economies. Domestic demand faces headwinds: (1) subsidy cuts, tax hikes and public wage restraint in pursuit of fiscal consolidation; (2) likely higher interest rates as global monetary conditions normalize; and (3) the resulting pressures on household budgets. With foreign demand absorbing more than half of domestic value-added, a better external outlook outweighs domestic headwinds.

Investments and imports of capital goods will remain robust as large projects move forward. Improved global conditions and the approval of the Pengerang Integrated Complex will result in further growth in investments – as well as growth in capital goods imports. The latter will keep the current account surplus at modest levels (4.4-4.6 percent of GDP in 2014 and 2015) despite the lift in exports.

Medium-term fiscal consolidation remains on track, but gets harder. Helped by revenues from asset sales and large underspending of the capital budget, the Government bettered its deficit target of 4.0 percent of GDP despite overspending in subsidies and weak income tax collections. As a result, the debt-to-GDP ratio stabilized just below 55 percent. With domestic activity moderating and revenue growth constrained, spending measures towards further reducing the subsidy bill and capping emolument growth are needed for the Government to meet its 2014 deficit target of 3.5 percent of GDP.

The central bank has signaled that it may have to tighten policy to avoid the build-up of financial imbalances. So far BNM has been managing risks to macroeconomic stability primarily through macro-prudential regulations. Although such efforts have borne fruit (credit growth continued to decelerate), there is concern that household debt has continued to climb, reaching 86.5 percent in 2013, and that the real interest rate has become negative as inflation picked up to 3.7 percent in the first four months of 2014 largely on increases to administered prices.

Healthy labor markets provide respite for households. Higher employment levels (the employment-to-population ratio increased 3.0 percentage points in 2013), real wage gains in manufacturing (up 4.7 percent in 2013), and the full implementation of the minimum wage of RM900 in peninsular Malaysia and RM800 in Sabah and Sarawak suggest higher labor incomes in the economy. Labor force participation and employment came down from a peak, but settled at a higher level likely due to participation by women.

External risks to the outlook have receded, but not disappeared. The high share of Malaysia's debt held by foreigners means that volatility in international capital markets would be disruptive.

The delicate balancing act of tightening fiscal and monetary policies and Malaysia's ability to leverage the improved global environment are key domestic risks. While necessary to rebuild buffers, policy adjustments carry risks of inducing excessive retrenchment in household spending. Boosting exports to fully leverage on the improved external environment is thus critical for sustained growth.

BOOSTING TRADE COMPETITIVENESS

Following the review of near-term developments and outlook, the thematic chapter of this Economic Monitor analyzes structural trends in trade competitiveness. Trade competitiveness is measured as Malaysia's ability to grow its exports and the domestic value-added embodied within them, leveraging foreign demand and knowledge to support its transformation to a high income nation.

Nearly 60 percent of value-added produced in Malaysia was ultimately consumed by foreigners in 2009 – one of the highest shares in the world. The share of Malaysia's GDP consumed in foreign markets includes the value-added of exporting firms and also of suppliers to export-oriented industries. Thus the actual significance of external demand to the Malaysian economy is higher than it appears from net exports (22 percent of GDP) or the output from externally-oriented industries (38 percent of GDP).

The export engine appears to have been faltering since before the Global Financial Crisis. The share of exports of goods and services in Malaysia's GDP declined by nearly 30 percentage points between 2005 and 2013. Unlike Thailand, Vietnam and Korea, which saw market shares expand, Malaysia's share shrunk from 1.35 to 1.22 percent in that period. However, Malaysian exports have included a higher portion of domestic value-added, mitigating the impact of the decline in gross shares.

The decline in exports has been concentrated in Malaysia's core export product segment – E&E products. E&E exports as a share of GDP declined from about 38 percent between 2002 and 2004 to 18 percent in 2013, and Malaysia's market share in the period declined from 5.25 percent to 3.74 percent of global E&E exports. Meanwhile, exports of commodities, and commodity-related manufactures such as petrochemicals expanded, but not enough to compensate the decline in E&E exports.

The domestic value-added of Malaysian E&E exports is relatively low due to limited domestic linkages. Malaysia remains an integral part of the E&E global value chain, but at 44 percent the share of value-added in exports is relatively low. This is partly due to limited domestic linkages. Compared to other countries, the contribution from domestic intermediaries to the value-added of exports is only 7 percent in Malaysia compared to 31 percent in Korea. This finding is supported by analysis of enterprise survey data, which finds that multinationals in Malaysia source less than 40 percent of their inputs from domestic firms compared to 46 percent in Vietnam and 82 percent in China.

Exports of services have also lagged and remain an area of significant potential. Malaysia has few services-exporting firms and at 12 percent of GDP services exports are below what would be expected for a country at its level of income.

'Behind the borders' restrictions hinders export growth and limits linkages between domestic providers and export-oriented industries. Although the Government has recently embarked on a liberalization of services sectors, many are still relatively restrictive as measured by the World Bank's Services Trade Restrictiveness index and assessment of the burden of non-tariff measures. Professional and transport services are more restrictive on average than most countries in East Asia for example. A restrictive domestic environment reduces incentives for exporting, and for exporting firms to buy more domestic value-added. Barriers are not limited to ownership restrictions, but extend to licensing and regulations that limit domestic competition.

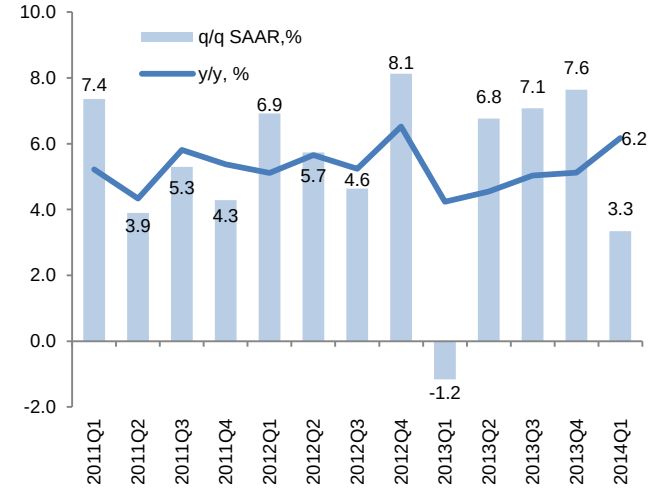
Engaging in higher value-added tasks in global value chains will also require addressing skills gaps. As energy prices have increased, so has the value of related assets. Thus it became relatively attractive for investors to come into the petrochemical sector. Meanwhile, as Malaysia grew, the availability of low-cost labor dwindled, especially in comparison with neighboring countries. At the same time, skills mismatches remain an obstacle for firms looking to scale up higher value-added activities.

Malaysia's upcoming chairmanship in ASEAN offers three concrete avenues to boost trade competitiveness. First, Malaysia can deepen its liberalization efforts in services by achieving a commitment of ASEAN members to classify and disclose their 'behind-the-border' restrictions on services trade; Malaysia could take the lead and implement such classification and disclosure as part of its own autonomous liberalization of services. **Second**, Malaysia can pursue mutual recognition agreements for professionals, both to create more competition but also to meet short-term skills gaps. **Third**, Malaysia can lead in streamlining non-tariff measures by reviewing domestic regulations such as licensing requirements affecting firms potentially linked to global value chains.

THE MALAYSIAN ECONOMY IN PICTURES

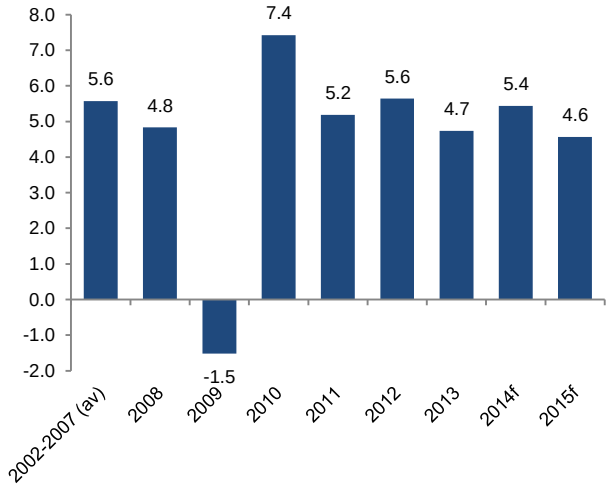
Quarterly growth decelerated in early 2014…

Real GDP, seasonally adjusted, annualized change from last quarter, percent



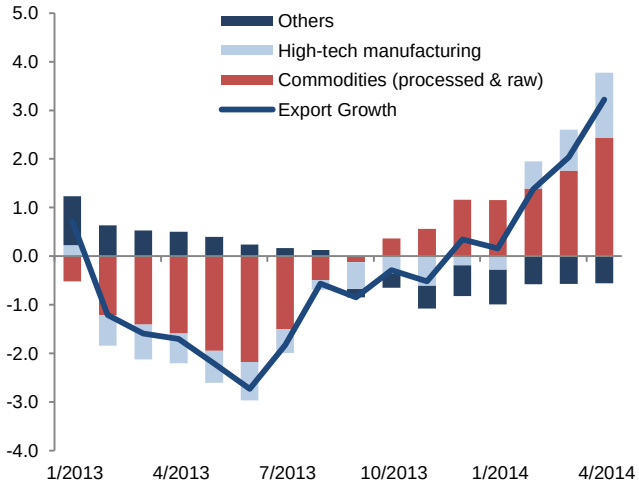
… but annual growth will pick up

Change from the previous year, percent



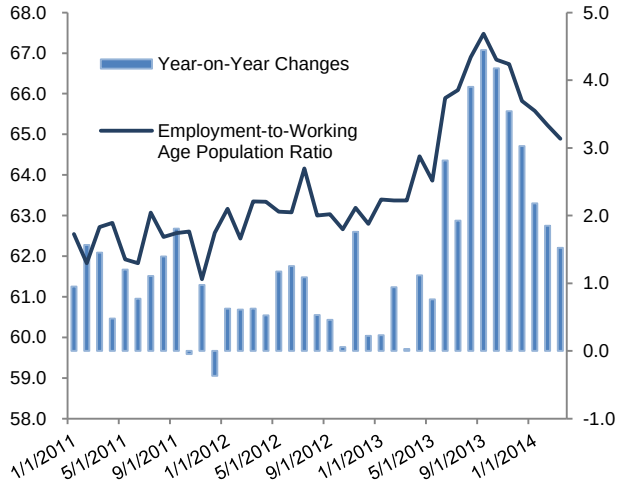
Exports recovered, helped a turnaround in high-tech

Change from the previous year, 12-month moving average, percent (line); contributions to growth, percentage points (bars)



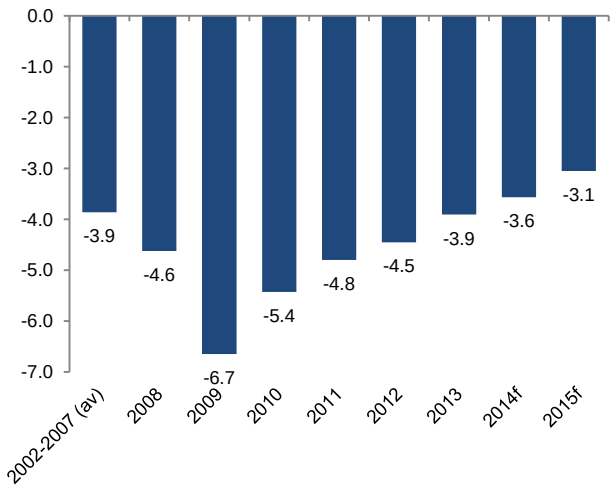
Employment grew strongly in 2013

Ratio of employment to working-age population, percent (LHS); changes from previous year, percentage points (RHS)



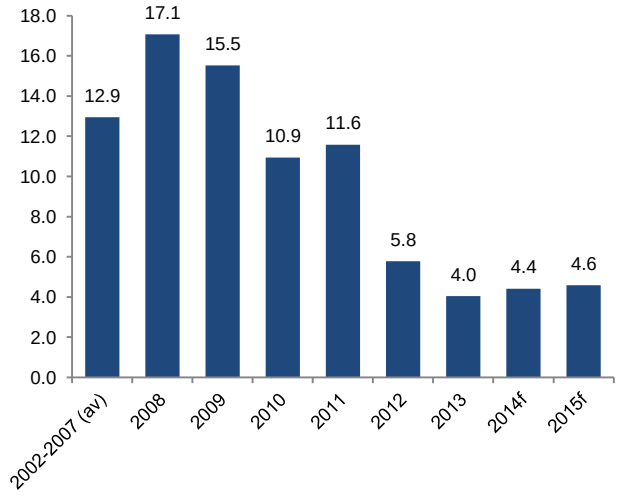
Fiscal consolidation continues

Federal Government balance, percent of GDP Balances, percent of GDP



The current account remains in a small surplus

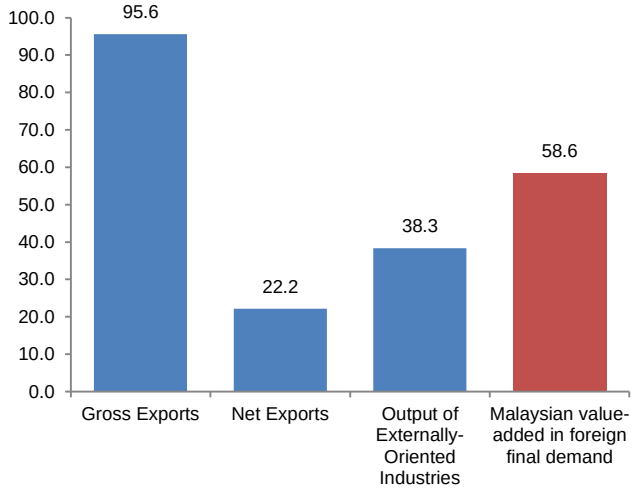
Percent of GDP



BOOSTING TRADE COMPETITIVENESS IN PICTURES

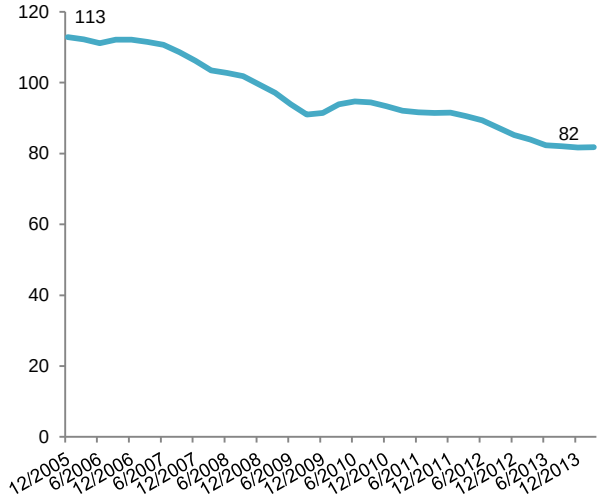
Trade drives more than half of Malaysia's economy

Measures of the importance of trade in the economy, percent of GDP



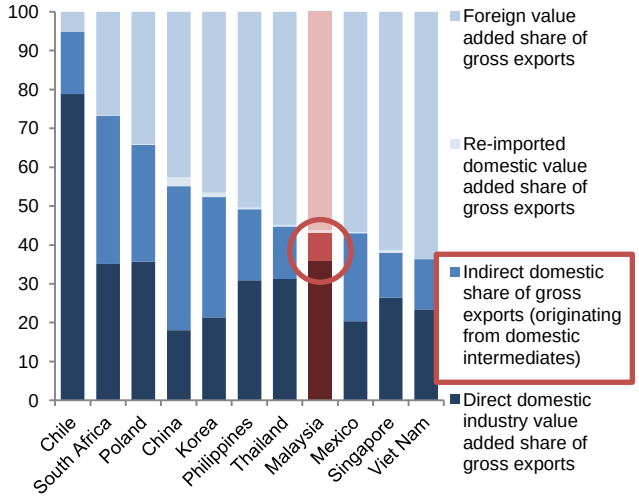
Trade as a share of GDP has declined sharply

Gross exports of goods and services, percent of GDP



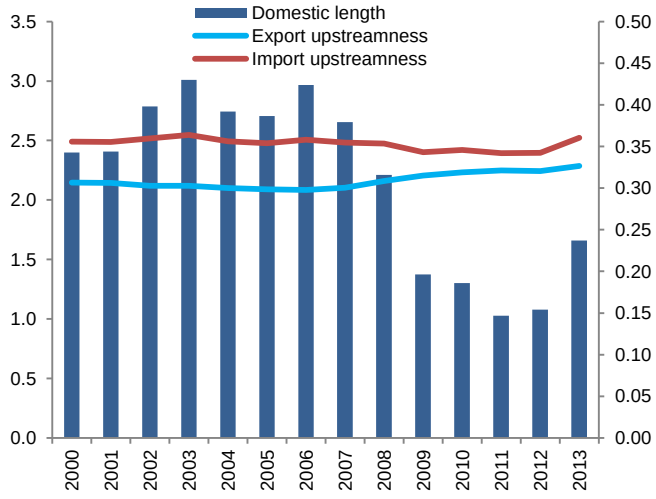
Limited linkages in E&E prevent higher value-addition

Components of gross exports in E&E, percent



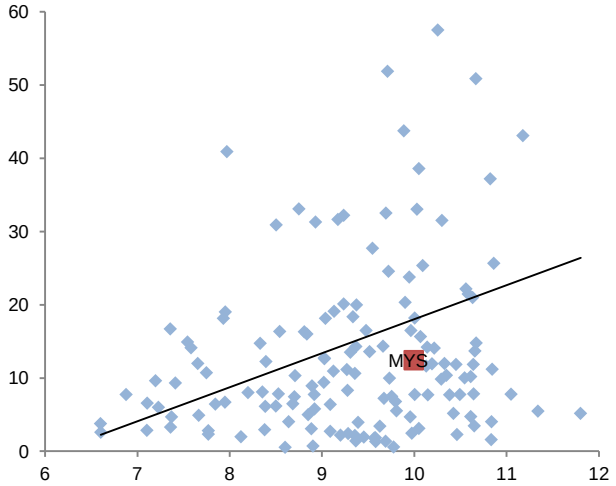
E&E exports moved upstream

Upstreamness indices (lines, LHS); Domestic length (bars, RHS)



