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Introduction: Middle income trap

- Definition:

Bhattacharya et. al, 2011

- The middle income trap refers to a situation whereby a middle-income country is failing in its transition to a high-income economy due to rising costs and declining competitiveness

Fernando G.I. and David R., 2013

- Income can be measured in absolute or relative terms—a fixed household income per capita threshold (in PPP dollars or national currency) is established for the former, while a fixed proportion of mean or median household income per capita is used for the latter. Where a trap implies some form of self-reinforcing mechanism driven by market failures or lack of institutional development that inhibits progress towards either an absolute or relative threshold.

Introduction: Middle income trap

- Every economy is confronted by this middle-income trap, or is dealing with it now.
- Malaysia also appears to be ‘caught in a middle-income trap’.
- Breaking out of it can be extremely difficult because it is necessary to overhaul the economic growth model most often used by emerging economies.

Target High Income Economy By 2020 (Per capita, constant price 2010)

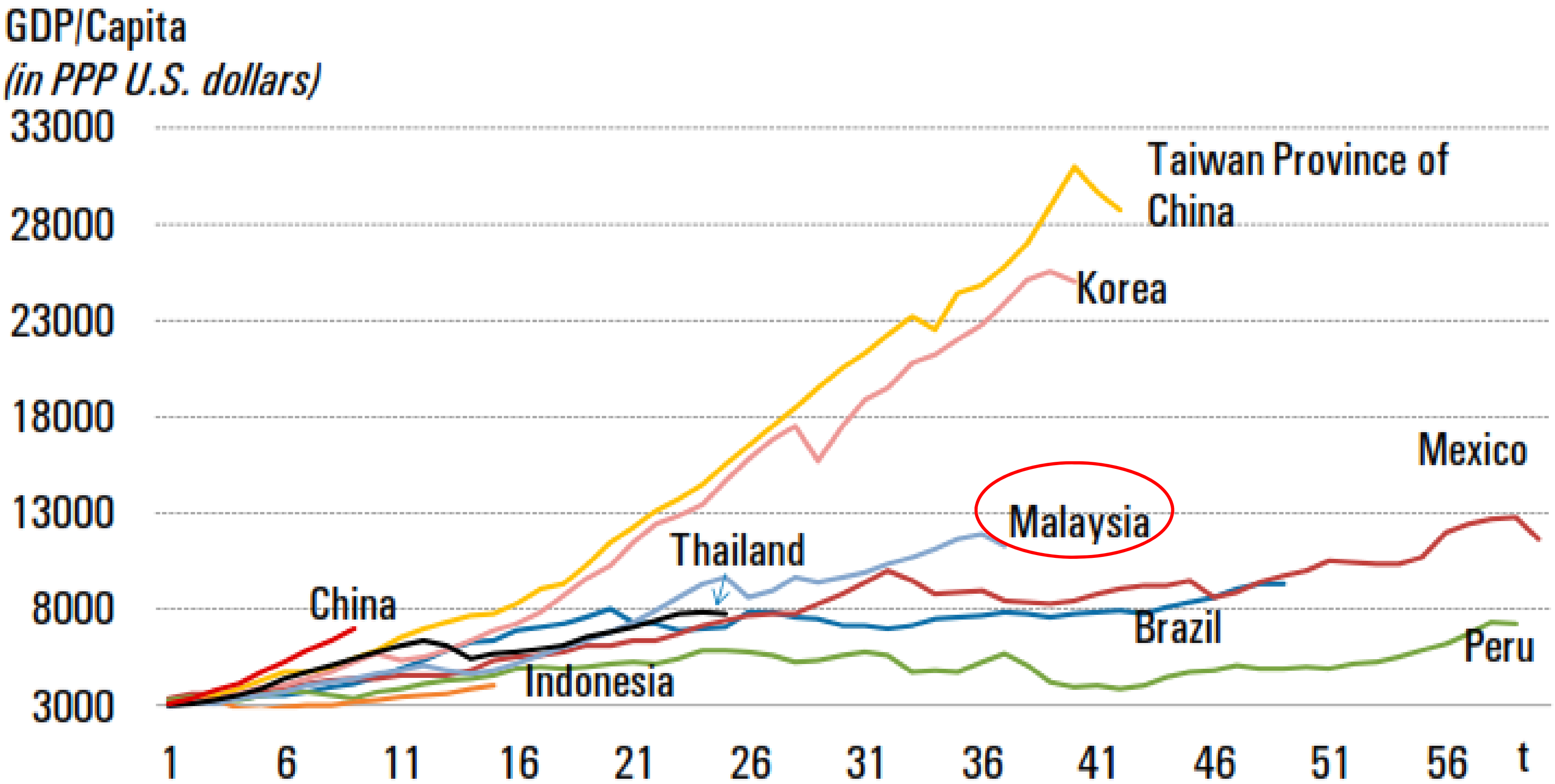
World Bank	RM 45,259.5
RMK 11	RM 43,071.6
NEM	RM 32,625.9