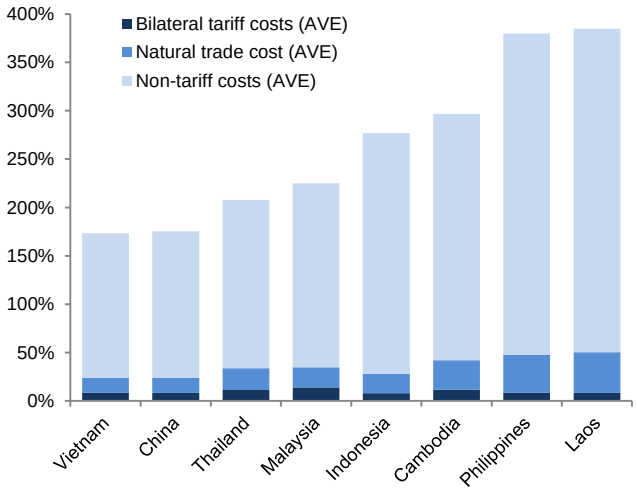
Services exports have not reached their potential

Service exports, % of GDP (y-axis); GDP per capita, PPP basis (logs; x-axis)



Non-tariff costs are high in ASEAN – including in Malaysia

Decomposition of total trade costs in ad valorem tariff-equivalent terms, %



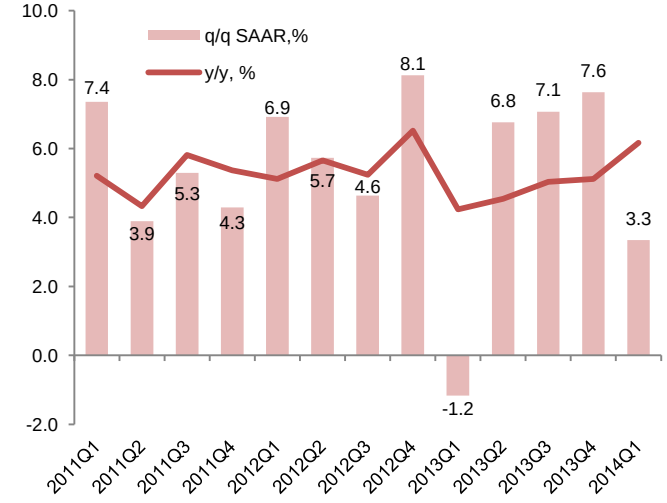
1. RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

Growth robust, with some moderation into 2014

1. After a solid performance in the last three quarters of 2013, growth moderated into 2014. In the fourth quarter of 2013, Malaysia's Gross Domestic Product (GDP) expanded by 7.6 percent (quarter-on-quarter, seasonally adjusted annualized rate – q/q saar), representing further acceleration of growth from the 6.8 and 7.1 percent rates recorded in the second and third quarters, respectively (Figure 1)[1]. This brought year-on-year (y/y) real GDP growth to 4.7 percent, slightly above the World Bank's previous forecast of 4.5 percent. Growth decelerated in the first quarter of 2014 as export growth cooled somewhat. Across East Asia, the performance of the Malaysian economy followed a pattern seen in most other regional economies where a slowdown in exports, possibly linked to the US weather-induced slowdown in the quarter, led to deceleration in early 2014 (see Figure 2).

Figure 1. Strong growth in the second half of 2013 was followed by deceleration in early 2014.

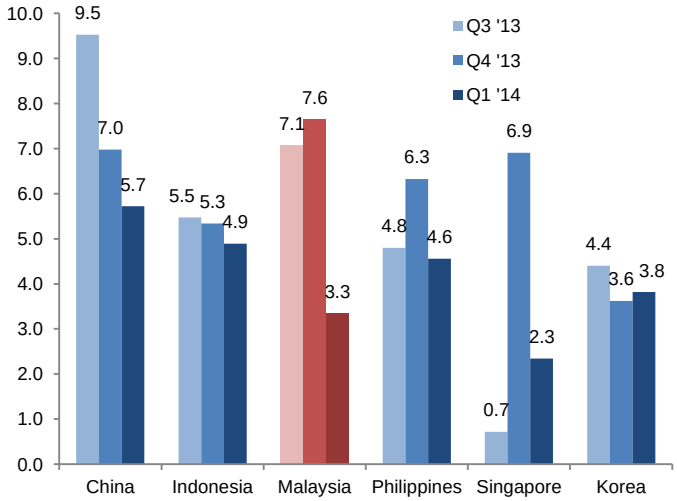
GDP adjusted for inflation and seasonal fluctuations, change from the previous quarter, annualized (bars), and from the previous year (line), percent



Source: CEIC, DOSM, World Bank staff calculations

Figure 2. Nearly all economies in East Asia slowed in the first quarter of 2014.

GDP adjusted for inflation and seasonal fluctuations, change from the previous quarter, annualized (percent)



Source: CEIC, DOSM, OECD, World Bank staff calculations

Export growth revives, lifting growth

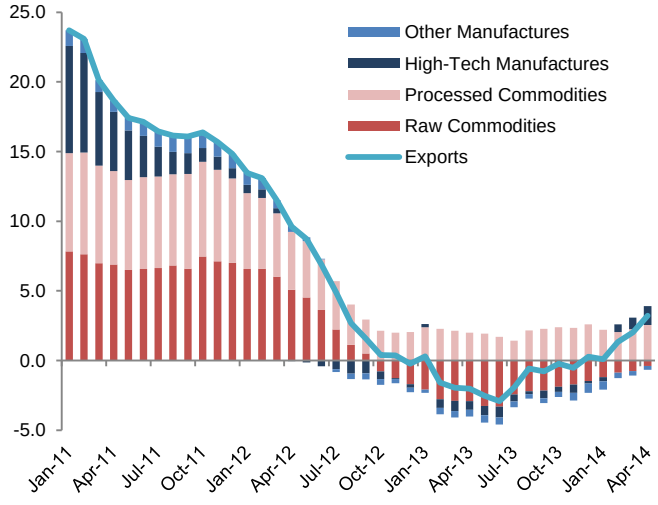
2. Revitalized exports of high-technology goods helped lift growth in recent quarters. A recovery in exports in the second half of the year supported GDP growth: the contribution of net exports was less negative at -1.1 pp in 2013 (2012: -4.0 pp). Of the 2.9 pp change, 2.4 pp came from better exports, which after several quarters as a drag on growth, has expanded sequentially since the third quarter of 2013. Export growth turned around from -3.9 percent in the first half of 2013 to 5.2 percent in the second half (y/y), partly due to higher shipments of high-technology products and partly due to a stabilization of commodity exports (Figure 3). Exports of E&E products expanded by 7.7 and 5.2 percent from the previous year in the last quarter of 2013 and first quarter of 2014, respectively (US dollar terms). This performance was driven by three main factors: most importantly, better growth prospects in advanced economies increased demand for Malaysian high-tech exports, which represent a higher share of trade to those regions; second, the political crisis in Thailand may have, at the margin, led MNCs with spare capacity in both countries to favor accelerating production in Malaysia; and finally, though growth in emerging markets slowed (especially in early 2014), commodity-related exports stabilized after declining through most of 2013.

[1] Unless stated otherwise, annualized quarter-on-quarter GDP figures are calculated based on the national account series seasonally adjusted by DOSM.

3. High-tech exports benefited from economic recovery in advanced economies. The recovery in high-income economies remains on track. The US economy expanded robustly in late 2013 and despite a bumpy start to 2014 due to weather-related factors, labor and housing markets continue to improve. Growth in the EU remains below pre-crisis levels, but has stabilized; in Japan, the economy has now expanded for six consecutive quarters. In all these economies, still-loose monetary policies, reduced drag from fiscal consolidation, improving labor market conditions, a steady release of pent-up demand and improved financial market conditions have supported growth. The improved demand environment in advanced economies led to a pick-up in exports of Malaysian high-tech products in the second half of 2013 (Figure 4). Despite the contraction in the US economy, exports to advanced economies continued to expand into the first quarter of 2014, with strong growth of high-tech exports to the EU and Japan. Commodity exports were weaker across high-income economies, especially the US, where weak commodity exports in 2013 likely reflect the expansion of domestic energy sources in the country.

Figure 3. Exports came out of negative territory, partly driven by a reversal in high-tech shipments

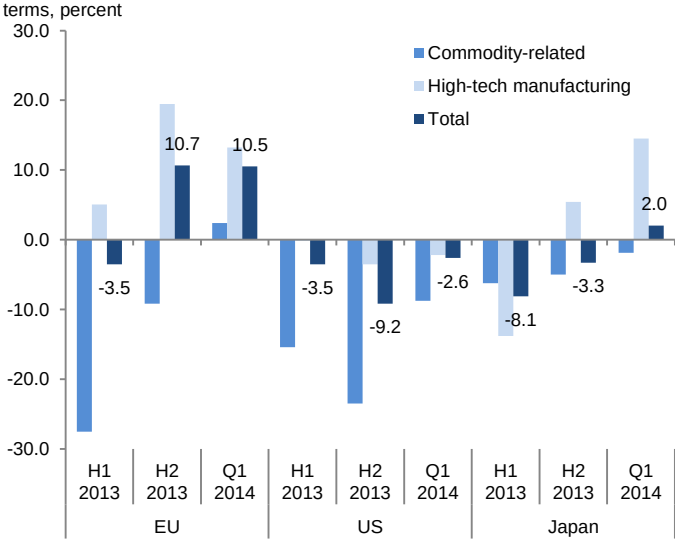
Change from the previous year, twelve-month moving average, percent (line); Contributions to growth, percentage points (bars), US dollar terms



Source: CEIC, DOSM, World Bank staff calculations
Notes: 1. Processed commodities include petroleum products, chemicals, processed agricultural commodities, and products from minerals
2. High-Tech Manufactures include machinery and transport equipment

Figure 4. Steady growth in advanced economies supported Malaysia's exports

Exports by destination and type, change from the previous year, US dollar terms, percent



Source: CEIC and World Bank staff calculations
Notes: 1. "Commodity-related" includes food and live animals; beverages and tobacco; inedible crude materials; mineral fuels; animal and vegetable fats and oils; and chemicals. High-tech is approximated by machinery and transport equipment
2. Exports to the EU approximated by exports to the U.K., France, Germany and Netherlands

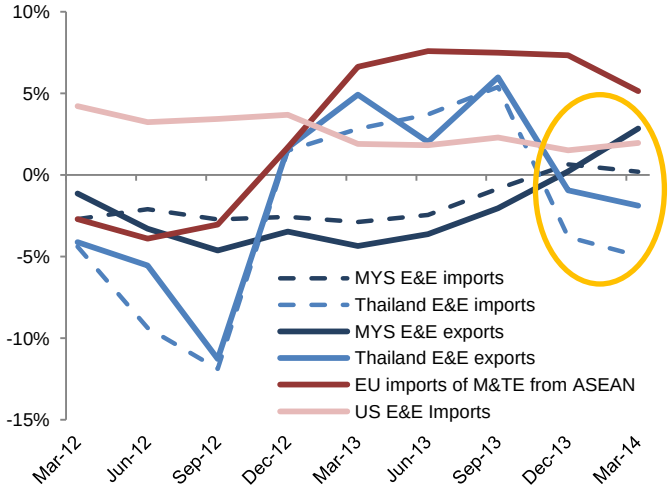
4. The political crisis in Thailand may, at the margin, have contributed to the pick-up in Malaysia's E&E exports. Many firms in the electronics global value chain have capacity to produce similar products in multiple countries for reasons of risk management and competition (intra-firm and inter-jurisdictional, with respect to tax incentives for example). According to JETRO (2013), 43 percent of Japanese companies in Thailand, and 48 percent of Japanese companies in Malaysia have alternative productive capacity in other countries. Such overlap between Thailand and Malaysia – and consequent potential for substitution – is unlikely to be extensive, as seen by the very modest pick-up in Malaysian E&E exports around the time of the Thai floods. Nevertheless, Figure 5 shows that the recovery of Malaysia's E&E exports does coincide with a sharp dip in Thai E&E exports following an earlier period of expansion.

5. Growth in emerging economies decelerated in early 2014, tempering somewhat Malaysia's export recovery. Growth in (gross) exports of goods and services, which averaged 12.1 percent (q/q saar) in the third and fourth quarters of 2013, slowed to 6.1 percent in the first quarter of 2014. This is partly due to slower growth in emerging economies, notably China. Chinese GDP expanded by 5.7 percent (q/q saar; see Figure 2) in the first quarter of 2014, the slowest pace in over two years. Although exports to China held up well due to large energy exports between December and February, the slowdown in emerging economies more broadly helps explain why Malaysia's exports

expanded more slowly in the first quarter despite improvements across G3 economies (Figure 6). Moreover, this slower growth is likely linked to weakness in commodity prices, which remain by and large below their 2012 levels (Figure 7).

Figure 5. E&E exports from Malaysia expanded while those from Thailand dipped

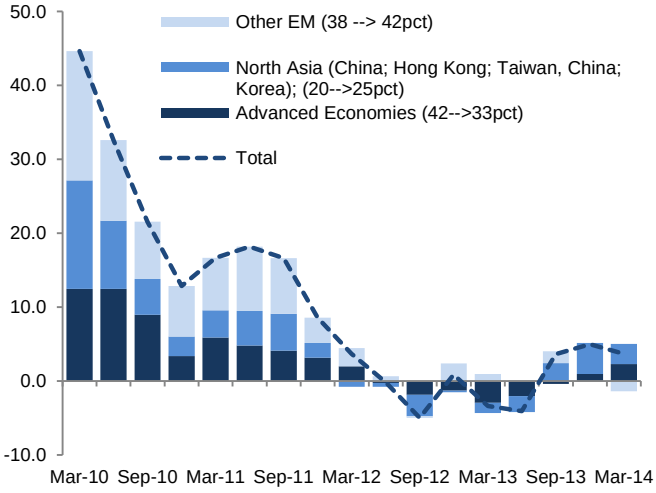
Growth from the previous year, four-quarter rolling sum, US dollar terms, percent



Source: CEIC, DOSM and World Bank staff calculations

Figure 6. Weaker growth in emerging markets led export growth to slow down in early 2014

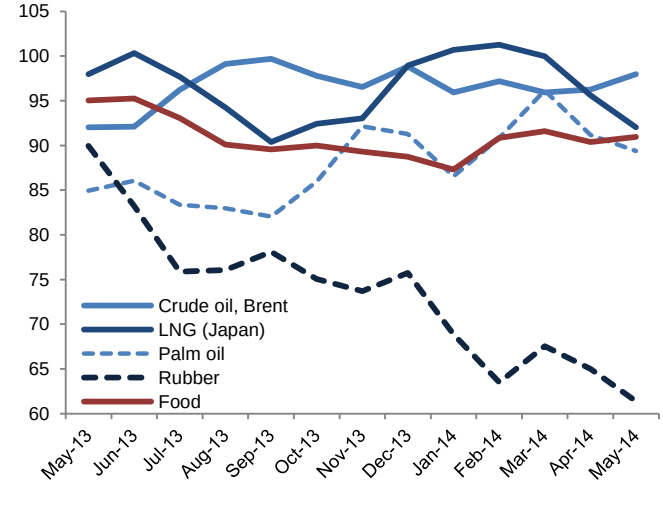
Change of US dollar value of exports from the previous year, percent; figures in legend represent export market shares in 2007 and latest four quarters



Source: CEIC, BNM and World Bank staff calculations
Note: M&TE – machinery and transport equipment

Figure 7. Commodity prices remain below 2012 levels, with rubber prices down almost 40 percent

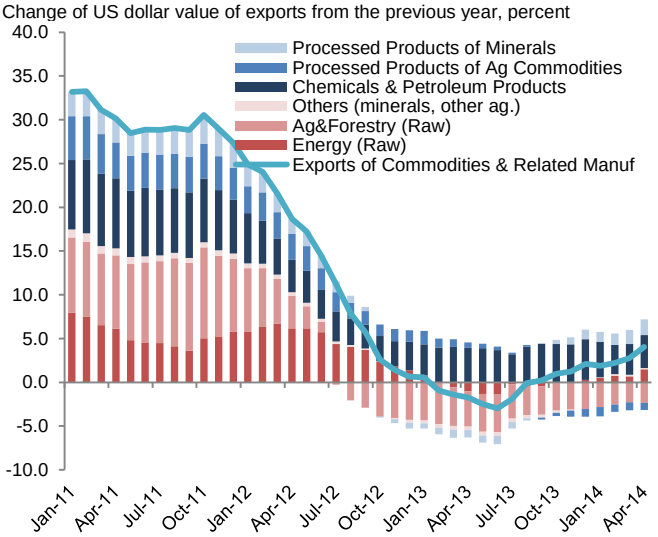
Index, 2012 average = 100



Source: World Bank DECPG

Figure 8. Exports of petroleum products have been growing steadily, while palm oil and rubber decline

Change of US dollar value of exports from the previous year, percent



Source: CEIC, DOSM, and World Bank staff calculations

6. Exports of petroleum-related products have been a steady contributor to export growth. Growth in exports of processed commodities has been largely due to chemicals and petroleum products (Figure 8). The value of exports from the petrochemical industry expanded by an average of 16 percent per year in US dollar terms over the past three years. Some of these exports reflect higher domestic production, but some reflect the construction of large storage facilities used for re-export: imports of petroleum products have grown by 27 percent per year on average in volume terms. Exports of crude petroleum and natural gas have expanded in 2014 after little growth the previous year, reflecting stable prices and output. The value of rubber and palm oil exports has declined over the past year. In the case of rubber, this is largely driven by a significant decline in prices (down by 17 percent in 2013 and a further 21

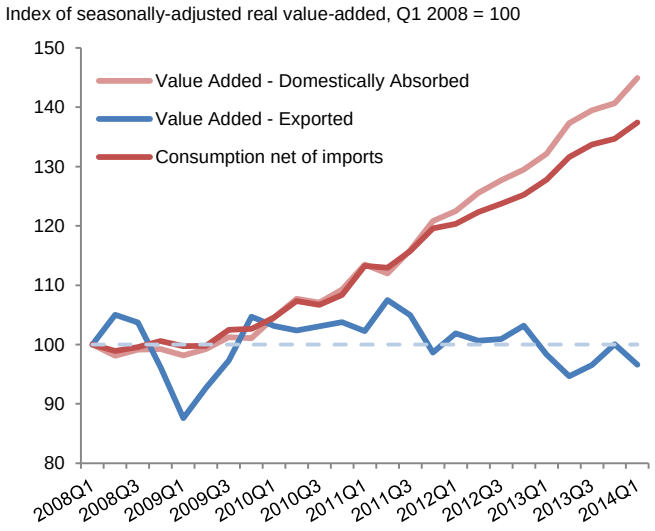
percent in 2014 through May see Figure 7). In the case of palm oil, prices declined in 2013 (by 14 percent) and volumes were flat. Prices recovered in 2014 but volumes came down, keeping growth in negative territory.

Domestic demand still expanding, but headwinds start to weigh

7. Domestic demand remained strong, especially in early 2014, when it was supported by expansion in private investment and government consumption. Domestic demand (GDP less net exports) contributed 5.8 percentage points to annual growth in 2013 (2012: 9.6 pp) and 4.9 percentage points in the first quarter of 2014 (but inventories subtracted 1.8 pp in 1Q 2014 vs. 0.9 pp in 2013). Government consumption surprised on the upside, rising by 23.2 percent (q/q saar) after two quarters of contraction; had government consumption been flat, quarterly GDP growth would have been nearly zero. The value-added produced in Malaysia and consumed domestically (World Bank estimate) expanded by 8.8 percent in 2013 (2012: 9.3 percent); this measure of domestic demand decelerated in the fourth quarter, but picked up again in 2014 thanks to a spike in government consumption and fixed investments (+12.4 percent q/q saar). The strength in domestic demand correlates with the continued acceleration in domestically-oriented sectors, especially services, which contributed more than half of total GDP growth for the quarter (3.5 pp, 2013: 3.1 pp), and construction, which expanded 53.5 percent (q/q saar) from the previous quarter and contributed 0.7 pp to year-on-year growth. Within services, the largest contributions to growth came from the retail sector (1.2 pp), government services (0.6 pp), and real estate and business services (0.5pp).

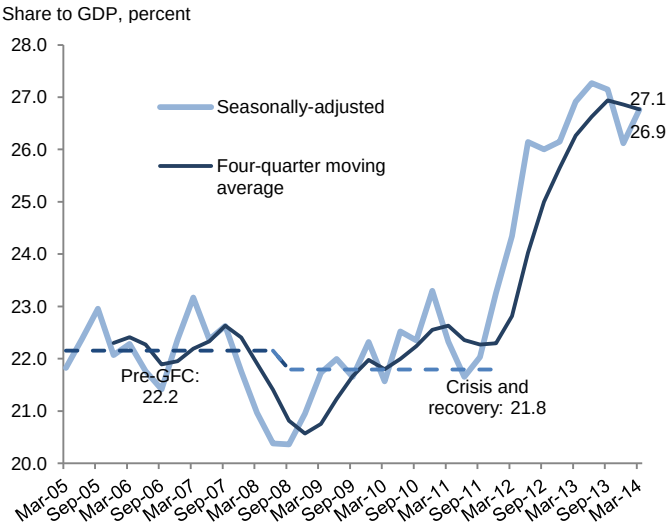
8. Household consumption kept expanding in the face of tighter credit and fiscal conditions. Softer commodities prices (and attendant implications for smallholder households), the fuel subsidy rationalization implemented in September 2013, lower bonuses to civil servants and macro-prudential measures aimed at moderating household credit growth tempered private consumption growth somewhat in 2013 (+7.2 percent vs. +8.2 percent in 2012, y/y), especially in the fourth quarter (-0.8 percent q/q saar). But private consumption picked up again in early 2014 (+6.8 percent q/q saar) as public consumption expanded, labor markets remained robust and credit growth, while somewhat slower, remained buoyant. Government consumption climbed 6.3 percent in 2013 despite contracting in the third and fourth quarters (-9.5 and -3.4 percent q/q saar), respectively, as the Government cut spending on bonuses for civil servants and supplies and services. Public consumption then spiked in early 2014 (+23.3 percent SAAR), however. Overall consumption remains a key driver of growth (Figure 9): consumption of domestic value-added (World Bank estimate) expanded by 7.4 percent in 2013 and by 7.5 percent (y/y) in the first quarter of 2014, contributing 4.0 percentage points to year-on-year growth rates in both periods.

Figure 9. Consumption has been a key driver of growth in domestic demand



Source: CEIC, DOSM and World Bank staff calculations
Note: See Box 1 of World Bank (2012) for an explanation of the estimates of value-added exported and absorbed domestically. Consumption net of imports of consumer goods

Figure 10. The investment-to-GDP ratio stabilized in late 2013 after rising sharply in 2012



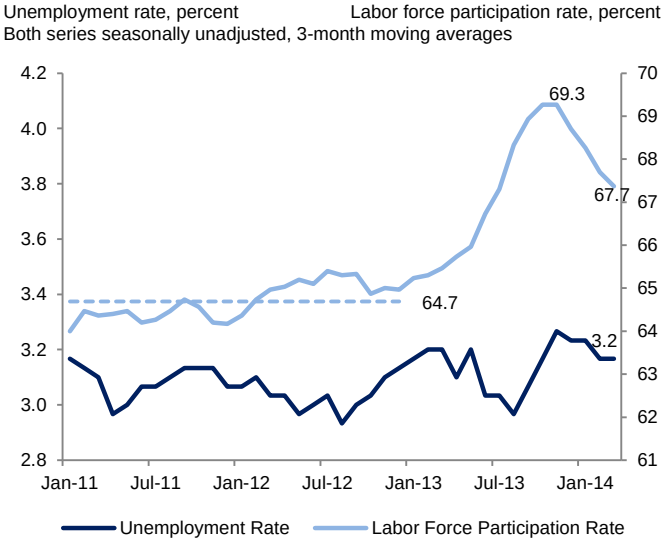
Source: CEIC, DOSM, World Bank staff calculations

9. The high pace of investment moderated as public investment slowed. Public investment grew by just 2.2 percent in 2013 (2012: 14.6 percent) and contracted in the previous two quarters (Q4 2013: -8.1 percent; Q1 2014: -4.0 percent, q/q saar, World Bank estimate) on slower investments by Non-Financial Public Enterprises (NFPEs) and sluggish disbursements of the capital budget. Since many NFPE projects are already underway and some have been completed (such as the LNG regasification terminal in Malacca), tapering of NFPE investment growth was expected. Private fixed investment also slowed, but still posted double-digit growth (+13.1 percent; 2012: +22.8 percent). Private fixed investments continued to decelerate in early 2014 (+6.9 percent q/q saar, World Bank estimate). Overall, gross fixed capital formation expanded by 8.5 percent in 2013 (2012: +19.2 percent) before slowing in early 2014. Growth was mainly supported by sustained momentum in the construction sector, which expanded by 10.9 percent from the previous year, a rate similar to construction investment (11.0 percent). The share of investment to GDP, which climbed quickly in 2012, stabilized at about 27 percent in late 2013 and early 2014, about 5 percentage points higher than the rate in the previous decade (Figure 10).

Strong labor markets support household consumption

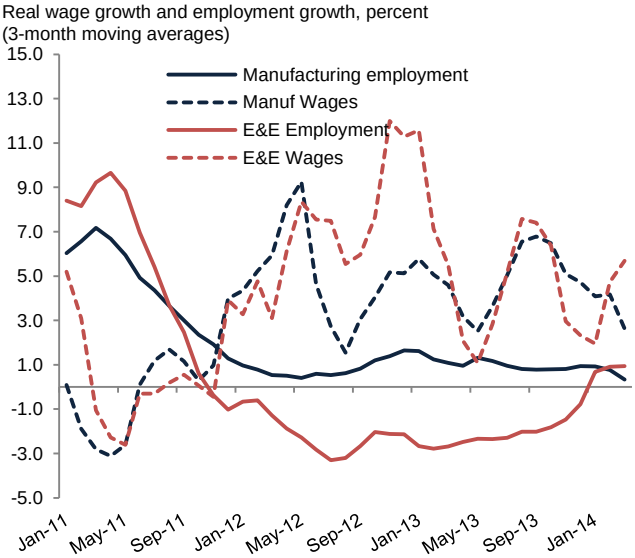
10. Labor markets have been volatile, but generally strong. The labor force participation rate surged by 4.5 percentage points from September 2012 to a peak of 69.6 percent in September 2013. Meanwhile, unemployment remained stable within a narrow range of 3.0 – 3.2 percent (Figure 11). Combined, these two developments reflect significant employment gains in 2013: the economy added 948,200 jobs between December 2012 and December 2013 and the ratio of employed persons to the working-age population climbed 3 percentage points to 67 percent. However, the economy shed 182,000 jobs in the first three months of 2014, as the labor force participation rate retreated[2]. The manufacturing sector made a small contribution, adding over 12,000 jobs in 2013 despite a small decline in E&E employment. E&E employment turned around in early 2014 along with the pick-up in activity of the E&E industry (Figure 12). While manufacturing wage growth slowed in early 2014, E&E wage growth accelerated as the industry offered higher salaries to attract workers; it added over 3,000 jobs (changes in average employment in the first quarter of 2014 compared to 2013) after several months retrenching.

Figure 11. The labor force participation rate declined after surging in 2013



Source: CEIC and World Bank staff calculations

Figure 12. Employment and wages in E&E grew as output expanded



Source: CEIC and World Bank staff calculations

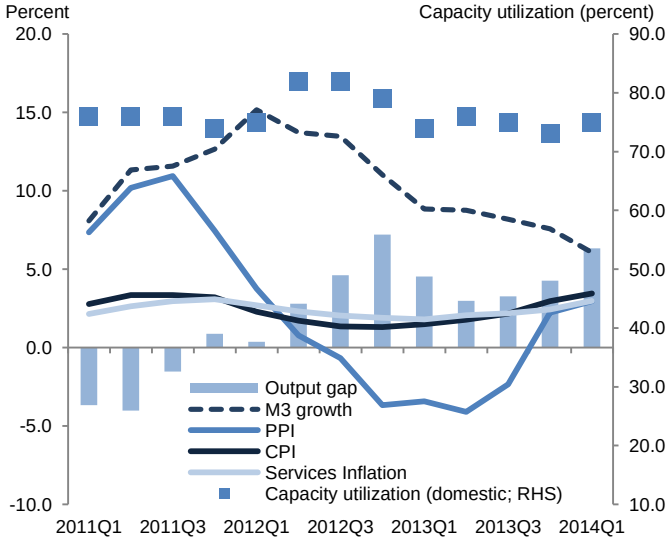
[2] It should be noted that the labor force participation rate (LFP) is also subject to seasonal fluctuations and therefore month-to-month comparisons may not be meaningful. Comparing March 2014 to March 2013 reveals that the LFP was still 1.4 percentage points higher than the previous year, though this represents a significantly lower increase in the LFP when comparing with the year-on-year increase registered in September 2013.

11. There are indications that real wages have increased. Real average manufacturing wages expanded by 4.9 percent in 2013, while real wages in wholesale, retail and repair of motor vehicles rose by 6.1 percent. These wage gains have exceeded real productivity growth. Real output per worker in manufacturing expanded by 4.1 percent, while that in wholesale, retail and motor vehicles expanded by 5.4 percent – in both cases, below the level of wage gains. This may be related to the introduction of a minimum wage, but also reflects tight labor markets in aggregate. Buoyant economic activity boosts labor demand, forcing firms to bid up wages, which in turn provide incentives for more workers to join the labor force. The result for the economy is one of higher household incomes as more household members are working, and on average earning more.

Inflation up on higher administered prices but few signs of second-round effects

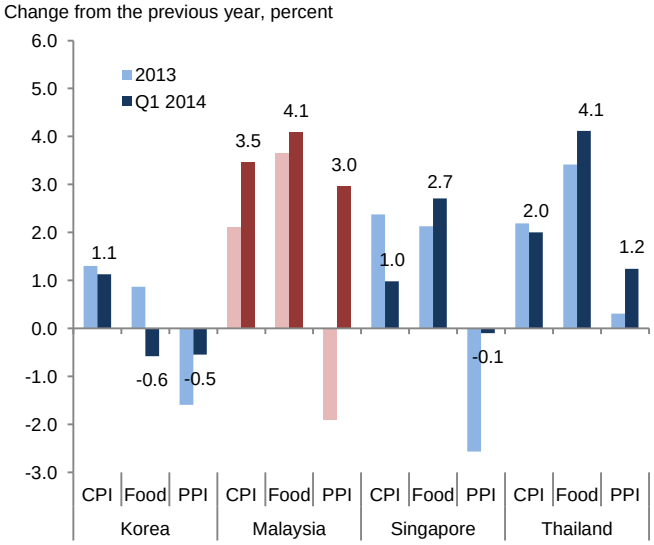
12. Considering the backdrop of tight labor markets, vigorous domestic demand, and higher energy and tobacco prices from subsidy cuts and tax hikes, inflation picked up only modestly in late 2013 and early 2014. Consumer price inflation accelerated from an average of 1.7 percent for the first eight months of 2013 to 2.8 percent in the last four months of 2013, climbing further to average 3.4 percent in the first five months of 2014. While the overall inflation rate is similar in Peninsular Malaysia and Sarawak, prices in Sabah have been rising more slowly, averaging only 2.3 percent in the first five months of 2014. Energy prices increased due to cuts to RON 95 and diesel fuel subsidies, which resulted in RM0.20 hikes in oil prices in September, as well as electricity price hikes between 15 and 17 percent effective in January, and higher natural gas prices to the non-power sector in the second quarter of 2014. Food inflation averaged 3.9 percent in the first five months of 2014 in tandem with a small increase in global food prices (see Figure 7). Excluding food, beverages and energy, "core" inflation increased by only 2.1 percent between January and May of 2014, a modest acceleration from the 1.1 percent average recorded in 2013. The producer price index, which had been negative for the past sixteen months finally turned positive in October likely due to the increase in diesel prices but levels remain moderate at 3.5 percent in April.

Figure 13. Softening demand-side pressures complemented benign supply conditions



Source: CEIC, DOSM, BNM and World Bank staff calculations
Note: Output gap and capacity utilization rates for domestic oriented sectors. Output gap calculated using the Hodrick-Prescott filter to estimate potential GDP

Figure 14. Producer prices have accelerated compared to 2013



Source: CEIC, DOSM and World Bank staff calculations
Note: 1. Red bars highlight Malaysia in cross-country charts
2. Simple averages of monthly rates

13. Inflationary pressures have been building but remain mild thanks to increased capacity. Concerns that higher administered prices may have second-round effects on inflation are intensified by pressure from demand-side factors (Figure 13). On the other hand, credit growth has decelerated and capacity utilization in domestic industries has come down despite the positive output gap, suggesting that the recent surge in investments may have increased domestic capacity and raised potential output. Services inflation – which may be expected to reflect labor market pressures on prices – has increased, but at 3.1 percent in May it remains moderate. Supply conditions have shifted from benign to neutral. On the one hand, oil prices have been stable (Figure 7), but global food prices have

increased in 2014 (though the year-on-year change is still negative), and producer prices across East Asia largely reversed their disinflationary trend due to higher energy prices (Figure 14).

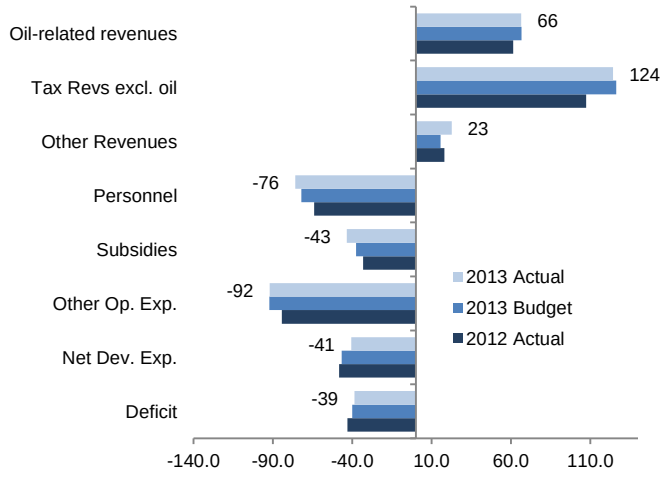
Fiscal and monetary policies gradually becoming less accommodative

14. The Government outperformed its deficit target for 2013 as additional non-tax collections offset higher expenditures on subsidies. Operating (current) expenditures exceeded their budgeted 2013 allocations by RM 9.4 billion (4.6 percent) and tax collections came in lower than budgeted by RM3.2 billion (2.0 percent). Nevertheless, the Government managed to slightly exceed its 2013 target for the overall federal government deficit (4.0 percent of GDP), posting a deficit of 3.9 percent for the year. This was achieved through lower-than-budgeted disbursements of development expenditures (RM 6.0 billion) and additional non-tax revenues (RM 7.9 billion; see Figure 15).