Source: World Bank, RMK 11 and New Economic Model

According to Asian Development Bank, based on 124 countries of the study (GDP/capita);

- There were 40 low-income countries (below US$2000)
- 38 lower middle-income countries (US$2,000-US$7,250)
- 14 upper middle-income countries (US$7,250-US$11,750)
- 32 high-income countries (above US$11,750)

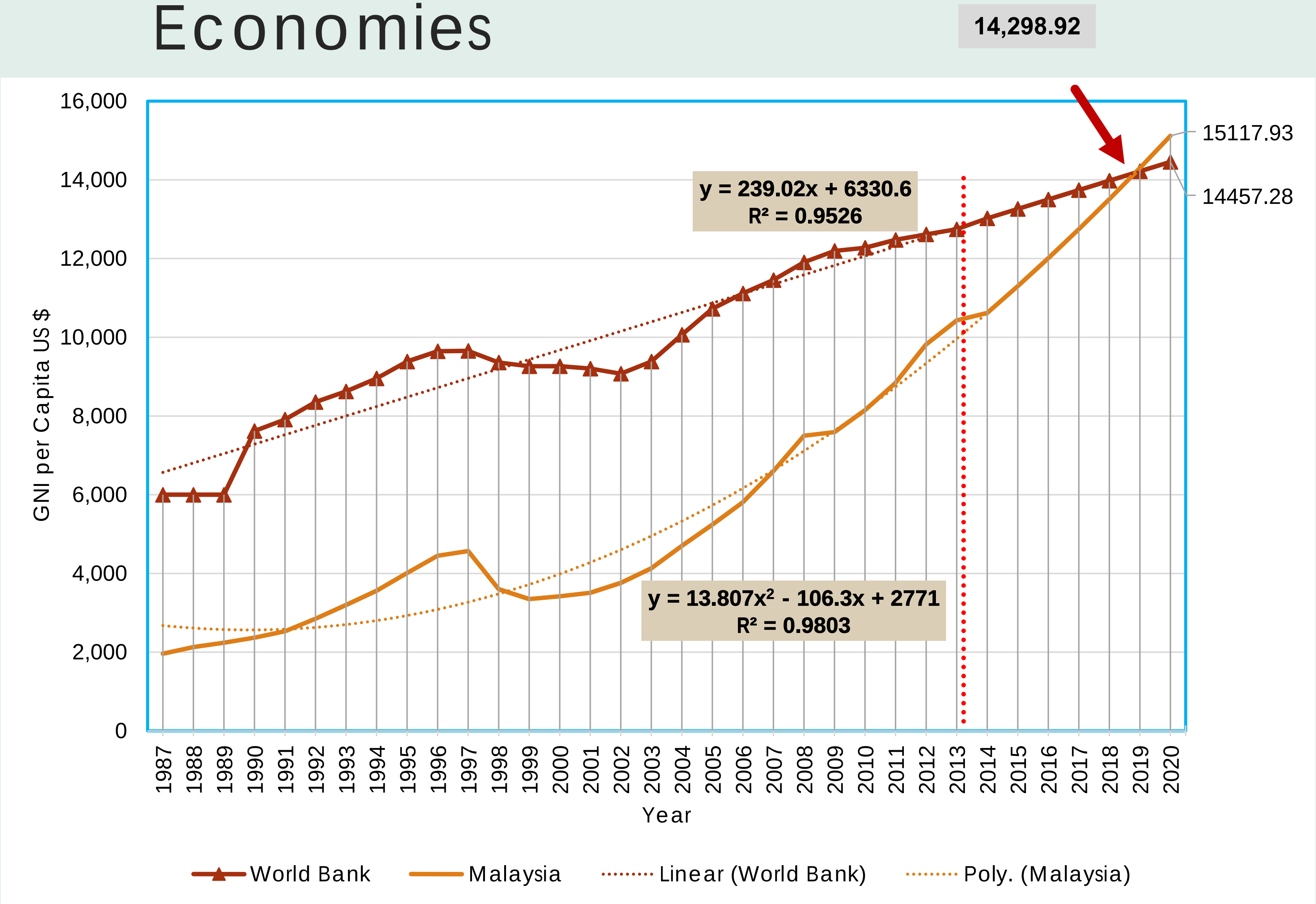
Figure 1. Cross Country Comparison[1]



Source: IMF staff calculations.