15. After several years exceeding targets, tax revenues came in lower than expected in 2013. This was primarily due to weakness in collection of personal income tax, which increased by just 0.3 percent in 2013 from the previous year (2012: +13.7 percent). Collection of indirect taxes also came in below target. Oil-related revenues came in line with expectations, with PETRONAS' dividend as budgeted, PITA and export duties somewhat lower, and petroleum royalties somewhat higher than originally expected. Oil-related revenues accounted for 31.2 percent of total revenue in 2013 compared to 33.7 percent in 2012. Corporate income taxes continued to demonstrate positive buoyancy[3], growing at a rate of 13.4 percent (2012: +9.4 percent) compared to 4.8 percent for nominal GDP. Despite the weak performance in personal income taxes in 2013, at 8.2 percent of GDP, personal and corporate income taxes continue to rise (2012: 7.9 percent) and are now closer to 2001-2002 levels of 8.6-9.0 percent of GDP.

Figure 15. Despite slower revenue collection, a contraction in development expenditures helped contain the deficit

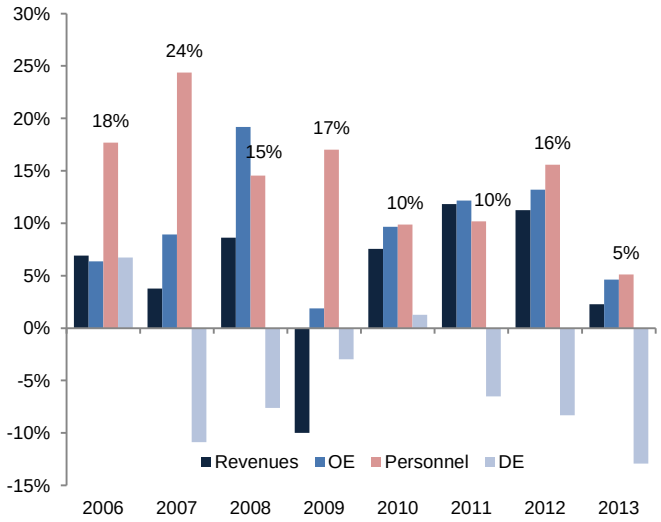
Federal Government finances, RM billions



Source CEIC, MOF, and World Bank staff calculations
Note: 'Personnel' includes emoluments, pensions and gratuities

Figure 16. Deviations from the budget are projected to come in at the lowest levels in recent years

Deviation of actual expenditures from budget, percent



Source: CEIC, MOF and World Bank staff calculations
Note: 'Personnel' includes emoluments, pensions and gratuities

16. A reduction in the growth of personnel spending partly offset significant slippages in subsidies, resulting in overall deceleration in operating expenditures. The expansion in current expenditures came in at a modest 2.8 percent in 2013 compared to 12.6 percent in 2012, with much of the change due to a sharp deceleration in personnel spending. After growing an average 12.6 percent per year between 2000 and 2012, emoluments rose by only 1.6 percent in 2013, the lowest annual growth rate in the past 10 years, supported also by lower bonuses given to civil servants. Expenditures on emoluments, gratuities and pensions continued to exceed original budget allocations, but this is expected to be at a more modest 5 percent in 2013 compared to an average of 10 percent between 2005 and 2012

[3] Growth rate of income taxes exceeds the growth rate of nominal GDP.

(Figure 16). These trends however, belay significant slippages in subsidies. Notwithstanding a slight decline in crude oil prices and the fuel subsidy rationalization in September, which is estimated to have saved the government RM1.1 billion, subsidies (including fuel subsidies and BR1M) are expected to exceed budget allocations by 15 percent.[4,]

17. Disbursements from the development budget shrank further. Development expenditures came in RM6.0 billion (11.6 percent) under budget, falling for the third consecutive year (2013: -8.2 percent; 2012: -2.2 percent). This likely was a major drag on public investment growth (+3.1 percent in 2013 in nominal terms) as investments by the 30 largest NFPEs were projected to increase by 50 percent in 2013. PETRONAS alone expanded investment (in nominal terms) by 25.7 percent to an estimated 5.7 percent of GDP in 2013, of which about 50-60 percent would be domestic investments. On the other hand, major investment projects such as the MRT as well as investments in independent power producers have been undertaken on a public-private partnership basis. Some of these projects are partially financed by government-guaranteed debt, which climbed to 15.9 percent of GDP at end-2013, from 15.2 percent in 2012 and 9.0 percent in 2008.

18. Monetary policy has remained supportive of growth. Bank Negara Malaysia (BNM) has kept its benchmark interest rate (the overnight policy rate, OPR) unchanged at 3.0 percent for over three years now, 50 bps lower than the rate that prevailed between 2006 and 2008. The holding pattern has been driven by counter-balancing forces. On the one hand, domestic demand growth has been robust over the past three years, the output gap has closed, wages seem to be rising, administered prices have started to increase and credit growth remains robust. Against these incipient demand-side forces, global interest rates remain low, the global environment has been weak until very recently, justifying domestic stimulus, and credit growth has been responding to macro-prudential measures. Importantly, inflation has been low and even recent pressures from hikes of administered prices have been mild.

Financial sector performance suggests stabilization in domestic demand

19. Credit growth to businesses moderated and financing from capital markets declined. Loans outstanding grew by 9.9 percent as at end-April 2014 compared to 11.6 percent a year earlier (12-month moving average; Figure 17). Outstanding household loans grew at a stable pace, but the growth of outstanding business loans moderated. Total financing extended through the banking system and private debt securities market to the business sector expanded by 5.1 percent as at end-2013 compared to 10.2 percent as at end-2012. Banking system loans to businesses similarly decelerated, growing 7.5 percent as of end-April 2014 (compared to 11.3 percent a year earlier). Working capital loans, which had been growing relatively slowly picked up, reflecting solid prospects for the economy. New issuances of private debt securities amounted to RM 83.9 billion in 2013, down from RM 121.1 billion in 2012, when several large issues were placed. New issuances amounted to RM 27.9 billion in the first four months of 2014 (Jan-Apr 2013: RM 26.7 billion). Following a record year in 2012, financing via the equity market in 2013 stood at RM16.0 billion.

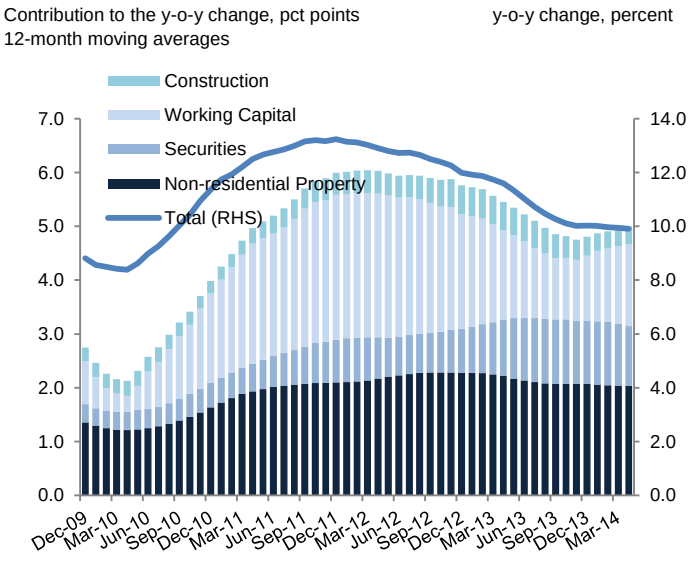
20. Households continued to borrow, especially to buy cars and residential property. Outstanding household loan growth from the banking system moderated marginally to 11.6 percent (y/y, as at end-April 2014), compared to 12.2 percent a year earlier. Despite the moderation in the growth of loans for personal use, credit cards, and, more recently, cars, the overall growth of household loans has been stable due to slightly higher growth in loans for the purchase of residential property, which is the largest category of loans (Figure 18). These patterns in loan growth combined with moderating but continued growth in lending by non-bank financial institutions (NBFIs) have kept household debt relatively high[5]. However, the asset position of households also improved as loans were increasingly taken for asset acquisition, and less for consumption. Since interest rates on mortgage loans are generally tied indirectly to the policy rate, the increase in the stock of mortgage debt held by households (35 percent of GDP as of April 2014 compared to 26 percent of GDP as of April 2008) poses additional challenges for monetary policy, as rate hikes are likely to have a relatively larger impact on household budgets than in the past.

[4] Brent crude oil prices declined by 2.8 percent on average between 2012 and 2013.

[5] According to BNM, as of December 2013, annual growth in outstanding NBFI lending to household sector (including lending by development financial institutions) halved to 9.6 percent (2012: + 22.1 percent). A similar trend was also evident between April 2014 and April 2013.

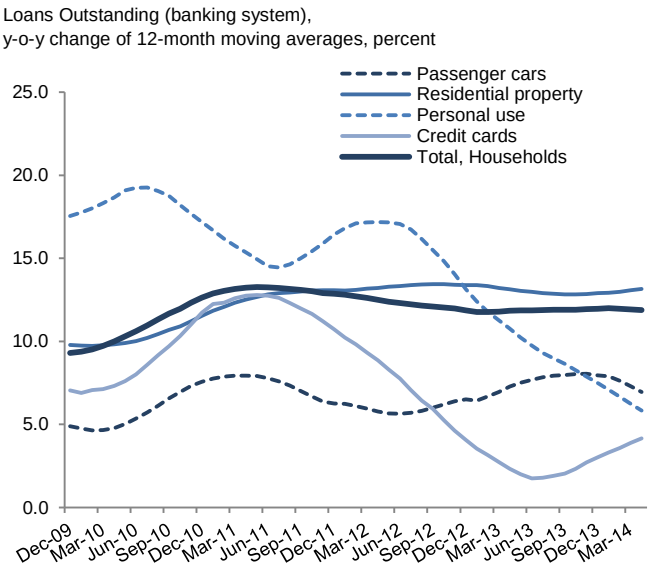
21. Impaired loans remain low, and banks are well-capitalized, mitigating the risk from buoyant credit growth. As of end-April 2014, the Malaysian banking sector remained well capitalized, with the Tier 1 capital ratio at 13.0 percent and total capital ratio at 14.7 percent, above levels required by national authorities and Basel III standards. Tier 1 capital comprised 88.4 percent of total capital. Asset quality was stable with the ratio of non-performing loans holding steady at 1.3 percent as of April 2014, similar to the ratio at end-April 2013. The volume of impaired loans actually contracted by 0.5 percent in April from the previous year, suggesting an improvement in the quality of assets in the banking sector.

Figure 17. Growth in working capital loans picked up again in 2014



Source: BNM and World Bank staff calculations

Figure 18. Household loan growth held steady along with credit for housing and auto purchases



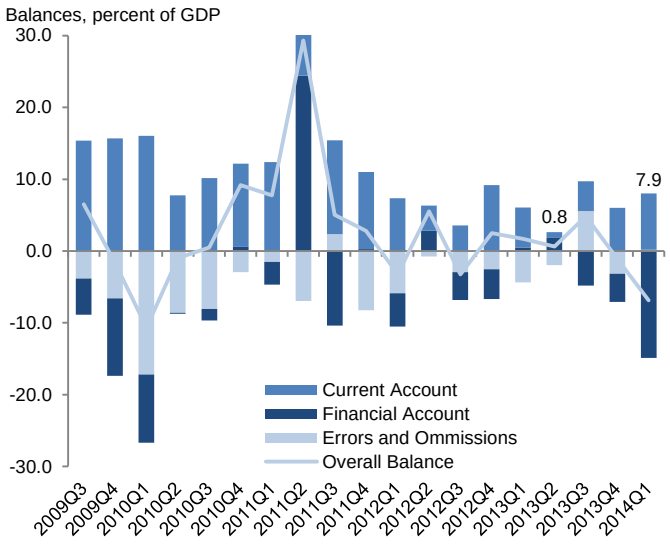
Source: BNM and World Bank staff calculations

A higher current account surplus only partially offsets portfolio outflows

22. Better export performance led to an improvement in Malaysia's current account. Malaysia's current account surplus declined from 15.5 percent of GDP in 2009 to 0.8 percent of GDP in the second quarter of 2013 (Figure 19). For 2013 as a whole, the current account posted a surplus of 4.0 percent of GDP, the lowest level in 15 years. This trend is linked both to the strength in productive domestic investments, which led to a surge in imports of capital goods, construction services and minerals for storage, but also to the weakness in exports of both goods and services. Accordingly, the improved export performance in the previous three quarters helped lift the current account to 7.9 percent of GDP for the first quarter of 2014. Figure 20 points to two proximate causes of this performance: first, the non-commodity balance recently improved thanks to a recovery in E&E exports and lower investment growth; and second, the decline in the commodity balance moderated on higher exports of crude oil in recent months.

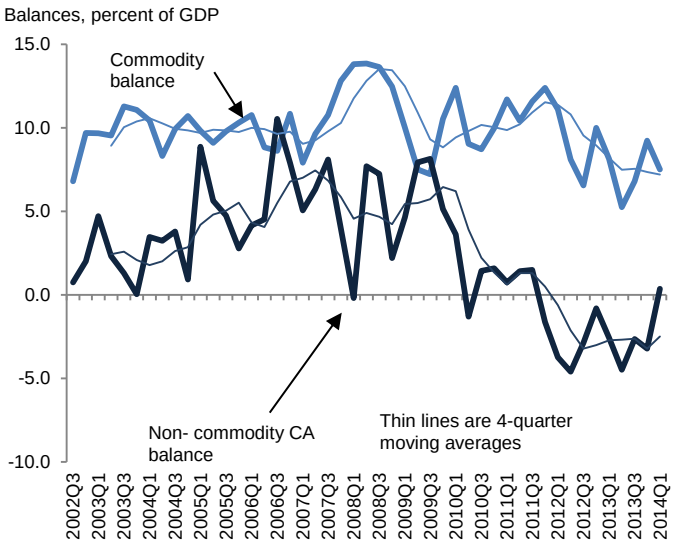
23. Portfolio outflows led to a negative balance in the financial account. Portfolio flows turned negative following signals from the US Federal Reserve in mid-2013 that it was getting ready to gradually reduce monetary accommodation. Foreign investors, who held 29 percent of Malaysian government securities as of March 2013, reduced their holdings as they rebalanced their portfolios (September 2013: 26 percent; March 2014: 27 percent). Outflows were also seen in equity markets, and were most pronounced in the third quarter of 2013 and first quarter of 2014; flows turned positive again in the second quarter of 2014 (Figure 21). Foreign direct investment (FDI) in Malaysia has averaged 3.7 percent of GDP in the past four quarters, slightly above the pre-crisis (2002-2007) average of 3.5 percent of GDP. Direct investment abroad contracted by 17.5 percent in 2013 (y/y) due to a lumpy investment in late 2012 (PETRONAS' USD 6 billion investment in Progress Energy in Canada). As a result, net FDI turned slightly positive (0.8 percent of GDP) in the past three quarters. Given increasing outflows in the three quarters through March 2014 the financial account posted a deficit of RM15.8 billion in 2013 (1.6 percent of yearly GDP, of which 21.4 billion in the second half) and RM 37.6 billion (14.9 percent of quarterly GDP) in the first quarter of 2014 (Figure 22).

Figure 19. A recovery in the current account surplus…



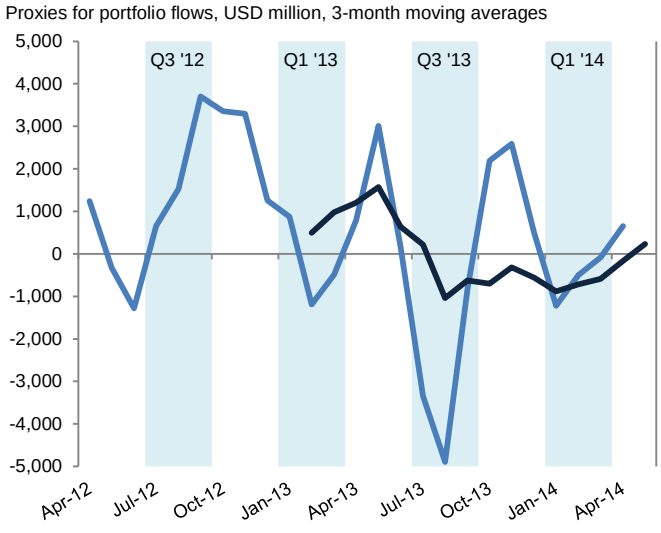
Source: CEIC and World Bank staff calculations

Figure 20. …was helped by improvements in the non-commodity current account balance.



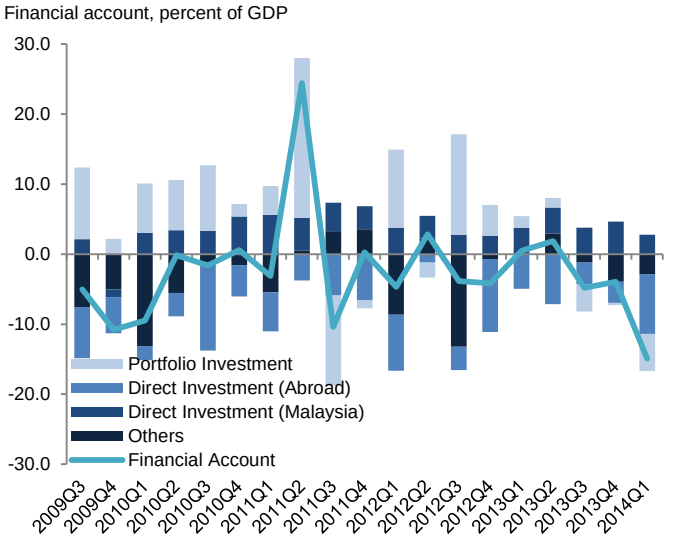
Source: CEIC and World Bank staff calculations
Notes: Commodity-related exports include food, beverages & tobacco; mineral fuels & lubricants; chemicals; animal and vegetable oils and fats

Figure 21. "Tapering" talk led to sales of Malaysian debt and equities by foreigners



Source: CEIC, MIDF and World Bank staff calculations

Figure 22. The financial account posted a deficit in the third quarter due to portfolio outflows



Source: CEIC and World Bank staff calculations

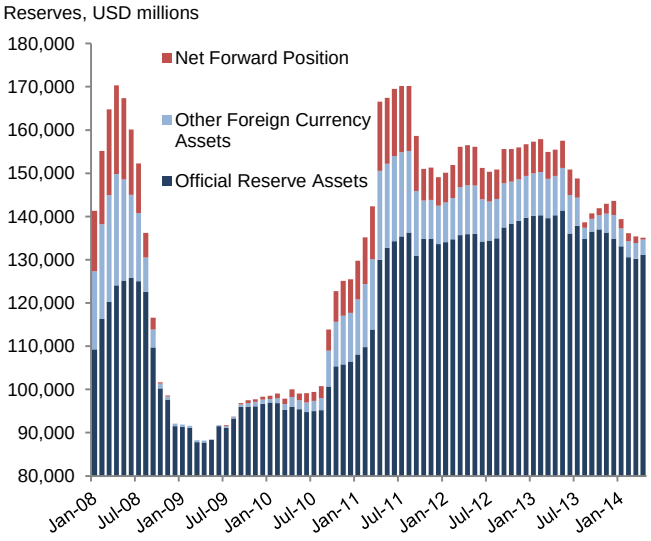
24. Net capital flows were negative in the previous two quarters, implying a decline in international reserves. The improvement in the current account only partly compensated for outflows in the financial account and errors and omissions, leading to overall capital outflows. As in previous episodes of volatility, BNM accommodated outflows first out of reductions in the net forward position and other foreign currency assets[6] before drawing on official reserve assets (Figure 23). Net official international reserves stand at USD 130.9 billion as of May 30, 2014. This level of reserves is sufficient to finance over 9.1 months of retained imports[7] and is 1.3 times the short-term external debt. Given

[6] Other foreign currency assets not included in official reserves, mostly BNM foreign currency deposits with residents.

[7] Retained imports are gross imports less re-exports.

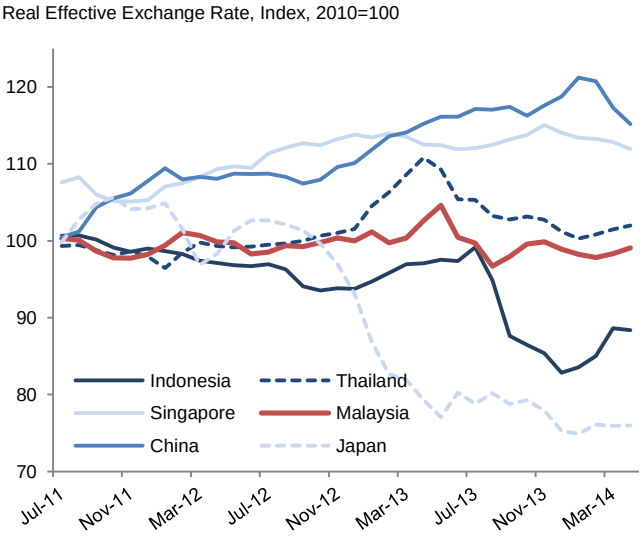
Malaysia's flexible exchange rate regime, outflows led to a nominal depreciation of the Ringgit in mid-2013 (Figure 24), which helped limit the extent of reserve depletion (reserves in fact remained steady in local currency terms).

Figure 23. Reserves are declining, but remain above the levels prior to the Eurozone crisis



Source: IMF
Note: Net Forward Position represents aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the domestic currency (incl. the forward leg of currency swaps)

Figure 24. The Ringgit depreciated between May and August 2013



Source: Bank for International Settlements

External demand will support growth in the near term

25. Malaysia's economic performance in 2014 and 2015 is projected to reflect a relative switch from domestic to external sources of growth. The outlook for the Malaysian economy is underpinned by two opposing trends: (i) a continued improvement in the external environment as the recovery in advanced economies takes hold and generates demand for emerging market exports, and (ii) tighter domestic conditions as policy makers at home and abroad respond to improvements by gradually withdrawing fiscal and monetary policy support. Tightening fiscal and monetary policie in the course of 2014 and 2015 are likely to dampen household consumption and investments. The combined contribution of fixed investments and consumption is expected to decline from 6.8 percentage points in 2013 to 5.7pp in 2014 and 5.3pp in 2015. On the other hand, as the global recovery continues to build momentum, net exports become less of a drag on growth. In 2014, the low base, higher export growth and the rebuilding of inventories that were depleted in 2013 leads growth to accelerate to 5.4 percent. The high base of 2014 leads to a slowdown in 2015, although quarterly growth is expected to accelerate from an average of 3.8 percent (q/q saar) in 2014 to 5.4 percent in 2015. Growth is expected to normalize by 2016 with higher contributions from final consumption. Table 1 and Table 2 present a summary of the forecasts.

Global recovery to remain on firm footing despite slowing growth in China

26. The 'old normal' of narrower growth differentials between advanced and emerging economies looks set to return in 2014 – 2016. Purchasing Managers' Indices (PMIs) in the advanced economies have been generally in growth territory since mid-2013, and remained there into 2014, although at a declining pace. In the Euro area, GDP is expected to grow by 1.1 percent in 2014 and 1.7 percent in 2015 (2013: -0.4 percent).[8] Meanwhile, the outlook is also favorable for the US (+2.1 percent in 2014 and +3.0 percent in 2015 vs. 1.9 percent in 2013) and Japan (+1.3 percent for 2014 and 2015 vs. +0.5 percent average for 2002-2007). Growth in emerging economies, especially China, is expected to moderate from recent peaks. China's PMI has diverged from the PMIs in G3 economies (Figure 25), and despite recently-enacted supportive measures, growth is expected to slow down to 7.6 percent in 2014 and 7.5

[8] Unless noted otherwise, all GDP forecasts are from the June 2014 Global Economic Prospects (World Bank 2014).

percent in 2015 (+11.6 percent in 2003-07). Prospects in the large ASEAN economies are also not bright and as a result, the difference in average growth rate between developing and advanced economies is expected to narrow to 2.9 percentage points (pp) in 2014 and 3.0 pp in 2015, compared to 4.3 pp in 2011. Given the relative size of advanced economies, these developments are likely to provide a net boost to global import demand and present opportunities for an export-oriented economy like Malaysia (see Box 1 for more details).

Table 1. GDP growth is expected to be maintained in 2014 and beyond…

Year-on-Year Growth Rates, percent

	2013	2014f	2015f	2016f
GDP	4.7	5.4	4.6	5.0
Domestic demand	6.4	6.3	5.7	6.3
Final consumption	7.0	5.7	5.1	6.3
Private sector	7.2	6.5	5.6	6.6
Public sector	6.3	2.6	3.0	5.2
GFCF	8.5	7.4	7.0	6.4
External demand	-12.6	-6.0	-12.3	-19.3
Exports of G&S	0.6	6.3	6.2	5.9
Imports of G&S	2.0	7.3	7.6	7.4

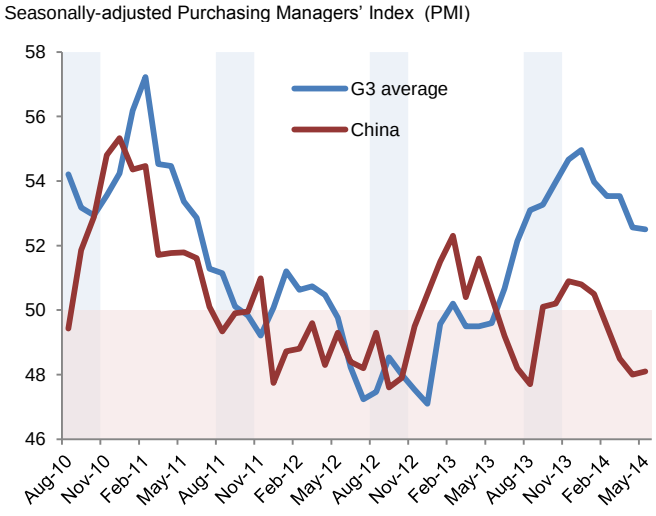
Table 2. …as exports compensate for weaker domestic demand in the near term

Contributions to GDP Growth, percentage points

	2013	2014f	2015f	2016f
GDP	4.7	5.4	4.6	5.0
Domestic demand	5.8	5.8	5.3	6.0
Final consumption	4.5	3.7	3.3	4.2
Private sector	3.6	3.4	3.0	3.5
Public sector	0.8	0.4	0.4	0.7
GFCF	2.3	2.0	2.0	1.8
Change in Stocks	-0.9	0.1	0.0	0.0
External demand	-1.1	-0.4	-0.8	-1.0
Exports of G&S	0.6	5.6	5.6	5.4
Imports of G&S	-1.7	-6.0	-6.3	-6.4

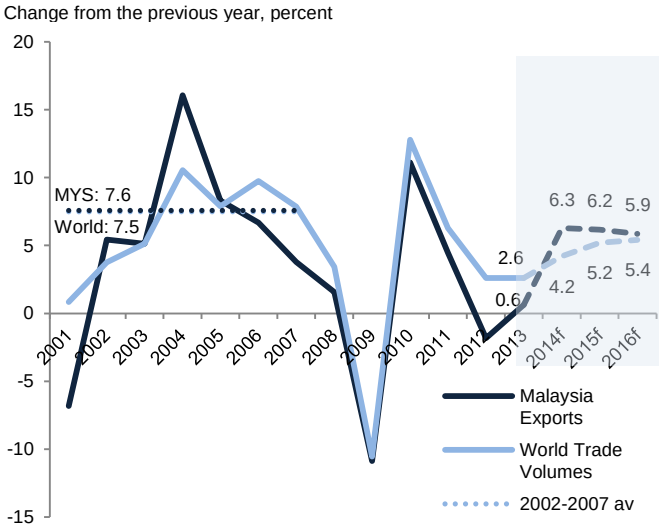
Source: CEIC, DOSM, World Bank staff calculations and projections; f=forecast.

Figure 25. The PMIs of China and the G3 decoupled in late 2013



Source: Bloomberg (Japan, Euro area), HSBC (China), CEIC (US)
Note: Simple average of PMIs for US. Euro area and Japan

Figure 26. World trade volumes are not expected to return to pre-crisis levels in the medium-term



Source: CEIC, World Bank Development Prospects Group and World Bank staff calculations
Note: World Bank forecasts as of June 2013

27. Export growth is expected to pick up momentum into 2014 and 2015. Export growth will be driven by higher energy commodity and petrochemical production, as new investments start to come online. A continued pick-up in E&E demand, as suggested by the Singapore electronics PMI (which remains on an expansionary mode, albeit weakly) and the recent response of Malaysia's E&E sector to improved demand conditions (perhaps aided by continued political uncertainty in Thailand) will make a substantial contribution. Based on a relatively favorable outlook for the global economy and gradual pick up in the output of energy commodities and E&E, Malaysia's exports are projected to expand by 6.3 percent in real terms 2014 and 6.2 percent in 2015. These rates are below Malaysia's pre-crisis averages of 7.6 percent export growth but above expected growth in global trade volumes, especially in 2014

due to the low base in 2013 (Figure 26). The negative contribution from net exports will continue in 2014-2016 but will narrow considerably (-0.4, -0.8 and -1.0 percentage points respectively).

Box 1. Slower growth in China vs. faster growth in high-income economies: are there effects on growth in East Asia?

Slower growth in China as it deleverages and rebalances its economy has raised concerns that developing countries (especially commodity exporters like Malaysia) will see current accounts balances deteriorate and growth slow, due to weaker import demand from China.

While certainly a valid concern, the slowing of Chinese growth unfolds against a backdrop of stronger growth in the high income world that, depending on the degree of trade dependence on China and type of trade, will offset the trade headwinds coming from China. Indeed, strengthening high-income demand partly explained the surge in developing country merchandise exports which rose at a 19 percent annualized pace in the final quarter of 2013, bolstering end-year GDP growth in a number of economies, including Malaysia. Momentum has eased since then, reflecting weakness in China and weather disruptions in the US, but should recover as these economies re-accelerate — to the benefit of developing economies with close trade linkages to the US and Euro Area.

On balance, rising high income demand should more than compensate for slowing Chinese import demand. Model simulations indicate that in response to a 1 percentage point increase in high income growth and a corresponding slowdown in China, growth rises by 0.24 percentage points in developing countries (excluding China), 0.22 percentage points in East Asia (ex-China) and 0.29 percentage points in Latin America and the Caribbean region.

Commodity exporters, notably metals exporters, benefit somewhat less due to China's large demand share in global metals markets. More generally, fears of Chinese growth's influence on developing country growth may be overblown. Slower growth in China in the post-crisis period had a negligible impact on the rest of East Asia, despite China being a major client for the region's commodities, and its intermediate and final goods. Although average Chinese growth fell from 11.6 percent in the period 2003-07 to 9.7 percent in the post-crisis period, growth in the rest of the region remained broadly stable and robust at around 5.5 percent.

Firms in the region have been able to leverage their underlying competitiveness and expanding supply potential to find other markets to offset the slower demand growth coming from China — in much the same way as growth in developing countries accelerated between 1995 and 2007 — even as growth in high-income countries was slowing (World Bank, 2012a).

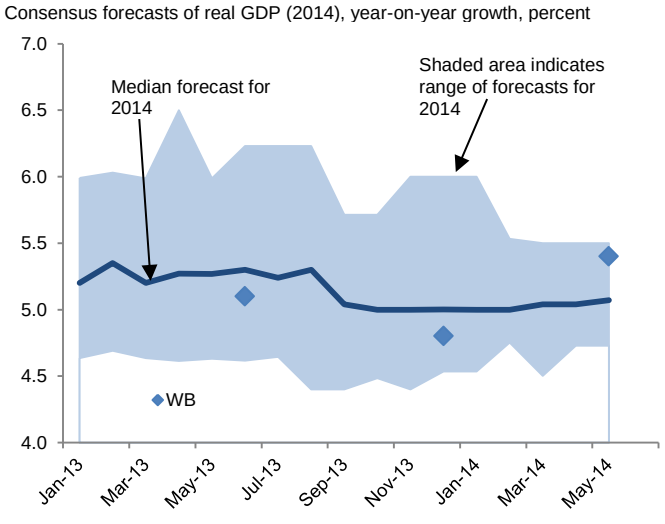
Source: Excerpted from World Bank (2014).

Headwinds on domestic demand to pick up

28. Several factors will create a drag on domestic demand and private consumption in particular. First, fiscal consolidation is expected to continue in earnest in 2014. Second, while tapering may be linked to a boost to the external sector (which in turn may spill-over to domestic sectors), the direct impact of higher interest rates or a weaker currency on both consumption and investment would be negative. Third, commodity prices are unlikely to make significant gains for a third year, impacting spending by agricultural households. Finally, households will be pressed to maintain the spending growth of recent years in the face of higher debt servicing costs and hikes in administered prices. Notwithstanding the headwinds, labor market conditions remain strong, and the Government is expected continue to provide cash transfers in lieu of subsidies, which would partially offset the impact of subsidy cuts on consumption. Consumption is expected to moderate accordingly and growth is expected to moderate from 7.2 percent in 2013 to 6.5 percent in 2014 (2015: +5.6 percent; 2016: 6.6 percent), before picking up to 7.2 percent in 2015. Growth in government consumption is expected to moderate significantly due to fiscal consolidation, from 6.3 percent in 2013 to 2.9 percent in 2014 and 3.0 percent in 2015 (2016: +5.2 percent).

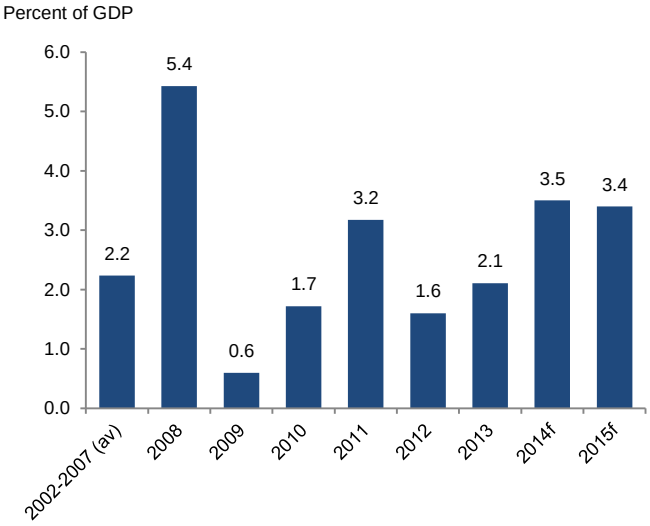
29. Gross fixed capital formation (GFCF) will continue to grow faster than GDP, but at a slowing rate. Given expectations of improvement in the global environment in 2014 as well as the significant pipeline of investment projects led by PETRONAS' Pengerang Integrated Complex (PIC) in Southern Johor, GFCF should continue to make an important contribution to growth[9]. Nevertheless, some dampening of the momentum is expected given the high base effect as well as the impact of tapering, higher global interest rates, and fiscal consolidation, which may also revive talks of sequencing certain investments with high import content. Real gross fixed capital formation is expected to decelerate from 8.5 percent in 2013 to 7.4 percent in 2014 (2015: +7.0 percent; 2016: +6.4 percent). As GFCF growth is expected to remain above GDP growth in the medium term, the share of investments in GDP is expected to climb further from 27.7 percent in 2013 to 29.2 percent of GDP in 2016.