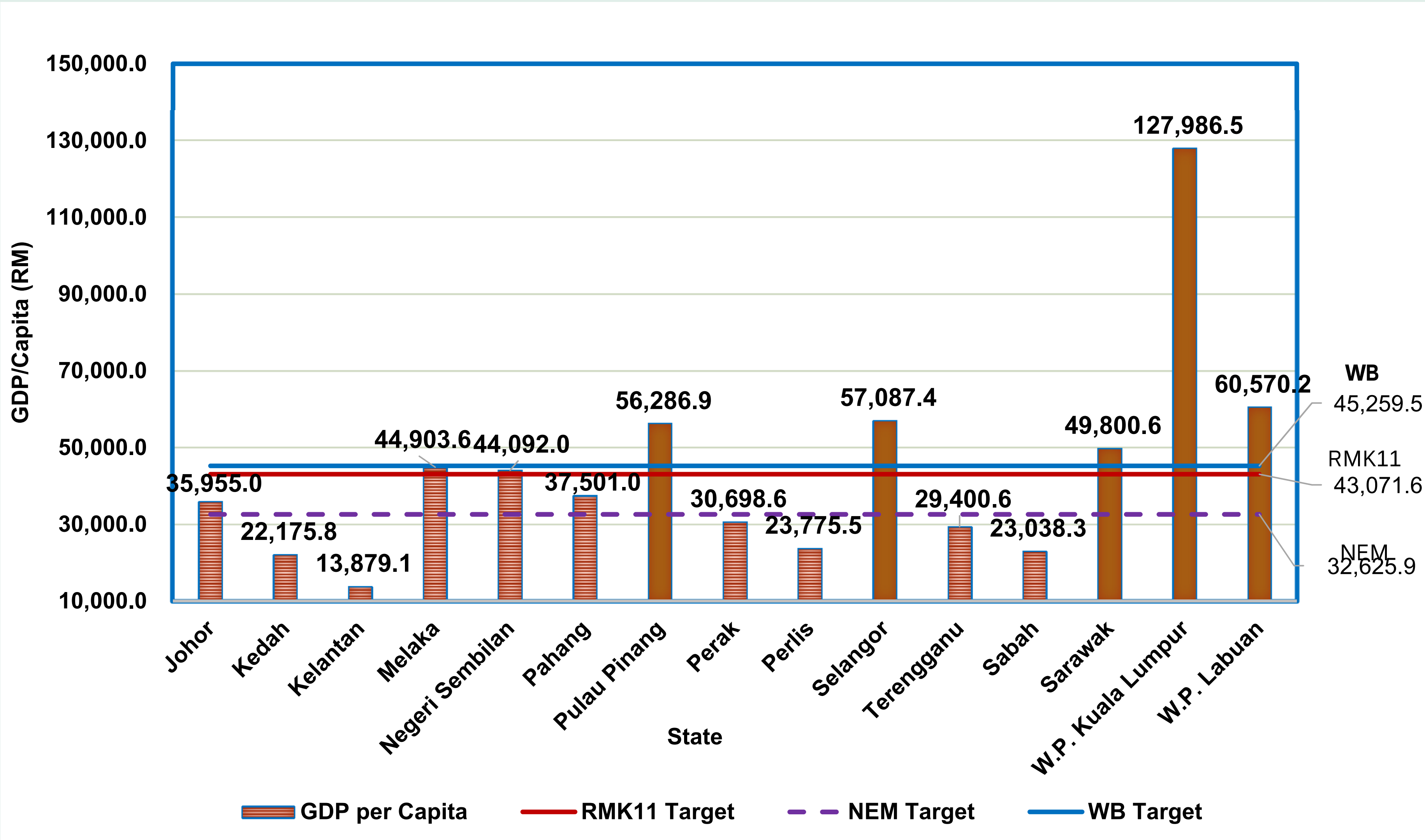
[1] t=0 is defined as the year when the GDP per capita for a particular country reached 3000 U.S. dollars in PPP terms.

Malaysia vs. High-Income Economies



Source: World Bank (2010)

Malaysia: RMK11 Target as High Income Economy 2020



Source: RMK11

MALAYSIA: STATES EXPECTED TO ACHIVE HIGH INCOME ECONOMY ACCORDING TO WB, RMK 11 AND NEM TARGETS

No	STATES	WB	RMK 11	NEM
1	W.P. Persekutuan	W.P. Persekutuan	W.P. Persekutuan	W.P. Persekutuan
2	W.P Labuan	W.P Labuan	W.P Labuan	W.P Labuan
3	Selangor	Selangor	Selangor	Selangor
4	Pulau Pinang	Pulau Pinang	Pulau Pinang	Pulau Pinang
5	Sarawak	Sarawak	Sarawak	Sarawak
6	Melaka		Melaka	Melaka
7	Negeri Sembilan		Negeri Sembilan	Negeri Sembilan
8	Pahang			Pahang
9	Johor			Johor
10	Perak			
11	Terengganu			
12	Perlis			
13	Sabah			
14	Kedah			
15	Kelantan			

WB = World Bank, RMK 11= Eleventh Malaysian Plan, NEM = New Economic Model

Background of Malaysian Economy

- From independence to 1980s, Malaysia progress rapidly, from an agricultural society in the 1950s, it evolved into an Asian Tiger Economy by the 1980s, mainly through labour intensive industrial.