Figure 27. Forecasts for 2014 growth have remained stable…



Source: Consensus Economics, World Bank staff calculations and projections

Figure 28. Inflation is expected to pick up modestly in 2014 and 2015



Source: CEIC, DOSM, World Bank staff projections

30. Overall, on a year-on-year basis Malaysia is expected to register real GDP growth of 5.4 percent in 2014, decelerating due to base effects to 4.6 percent in 2015 before normalizing to 5.0 percent in 2016. The contribution of domestic demand will decline as exports pick up. Domestic demand as defined in the national accounts (total consumption and investment) is expected to contribute 5.8 and 5.3 percentage points to GDP growth in 2014 and 2015, down from 9.8 percentage points in 2012 (Table 1). The World Bank's forecast for 2014 lies 0.3 percentage point above the median consensus forecast (as of June; Figure 27) and that for 2015 somewhat below the median consensus estimate. On a quarter-on-quarter basis, the forecast assumes a 3.8 percent average annualized growth in 2014. Headline GDP growth projections have been increased for 2014 compared to those in the December 2013 Malaysia Economic Monitor due to economic expansion surprising on the upside in the first quarter of 2014 and the further improvement in external conditions.

31. Changes in administered prices and the introduction of the GST will lead to a modest pick-up in inflation in 2014 and 2015. Malaysia's headline inflation rate is projected to come at around 3.5 percent in 2014 (2013: 2.1 percent), moderating to 3.4 percent in 2015 (Figure 28). The forecast for 2014-2015 is higher than the average rate observed during the 2002-2007 period (2.2 percent) due to the low base in 2013, strength in domestic demand, hikes in fuel prices, electricity tariffs and tobacco taxes, and finally the broader implementation of the minimum wage. These factors are tempered by the continuation of benign supply conditions, as indicated by the expectation of stable

[9] The proposed PIC comprises a world scale Refinery and Petrochemical Integrated Development (RAPID) and other associated facilities. RAPID is estimated to cost about US$16 billion while the associated facilities will involve an investment of about US$11 billion. The project is expected to start in 2014 and be completed by 2019.

commodity prices. Inflation is expected to come at 3.0 percent in 2016, as the base effects from fiscal consolidation in 2014 wane.

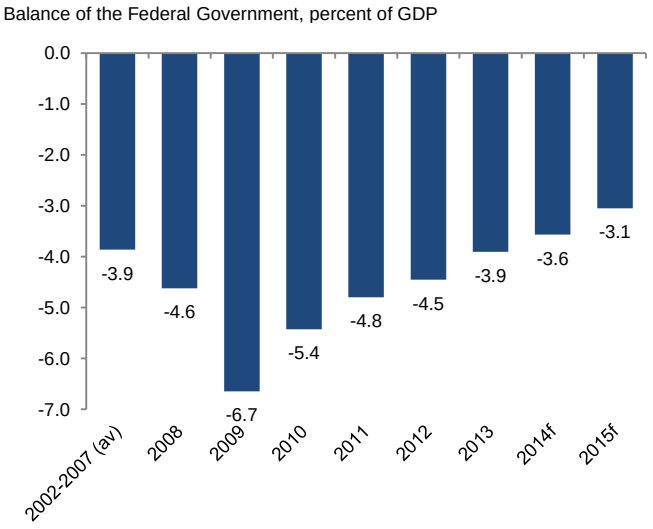
Fiscal and monetary accommodation to be reduced in 2014 and 2015

32. Fiscal consolidation will have to take place primarily through spending restraint rather than revenue gains. The Government reaffirmed its commitment to achieving a budget deficit of 3.5 percent of GDP in 2014 and 3.0 percent in 2015. The 2014 targets are premised on realistic projections for moderate revenue growth including a further reduction in oil-related revenues. The revenue-to-GDP ratio is in fact projected to decline to 21.2 percent of GDP in 2014 from 22.1 percent in 2012. Although the GST is likely to provide additional revenues starting in 2015, there is limited immediate potential for significant upside, especially with additional tax breaks that are coming online with the introduction of GST as well as pressure at that time to delay further adjustments to administered prices. Therefore, the reduction in the deficit will need to be achieved through expenditure restraint.

33. Slower growth in emoluments and a reduction in subsidies will be the drivers of consolidation. Spending on personnel (wages, pensions and gratuities) is projected to expand by a modest 4.5 percent in 2014. Ensuring that spending on emoluments consistently comes close to budgeted allocations, as was the case in 2013, will be critical to the consolidation effort and also to build the credibility of the budget. The bulk of the consolidation effort targets subsidies. The Government abolished the sugar subsidy, which is expected to save RM 500-600 million in 2014 compared to 2013. However, most of the contraction in the subsidy bill comes from fuel subsidies. The Government has recently announced plans to reduce the volume of subsidized fuel through better targeting of fuel subsidies. Further details are required to assess whether to meet the Government's ambitious targets these measures are sufficient without further reductions in the quantum of subsidies.[10]

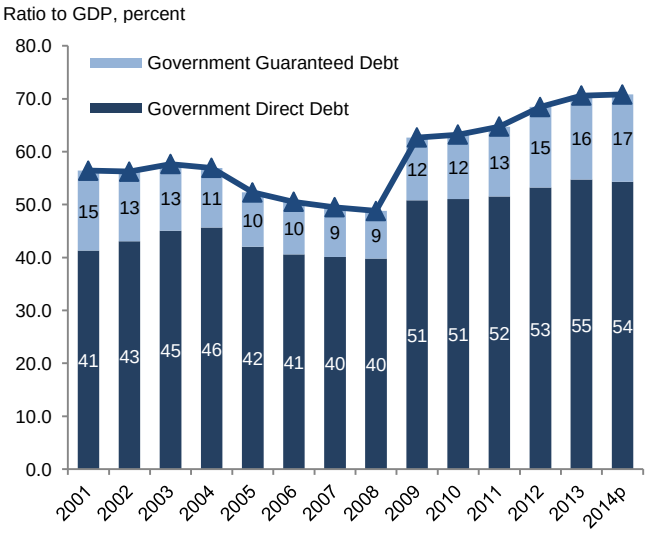
34. The introduction of the GST will support consolidation efforts in the medium-term. The main fiscal policy reform introduced in the 2014 budget was the announcement that a Goods and Services Tax (GST) would be implemented in April 2015 at a rate of 6 percent, with cash transfers expanded to mitigate the impact both of the GST and subsidy cuts on lower-income households. GST is expected to eventually broaden the tax base and diversify it from oil-revenues, ensuring greater buoyancy of revenues in the medium-term.

Figure 29. Despite higher expenditures, the federal balance is expected to improve



Source: CEIC, MOF, and World Bank staff calculations and projections

Figure 30. Debt levels are expected to stabilize in 2014



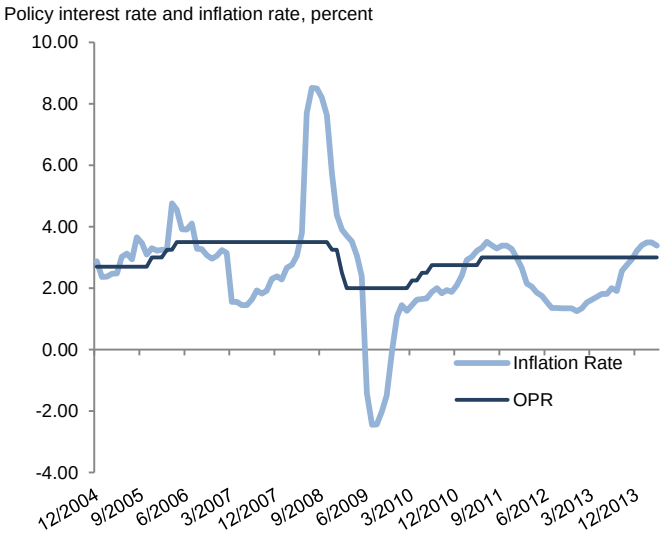
Source: CEIC, MOF, World Bank staff projections

[10] The allocation for fuel subsidies has been reduced by 23 percent, but the allocation for BR1M, which is included in the same line as fuel subsidies, has been increased by 12 percent on account of the expansion of the program. Therefore, the 'actual' spending on fuel subsidies needs to contract by RM7.1 billion or 28.6 percent in 2014 in order for the target to be met.

35. As a result of consolidation, debt levels are expected to decline. To signal its commitment to fiscal prudence, the Government will continue to make a significant effort to meet its deficit targets. Given continued momentum for fiscal consolidation in 2014 and 2015, the deficit is projected to remain on a downward trajectory, though challenges in fully implementing subsidy reforms in 2014 and reduced headroom to increase revenues mean that the headline deficit could be narrowly missed (Figure 29). Declining deficit levels are expected to lead to a reduction in the ratio of federal government debt to GDP from 54.8 to 54.3 percent, while contingent liabilities are expected to continue to increase (Figure 30). Long-term fiscal sustainability will require continuing on the path of consolidation, while carefully monitoring and managing contingent liabilities and other sources of fiscal risk.[11]

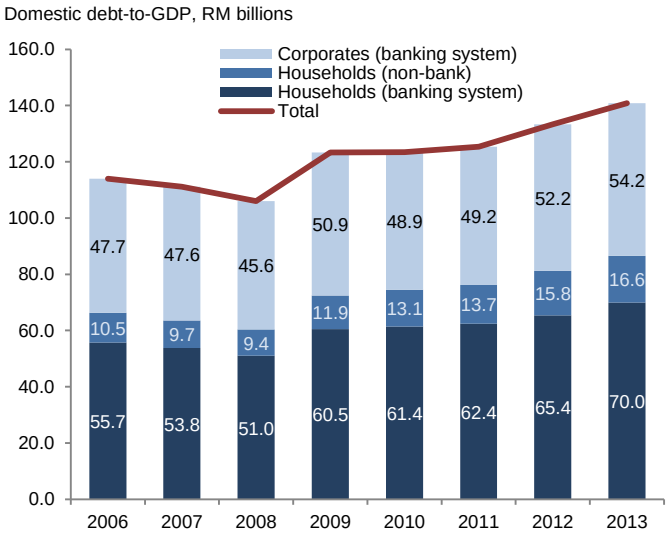
36. Bank Negara has signaled that it may have to tighten policy to avoid the build-up of financial imbalances. So far BNM has been managing risks of financial imbalances primarily through macro-prudential regulations. In 2012 and 2013, BNM issued guidelines that require financial institutions to assess borrowers based on net rather than gross income and, among other things, established a maximum loan tenure of 10 years for personal financing and a maximum of 35 years for financing granted for the purchase of residential and non-residential properties, as well as the prohibition of pre-approved personal financing products. Although such efforts have borne fruit (credit growth continued to decelerate, albeit slowly, in 2013), there is concern that the real interest rate has become negative (Figure 31), and that household debt has continued to climb, reaching 86.5 percent in 2013 from 81.3 percent in 2012 (Figure 32). BNM accordingly noted that "the current monetary and financial conditions could lead to a broader build up in economic and financial imbalances. Going forward, the degree of monetary accommodation may need to be adjusted to ensure that the risks arising from the accumulation of these imbalances would not undermine the growth prospects of the Malaysian economy." To ensure that future changes in monetary policy stance is adequately transmitted to borrowers, BNM has also reformed the interest rate framework, effective January 2015.

Figure 31. Real policy rates turned negative in early 2014



Source: CEIC, DOSM, BNM
Note: Calculated subtracting current inflation from the policy rate

Figure 32. Household debt continued to build in 2013, even as corporate leverage was stable



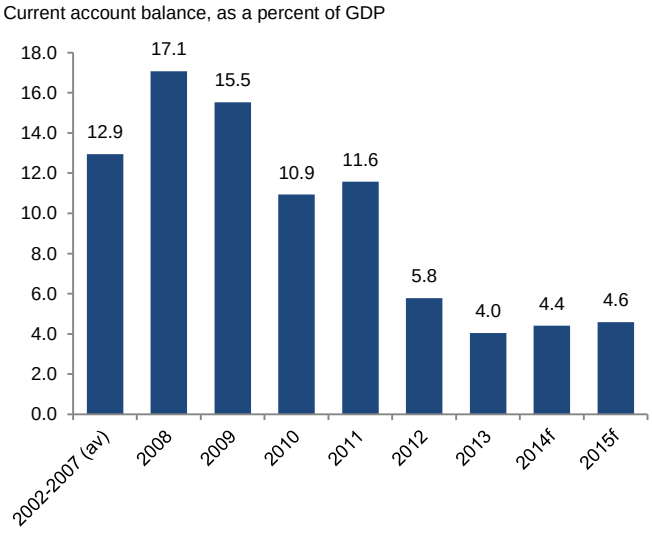
Source: CEIC, BNM, IMF and World Bank staff calculations
Note: Corporates (banking system) corresponds to other depository corporation claims on private sector less banking system loans to households. Excludes private debt securities, which are estimated at 29.8 percent of GDP in 2013

[11] Contingent liabilities include contingent commitments under PPPs and government guarantees, among others. Non-debt liabilities include unfunded pension liabilities and non-contingent commitments under PPPs such as capital leases.

The current account should stabilize at a modest surplus

37. The current account surplus is expected to stabilize above 4 percent of GDP. A recovery in exports accompanied by a dampening of domestic demand would lead the current account surplus to stabilize as a percentage of GDP at 4.4 percent in 2014 and 4.6 percent in 2016 (Figure 33). The current account surpluses in 2014 and 2015 increase only slightly despite more moderate investment growth and higher in exports due to lower commodity prices, the projection of a positive contribution from inventory investments (much of which are imported parts), and the high import content of E&E exports, which are expected to pick up as part of the export recovery.

Figure 33. The current account is expected to remain in surplus, albeit a narrowing one



Source: CEIC, DOSM, and World Bank staff projections

Risks now more evenly external and domestic

38. The uncertainty about the favorable outlook for the global economy has receded, but the balance of risks remains on the downside. Risks have not changed materially in the past six months and include a disorderly exit from quantitative easing in advanced economies, substantially slower growth in China and a sharp decline in commodity prices. Although the US has started normalizing monetary policy, the EU has recently come up with further monetary stimulus to fight deflation, providing at short-term support to global liquidity as well. In addition, Chinese policy makers have levers to prevent growth from crossing a lower-bound threshold (which also contributes to stable commodity prices). Therefore, while these risks cannot be written off, they appear to have receded for the near term. Domestic risks are perhaps more salient and include larger than expected spillovers from fiscal and credit tightening on domestic demand as households deleverage, and a failure of export-oriented industries to fully capitalize on improved demand conditions due to supply constraints. While Malaysia's export performance in the past five months provides some reassurance with respect to the latter risk, the full impact of fiscal and monetary tightening is yet to be seen.

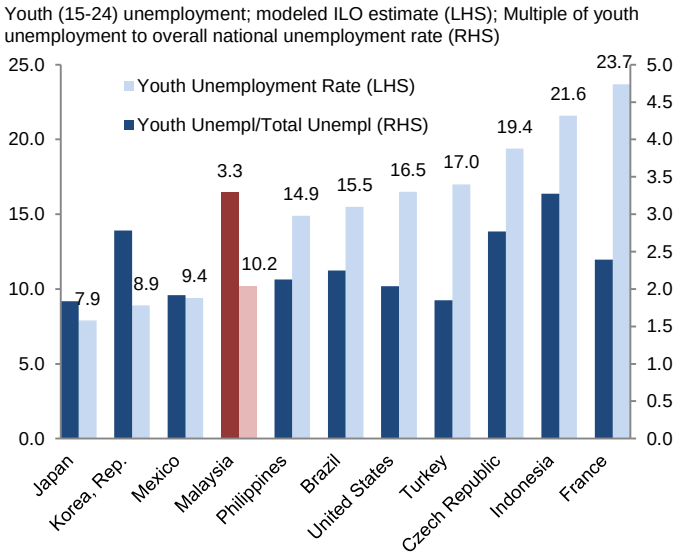
2. SELECTED ISSUE NOTE

A. Matching Talent to Jobs

Fallow talent amidst a talent shortage?

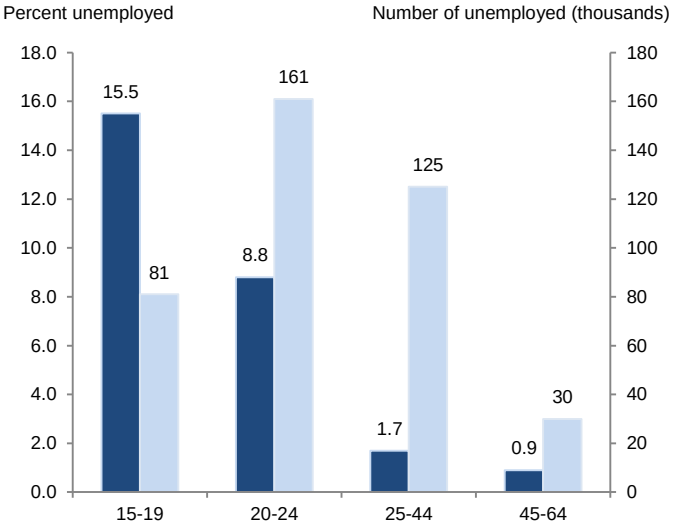
39. Youth unemployment in Malaysia presents a puzzle: if the economy requires increasing numbers of talented workers, why does a relatively large share of better-educated youth have trouble finding a job? At 10.2 percent (2012), the unemployment rate among 15-24 year-olds in Malaysia is not particularly high when compared to other economies (Figure 34). Youth unemployment is also typically higher than the overall unemployment rate (all darker bars in Figure 34 are above 1). But in Malaysia the ratio of youth unemployment to overall unemployment appears high at 3.3 times and 60 percent of all unemployed workers in Malaysia are between 15 and 24 (Figure 35). Of special concern is the concentration of the unemployed among 20-24 year-olds, as this cohort of workers is relatively well-educated. The number of workers with a tertiary education rose by 46 percent between 2007 and 2012, largely due to new entrants likely to be in the 20-24 age group in 2012 and many of whom fresh graduates. According to the MoHE (2013), in 2012, a quarter of all graduates had not secured employment at graduation, and World Bank (2013) finds that nearly one in five degree holders under the age of 25 were unemployed in 2012.

Figure 34. The youth unemployment rate in Malaysia is not atypical



Source: WDI, ILO
Note: Figures are for reference year 2012

Figure 35. Unemployment is concentrated among the youth in Malaysia



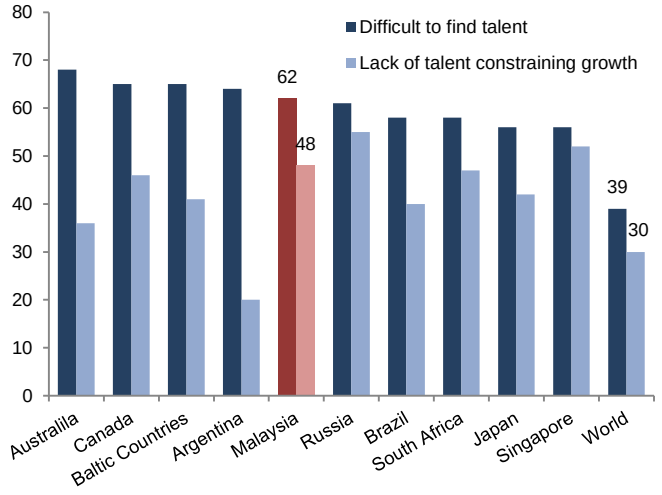
Source: DOSM (Labor Force Statistics Time Series), 2012 and World Bank staff calculations

40. On the other hand, firms regularly cite talent as one of their top business challenges. A recent survey conducted by global consultancy Grant Thornton (2013) finds that 62 percent of Malaysian firms have difficulty finding skilled workers, and 48 percent identify lack of talent as a constraint for future growth (Figure 36). These are similar to findings of 2007 Productivity and Investment Climate Survey, where 40 percent of Malaysian firms reported not being able to fill their vacancies due to shortages of skilled production workers. The demand for skilled talent is only set to increase further; across all National Key Economic Areas (NKEAs), most firms already demand basic Mathematics and communication skills, even for mid-tier positions (Figure 37).

41. To enhance the employability of its youth, Malaysia needs to address the mismatch in skills formation and build a functioning feedback mechanism between educational institutions and the industry. This note probes into some of the causes of the skills mismatch with evidence from a survey conducted by TalentCorp and the World Bank (see Box 2 for details), and suggests policy options to address the potential causes.

Figure 36. Firms say they cannot find fresh graduates with the necessary skills

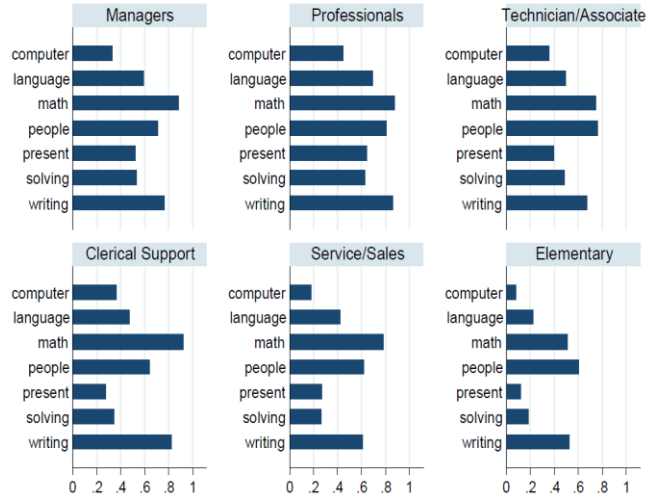
Share of respondents agreeing, percent



Source: Grant-Thornton International Business Report 2013

Figure 37. Most NKEA firms require Math and writing skills even for mid-level jobs

Share of NKEA firms requiring the skill for a given occupation, percent



Source: World Bank 2013

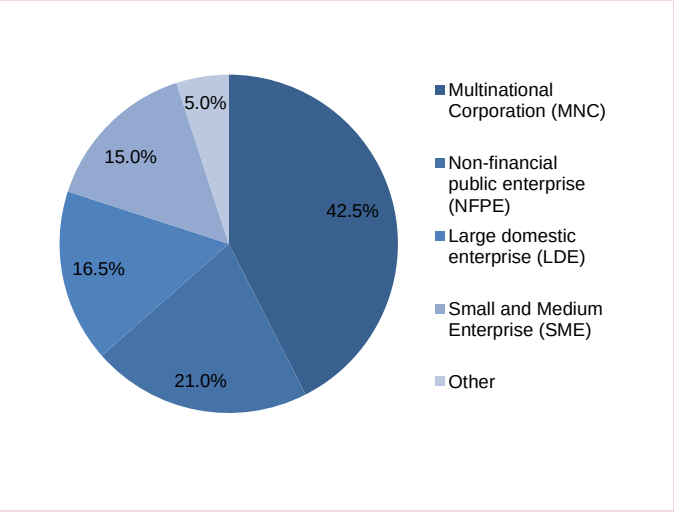
Box 2. The World Bank-TalentCorp Survey on Graduate Employability

In 2014, TalentCorp, in collaboration with the World Bank, conducted a graduate employability survey to learn more about trends in graduate employability in Malaysia, the perceived quality of Malaysian graduates by top employers, as well as the efficacy of career services in universities and Government-funded graduate employability programs. The survey was conducted from March 28 to April 18 2014 on line, via telephone and in person

The survey covered 200 companies that employ around 245,000 workers and represent a wide cross-section of National Key Economic Areas (NKEAs). Most respondents were foreign multinationals (43 percent), followed by non-financial public enterprises (including government-linked companies), large domestic enterprises (both listed and unlisted) and SMEs (Figure 38). Other institutions comprised of several government/not-for-profit bodies. With respect to sectors of activity, respondents represented over 14 NKEAs, notably education (18 percent), manufacturing (15 percent) and agriculture (13 percent); see Figure 39.

Figure 38. Surveyed companies by type

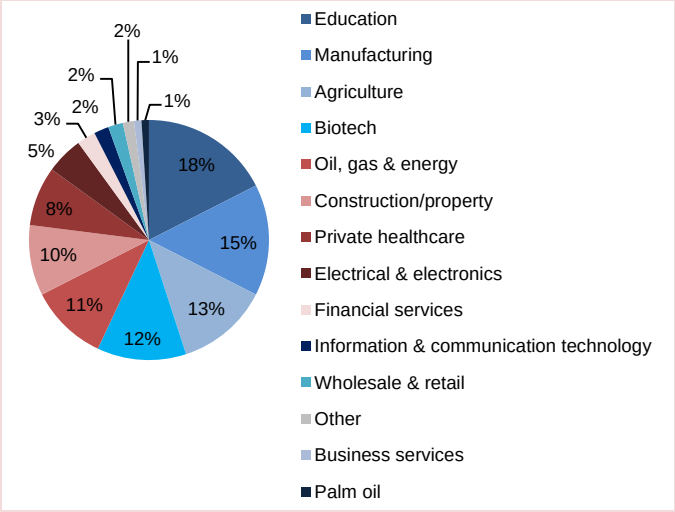
Percent



Source: World Bank / TalentCorp 2014

Figure 39. Surveyed companies by industry

Percent



Source: World Bank / TalentCorp 2014

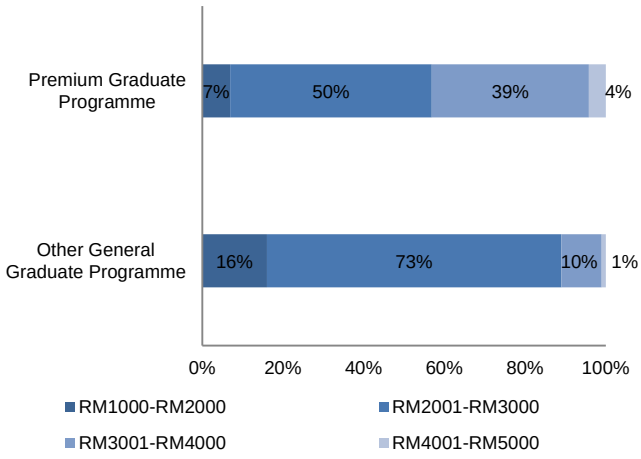
Source: Authors

Companies seem to be willing to pay for talent – when they find it

42. Graduate unemployment is not necessarily linked to inadequate salary incentives for skilled graduates. One possible explanation for the relatively high rate of graduate unemployment could be employers' unwillingness to offer the level of compensation needed to meet the expectations of recent graduates and attract the required talent. In a 2011 Jobstreet survey, employers claimed many graduates have "unrealistic" salary expectations. Hays (2014, p. 29) shows that a graduate accountant makes about 2.5 times more in Singapore compared to Malaysia despite similar qualifications; this may influence the salary expectations of Malaysian graduates and their willingness to take up available positions. While pay levels could be relevant in specific sectors, many companies say they do pay premium wages for graduates with the right skills. About 75 percent companies responded that they have introduced premium graduate programs to recruit their top entry-level talent (including management trainee programs), in addition to their existing general graduate programs. According to the survey, 43 percent of companies interviewed paid these 'premium' entry-level graduates between RM3,000 – RM5,000 a month (Figure 40). By contrast, only 11 percent of respondents paid general entry-level graduates the same salary.

Figure 40. Employers are willing to pay a premium for soft skills.

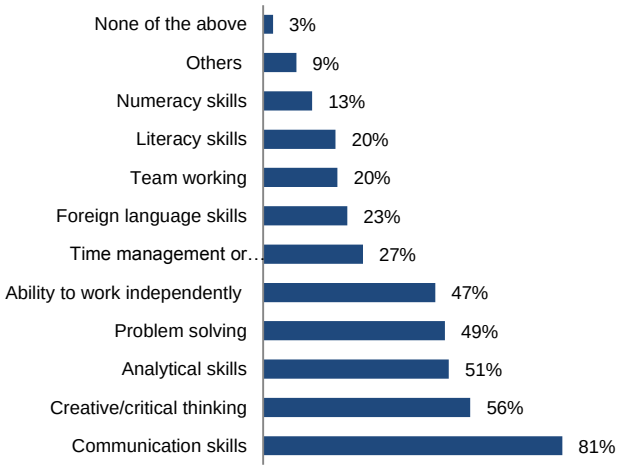
Share of respondents according to salary range, percent



Source: TalentCorp/World Bank 2014

Figure 41. Fresh graduates from local universities lack soft skills

Share of respondents citing skill deficits in fresh graduates, percent



Source: TalentCorp/World Bank 2014

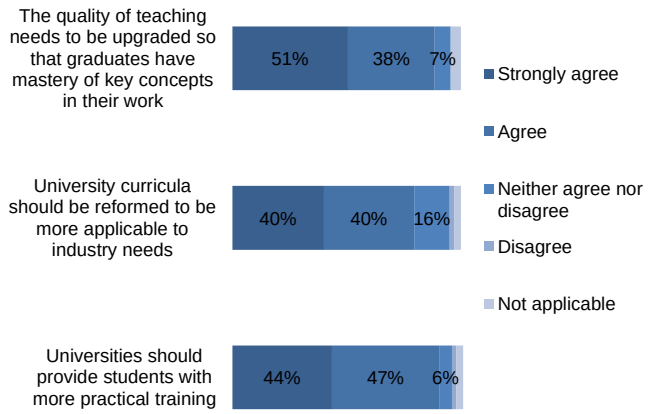
43. A main driver of graduate unemployment according to survey respondents are skills mismatches between recent graduates and employers' demands. Employers increasingly view soft skills – such as the ability to think critically and creatively, and to communicate and work independently – as a key factor in hiring entry-level graduates, but graduates from Malaysian universities seem to be lacking in these areas. According to the survey, 81 percent of all respondents identify communication skills as the major deficit, followed by creative/critical thinking, analytical and problem-solving competencies (Figure 41). For 65 percent of firms answering this question, the overall lack of skills is the main difficulty in recruiting local graduates.

44. The skills mismatch is primarily linked to deficiencies in the post-secondary education system, which has not evolved in tandem with industry needs. Companies overwhelmingly agree that the content and quality of local university education do not adequately prepare students for the workforce. 90 percent of all companies surveyed think that universities should provide students with more practical training, while 80 percent think that universities should consider reforming university curricula to reflect the current realities of the labor market (Figure 42). The majority of companies also think that universities need to improve the quality of teaching, given that many fresh graduates do not demonstrate mastery of key concepts related to their job scope. Consistent with these views, firms rank foreign universities well above domestic institutes, especially with respect to soft skills. Interestingly, private higher

education institutions (IPTS) rank higher among employers across all skills areas, but again particularly with respect to soft skills, strongly suggesting this to be a major area of deficit (Figure 43).[12]

Figure 42. Firms do not think that universities prepare students for the workplace

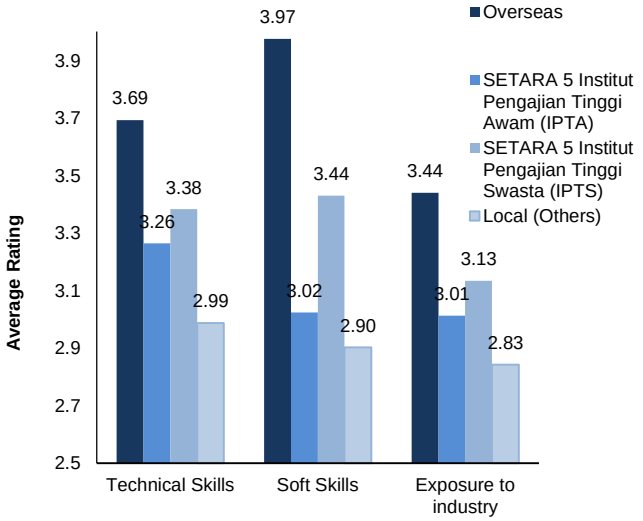
Share of respondents who agree/disagree, percentage



Source: TalentCorp/World Bank 2014

Figure 43. Graduates from foreign universities are more favorably ranked, especially for soft skills

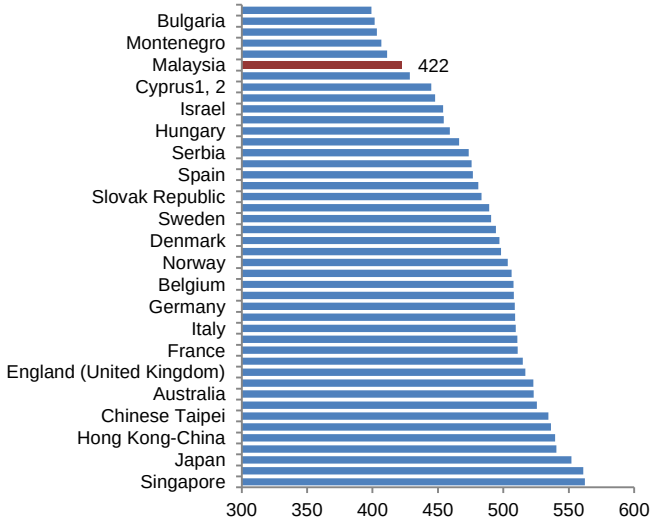
Average skill rating by university type



Source: TalentCorp/World Bank 2014

Figure 44. Malaysian students rank in the bottom quintile in an international test of creative problem solving

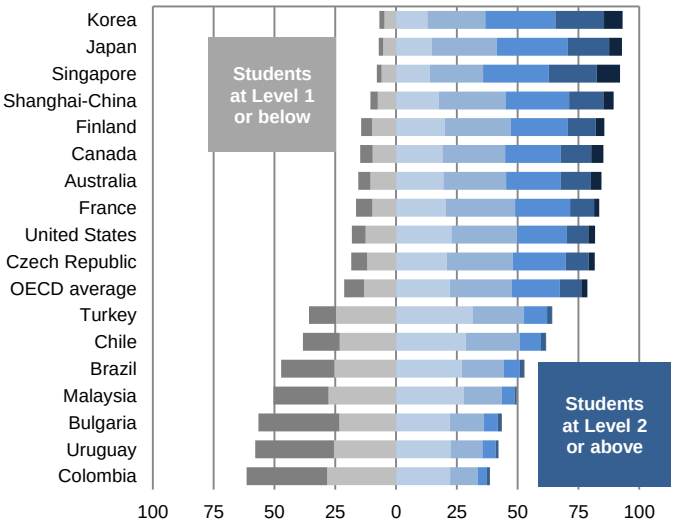
Score in PISA problem-solving assessment



Source: OECD 2014

Figure 45. Only half of Malaysian students can solve unfamiliar problems

Percentage of students at the different levels of problem-solving proficiency



Source: OECD 2014

Note: Level 1 students can partially explore familiar problem scenarios and only solve straightforward problems. Level 2 students can explore and partially understand unfamiliar problem scenarios, test a simple hypothesis and solve problems with a single, specific constraint.

45. At one level, the identified weaknesses in producing graduates with adequate soft skills can be traced back to basic education. While the onus is on universities to produce the required skills for the labor market, addressing shortcomings in basic education are critical. Consider problem-solving skills, which half of the respondents said was

[12] Nevertheless, the tracer study conducted in 2013 by MoE recorded graduate unemployment for IPTA at 24.5 percent compared to 26.6 percent for IPTS.

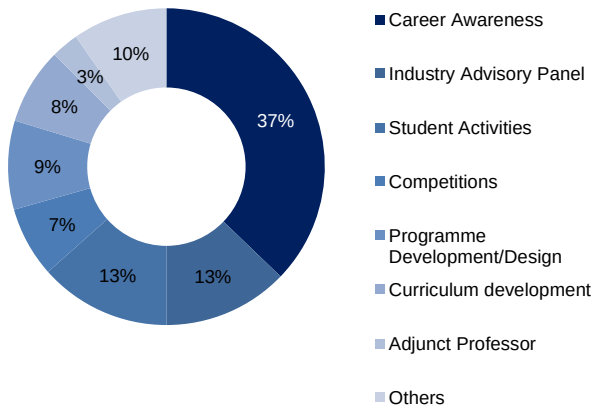
lacking in Malaysian graduates (Figure 41). In the most recent PISA assessment of creative problem solving conducted in 2012 (OECD, 2014), 15 year-old students performed relatively poorly, with about half of students unable to understand even a small part of an unfamiliar problem (Figure 44 and Figure 45). Students carry these deficiencies up to the tertiary level, where the emphasis shifts to developing in-depth technical knowledge of a subject as opposed to improving these skills, which are nonetheless highly prized in labor markets.

Limited interaction between employers and institutions of higher education

46. The skills mismatch is exacerbated by the lack of communication between universities and firms on how to develop employable graduates. Universities cannot produce graduates who are ready for the workforce unless they develop a clear, accurate understanding of what firms are looking for in entry-level employees and incorporate these requirements into the course curricula, teaching and assessment methods, or other means. Unfortunately, most companies do not currently engage with local universities on such a strategic level, nor communicate their views of what or how students should be learning in order to boost their employability. Less than 10 percent of companies who responded to the survey have had experience in developing curricula or joint programs with universities (Figure 46). The representation of industry professionals in the teaching faculty of universities is also meagre, with only 3 percent of respondents having participated in the classroom as adjunct professors.

Figure 46. Companies largely do not cooperate with universities to inculcate students with the right skills…

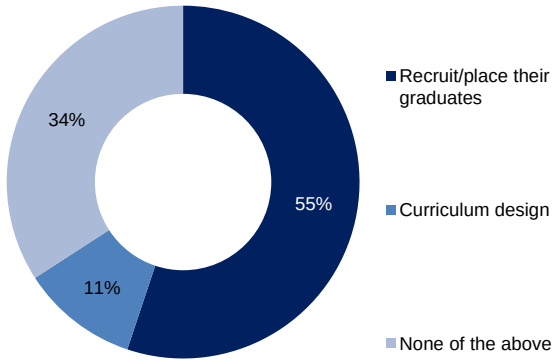
Share of respondents, percent



Source: TalentCorp/World Bank 2014

Figure 47. … nor do they always collaborate to recruit/place graduates into the workforce.

Share of respondents, percent



Source: TalentCorp/World Bank 2014

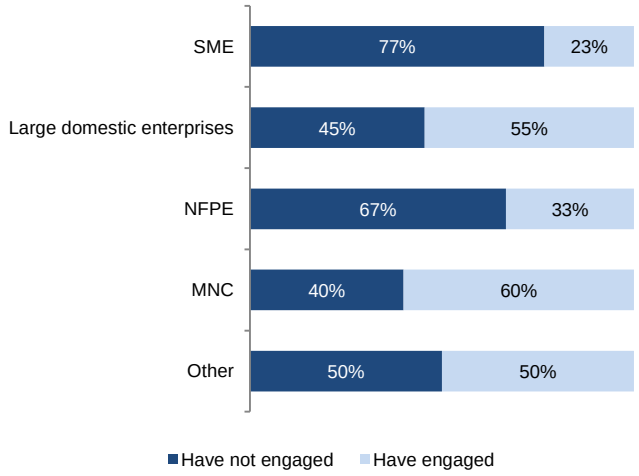
47. Even at the recruitment stage, companies and universities do not always cooperate in matching graduating students with entry-level opportunities. Through industry awareness, networking or recruitment events, universities provide first-time job seekers with important opportunities to interact with potential employers and understand the specific qualifications/skills they are looking for. In turn, these events should help firms identify and recruit high-performing students. Although this appears to be the case for the majority of respondents in the survey, cooperation between local universities and firms in this regard is far from ideal. 34 percent of firms have never approached universities to recruit candidates, nor been approached by universities to place their graduates into entry-level positions (Figure 47). If graduating students do not have access to potential employers through other means, they may not be aware of the full range of opportunities available to them, or fully understand the requirements of entry-level positions in their fields to position themselves competitively in the application process.

48. Career services centers are underutilized and do not fully understand companies' needs. Universities' career services centers should be the primary link between students and the labor market, matching students with the appropriate types of professional opportunities, providing career counselling and other types of support during the job search process. In Malaysia, they are somewhat under-utilized: 53 percent of survey respondents said that they do not work with these centers. Engagement with career services centers is lowest among SMEs at 23 percent, followed

by NFPEs at 33 percent (Figure 48). Even companies that have engaged with such services are largely ambivalent on their effectiveness; 43 percent of survey respondents opted to remain neutral on the question of whether career services centers are effective in matching students with the firm's needs (Figure 49). While firms' perceptions of career services may vary according to industry, the findings reinforce the overall absence of a functioning mechanism for feedback and cooperation between universities and firms to address the skills mismatch.

Figure 48. With the exception of MNCs, half of all companies do not engage with career services centers…

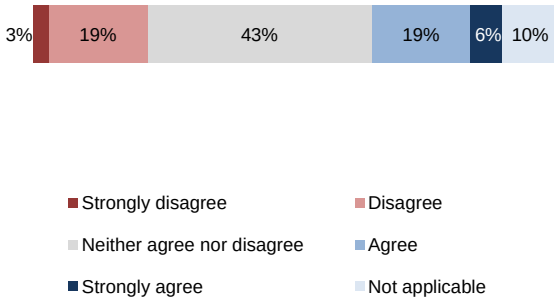
Share of respondents who have/have not engaged with university career services, percentage, percent



Source: TalentCorp/World Bank 2014

Figure 49. …and those who have are ambivalent about their effectiveness.

Share of respondents who agree/disagree with the statement that university career services are effective at matching employers' needs, percent



Source: TalentCorp/World Bank 2014

Preventive measures to address the root causes of the skills mismatch among recent graduates

49. Malaysia has made efforts to help unemployed graduates enter the workforce, but more attention and resources must be given to deficiencies in the education system that lead a relatively large share of graduates to become unemployed in the first place. Many existing programs to address graduate employability are targeted at those who already have degrees, and/or been unemployed for six months or more. Greater emphasis may be given to preventative measures that focus on boosting students' employability before they graduate from university and enable graduates to find employment without relying on government resources.

50. In order to align the skills imparted in universities with those required by employers, there must be greater collaboration between universities and firms to improve the quality and content of university education. Post-secondary education can take into account labor market needs to ensure that students graduate with relevant skill sets. At a minimum, industry experts could be involved in efforts to improve and develop university curricula to ensure that students develop the necessary soft and technical skills required for a particular field. For example, the City College of Chicago conducted interviews with employers and partnered with firms to narrow the skills gap among its graduates in key sectors of the local economy (see Box 3 for details). Apart from improving content, industry experts may also be invited to teach short courses at universities, support final year projects or participate as board members of higher education institutions. In addition, the Ministry of Higher Education may consider establishing permanent mechanisms for ongoing dialogue between universities and firms on how to improve graduates' employability. One benchmark for such efforts is New Zealand, where the Tertiary Education Commission funded "experts in residence" from industries to increase the relevance of curricula and developed a Business Links Fund to formalize industry input into curricular design (OECD, 2008). Strengthening collaborations with firms will also enhance the responsiveness of universities to the changes in industry demand, enhancing their ability to produce graduates with the relevant skills sets.

Box 3. Solving the Skills Mismatch – City College of Chicago's "Reinvention Campaign"

The City College of Chicago (CCC) is one of the largest community college systems in the United States, with more than 115,000 students in 2012. In 2010, a review of CCC found that programming was not related to employer needs, with courses either misaligned with or insufficient for the current skills demands of employers. In particular, there was a mismatch between fields in which well-paying jobs were growing and enrollment in and completion of related CCC courses.

The CCC subsequently launched a reinvention initiative to ensure that more students receive credentials with more economic value. For example, recognizing the importance of the local manufacturing sector to Chicago's economy, CCC mapped out five career levels in the local manufacturing sector, from low-skilled employment (materials handler) to high-skilled employment (manager). From interviews with industry employers and experts, they found that entry-level students were viewed as underprepared and that a more highly specialized core curriculum was needed. CCC then partnered with employers such as Caterpillar and Kraft to develop their curriculum and programming to fit these needs.

Source: Authors

51. Greater involvement of the private sector in training and producing high-quality graduates is likely to have significant payoffs. According to the TalentCorp/World Bank survey, only half of the companies that responded to this question offer structured internship programs, which can help expose university students to a variety of career paths and help them develop the requisite soft skills for any position. More companies must be incentivized to provide apprenticeship opportunities to students across a variety of sectors and functions. Although a positive relationship between internships/apprenticeships and employment can be observed over time, the impact of these opportunities on students largely depend on the quality of the experience. Therefore, companies would benefit from ensuring that these opportunities are structured to help students develop professional, communication and personal skills that are relevant to the job, while providing interns with mentorship and guidance. In Malaysia, benchmarks such as the Human Resource Development Fund's Industrial Training Scheme (ITS), Multimedia Development Corporation's (MDeC) MSC Malaysia Undergraduate Apprenticeship and Development Programme (UGRAD) and TalentCorp's Structured Internship Program (see Box 4) may be utilized to promote higher quality industry exposure for students. The more progressive graduate employers in Malaysia have also been known to promote industry exposure through supporting final year projects, running business competitions and hosting career awareness programs.

Box 4. Increasing Industry Exposure – TalentCorp's Structured Internship Program

TalentCorp, in collaboration with the Ministry of Higher Education, initiated the Structured Internship Program (SIP) in 2011 to tackle the talent shortage and help produce employable fresh graduates. Under the SIP, companies offer internships for a minimum duration of 10 weeks with focused learning outcomes that develop students' technical, personal and business competence. Participating companies must also offer interns a monthly allowance of not less than RM500. To ensure that companies focus on developing local talent, only Malaysian undergraduates from local universities are eligible to apply.

In 2013, more than 10,000 students were placed as interns in over 1,000 companies in the country. Undergraduates gain relevant experience and exposure to priority sectors of the economy, while participating companies gain a platform to assess and select interns with the potential to become full-time hires, as well as tax deductions on internship training-related expenses of up to an average of RM5,000 per intern for each assessment year.

Source: Authors

52. The capacity and effectiveness of career services offices can be significantly improved to prepare students for the job search process. Universities' career services centers are often the primary link between students and employers, providing students with information on careers and firms with a qualified pool of candidates from which to tap into. However, the survey results suggest that there is vast room for improvement for career services in Malaysian higher education. An unpublished study by the Boston Consulting Group suggests that career services centers can play expanded roles to enhance graduate employability by hiring staff with the expertise to fulfil three main roles: a) provide professional advice to students on career paths, resume-writing and the interview process; b) improve student marketability to employers and c) develop partnerships with external firms for industry visits and to recruit candidates.

53. Universities and the government can help increase students' awareness of career options and access to information regarding the labor market. One possible reason for the skills mismatch is that students often do not have adequate information to select higher education courses that match labor market demands, and end up with non-marketable degrees for their areas of interest (Ministry of Higher Education, 2012). To address this issue, the Government could encourage students to explore a variety of careers even before they enter university by disseminating comprehensive, accurate information on career options and their academic requirements. Although Malaysia already has online portals such as Ready4Work.my and IWANT2B, it can learn from countries such as Chile and Italy, which have developed interactive labor market portals that support students and graduates seeking employment (Box 5). In addition, the Government can take steps to augment the ILMIA workforce dashboard to raise greater awareness of careers in high demand. Another option to improve coordination among young job-seekers, labor market demands and education institutions could be to develop a list of occupations and skills that are currently in shortage. In the United Kingdom, the Migration Advisory Committee's skills shortage list is regularly updated and used as a policy tool to influence workforce planning and to guide curriculum development and student intake by higher education institutions (Box 6).

Box 5. Preparing students for the job search: interactive online portals in Italy and Chile

Managed by a consortium of universities together with the Ministry of Education, University and Research, Italy's ***AlmaLaurea*** program caters to students, graduates, employers and universities. Among its main offerings are online publishing of resumes, free resume writing services, current job postings, employers' profiles, and other job search tools. Regular reports on graduates' employability are also published.

Chile's ***Mi Futuro*** portal, also supported by the Ministry of Education, provides comprehensive information of a hundred different professional and technical careers. Students can look for a program by level, area, or career, be redirected to external websites containing information on career and work in other countries, and access an online library of information on the employability of technical and professional graduates.

The Ministry of Education's **Graduados Colombia** provides detailed information on the profiles of workers in different occupations, such as their education levels, salaries and average time taken to find their first job. In addition, updated information on the demand and supply of workers in the Colombian labor market is provided. They also direct graduates to online job vacancies and provide resume writing services.

Source: Authors

Box 6. The Skills Shortage List in the UK

Established in 2007, the Migration Advisory Committee (MAC) is a public body that provides evidence-based advice to the UK Government on its immigration system. In recent years, MAC was asked to develop an occupational shortage list to guide the UK Government on the professions that could qualify as part of the skilled stream of its immigration program (Tier 2 – jobs that cannot be filled by settled workers). See Table 3 for an example.

MAC developed the list using: 1) top-down analysis based on national-level datasets to identify shortages at the occupational level and 2) bottom-up analysis based on consultations with sector experts to identify individual job titles not identifiable through national data analysis.

To assess skill-shortages, MAC uses national data and considers twelve indicators falling in four broad categories: 1) employer-based indicators (e.g. reports of shortage), 2) price-based indicators (e.g. earnings growth), 3) volume-based indicators (e.g. employment or unemployment) and 4) indicators of imbalance based on administrative data (e.g. vacancy duration or unemployment ratios). In order to be considered in shortage, an occupation needs to be above a given threshold in at least 6 of the available indicators (green-light approach).

A key feature of the list developed by MAC is its dynamism. Each indicator is updated as soon as new data is available. The list is provided to training institutions so that they can focus on forming these skills.

Table 3. Example of the Skills Shortages List

Job title	SOC 2000 Occupation		SOC 2010 Occupation	
Geophysicist specialist	2113	Physicists, geologists and meteorologists	2113	Physical scientists
Geophysicist				
Geoscientist				
Hydro-geologist				
Geo-mechanical engineer	2121	Civil engineers	2121	Civil engineers
Geotechnical specialist				
Engineer – petroleum				
Engineer – reservoir, panel				
Engineer, rock mechanics				
Engineer, soil mechanics				

Source: Adapted from the Skilled Shortage Sensible 2013, Migration Advisory Committee, United Kingdom

Corrective measures to help unemployed graduates could be enhanced

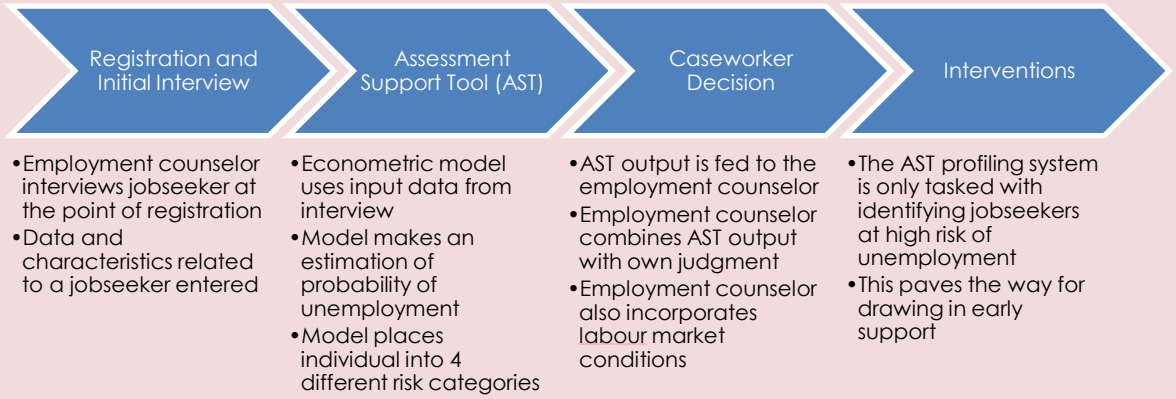
54. Malaysia has a number of programs to support recent graduates who cannot find a job. Following the National Graduate Employability Blueprint 2012 – 2017, the Government has implemented several training programs for unemployed graduates to boost their chances of finding employment, with some success. For example, the Graduate Employment Management Scheme (GEMS) has placed 12,000 unemployed graduates into the workforce since its inception in 2009 by training them in soft and sector-specific skills (TalentCorp, 2014).

55. Government-funded training programs to boost the productivity of unemployed graduates and unskilled workers could be reviewed to ensure their relevance to firms' needs. Feedback from employers on programs to meet the skills shortage among workers and recent graduates suggests that these programs could be improved. While 72 percent of respondents of the Graduate Employability Survey are aware of at least one government-funded training program, only 28 percent of companies view participation in such programs as an important factor affecting their hiring decisions. Moreover, despite the evidence from the National Employment Return survey (2011) showing that training has a positive impact of firms' productivity, only 24 percent of companies report having a partnership with a training provider.

56. Addressing the skills gap among unemployed graduates requires a thorough understanding of who is unemployed, and why. Given the relatively high number of unemployed graduates in the country and various government agencies with programs for unemployed graduates, the Government needs to differentiate between the various types of unemployed graduates, the reasons why they are unable to find work, and the interventions that must be taken to help them find employment. Profiling (see Box 7) could help policymakers to: 1) assess the likely duration of unemployment for jobless graduates, 2) differentiate between easy- and difficult-to-place jobseekers, 3) define the intensity of services offered and identify the type of support that could successfully place the person into the workforce. Better profiling of unemployed graduates will not only make it easier for government agencies to identify the appropriate type of intervention and prioritize the highest-need groups, but also ensure that public resources are used efficiently to enhance graduate employability.

Box 7. Profiling unemployed workers in Sweden

Sweden uses profiling to ensure that its programs to help people find employment are effective and efficient. It uses a mix of caseworker discretion, screening and statistical profiling to help match those individuals most at-risk of long-term unemployment with adequate government resources.



Source: Advanced Profiling of Jobseekers in Public Employment Services, World Bank