- However subsequent attempts to further deepen our industrialization process met with mixed results; and Malaysia economy well-being generally remained stagnant, while many other countries galloped away under the scenario of a rapidly expanding world trade.

Factors causing middle income trap

- Malaysia's slower growth momentum, which therefore is keeping Malaysia trapped in middle-income status, is due to several factors.

Low private investment	Price control	Subsidies
Difficulties of doing business	Low value added industries	Low-skilled jobs and low wages
Stagnating productivity growth	Insufficient innovation and creativity	Low wages

1. Low private investment

- In some industries, heavy government and GLC (Government Linked Companies) presence has discouraged private investment.
- In addition, cumbersome and lengthy bureaucratic procedures have affected both the cost of investing, and the potential returns on investment.
- The persistent shortage of skills has had an impact on investment as well.

2. Price Control

- In 1946, the colonial government enforced price controls in Malaya to avoid economic hardships after World War II. This policy holds until today.
- Price control restrains wages, and severely distort domestic economic factor proportions, resulting in many factories using non-efficient economic production processes.
- With diesel and fuel prices controlled, and workers' wages suppressed, manufacturers choose to use more fuels and labour as inputs – instead of more machines – resulting in low quality Malaysia products and, of course, low productivity growths.

3. Subsidies

- Subsidies began in 1961 under the Control of Supplies Act 1961. Subsidized items include petrol, gas, sugar, rice and other basic items.

- High cost of subsidies in turn restraints the Government's ability to upgrade infrastructures such as public transport. It also retards the Government's ability to provide competitive incentives for attracting high-income activities into the country.

4. Difficulties of doing business

- Doing business in Malaysia is more difficult than in competing countries, especially in aspects related to entry and exit of firms.
- Several measures of doing business, such as starting a business, registering property and dealing with construction permits, show Malaysia ranking behind developed countries globally and regional economies. This has the unintended effect of favouring existing businesses and hampering competition.
- In addition, a very long backlog of cases in Malaysian courts appears to weigh negatively on investors' perception as this slows down resolution of commercial disputes.

5. Low value added industries

- Malaysia’s export structure has focused mainly on electrical and electronics (E&E) products and on primary commodities such as petroleum and palm oil. The E&E sector is a good illustration of the difficulty we face in moving up the value chain.
- Malaysia’s E&E cluster has created a huge community of component manufacturers, namely original equipment manufacturing (OEM) suppliers. Profit margins are substantially lower in OEM sales than from own brand name sales. This in turn makes it difficult for Malaysian companies to muster the capital needed to invest in R&D and make a breakthrough to new higher value added products.

6. Low-skilled jobs and low wages

- In Malaysia, the use of low-skilled labour increased between 2002 and 2007 across industries. And the E&E sector, which is the major contributor to Malaysia's growth, has experienced some of the biggest declines in use of high-skilled labour.
- In many instances, employers do not pay for skills, relying instead on tried and tested means such as a readily available pool of unskilled foreign workers and underpriced resources to generate profits.
- Also, immigration policies favour low skilled and cheap labour.

Labour Productivity Growth Rate (%)

Growth	Malaysia	Korea	Singapore	Hongkong
1961-1980	3.87	5.33	5.20	5.73
1980-2000	3.48	5.76	3.69	3.50
2000-2013	2.37	2.76	1.55	3.04

Source: Total Economy Database, The conference Board

7. Stagnating productivity growth

- The dismal productivity growth in Malaysia has much to do with slowing investment after the Asian Financial Crisis of 1998/99. Capital contributed to over 60% of growth in output per worker during the 1987-1997 period but its share fell to just over a third from 1998 to 2006.
- The weak productivity growth also highlights the stark reality that Malaysia still lacks the sort of creativity and innovation that result in technological and technical progress as well as more efficient practices and systems – as shown in stagnant contribution by total factor productivity and education to output growth.

8. Insufficient innovation and creativity

- The weak track record of domestic innovation in Malaysia is reflected by the comparatively low number of researchers.
- At the same time, the number of scientific and technical articles published in internationally recognized journals by Malaysians is also well below comparable countries.
- The lack of researchers and R&D results in a lack of innovation in the industrial and export sectors, sectors in which an unrelenting search for higher value added products and processes, and the capacity for their commercialization are essential to global competitiveness.

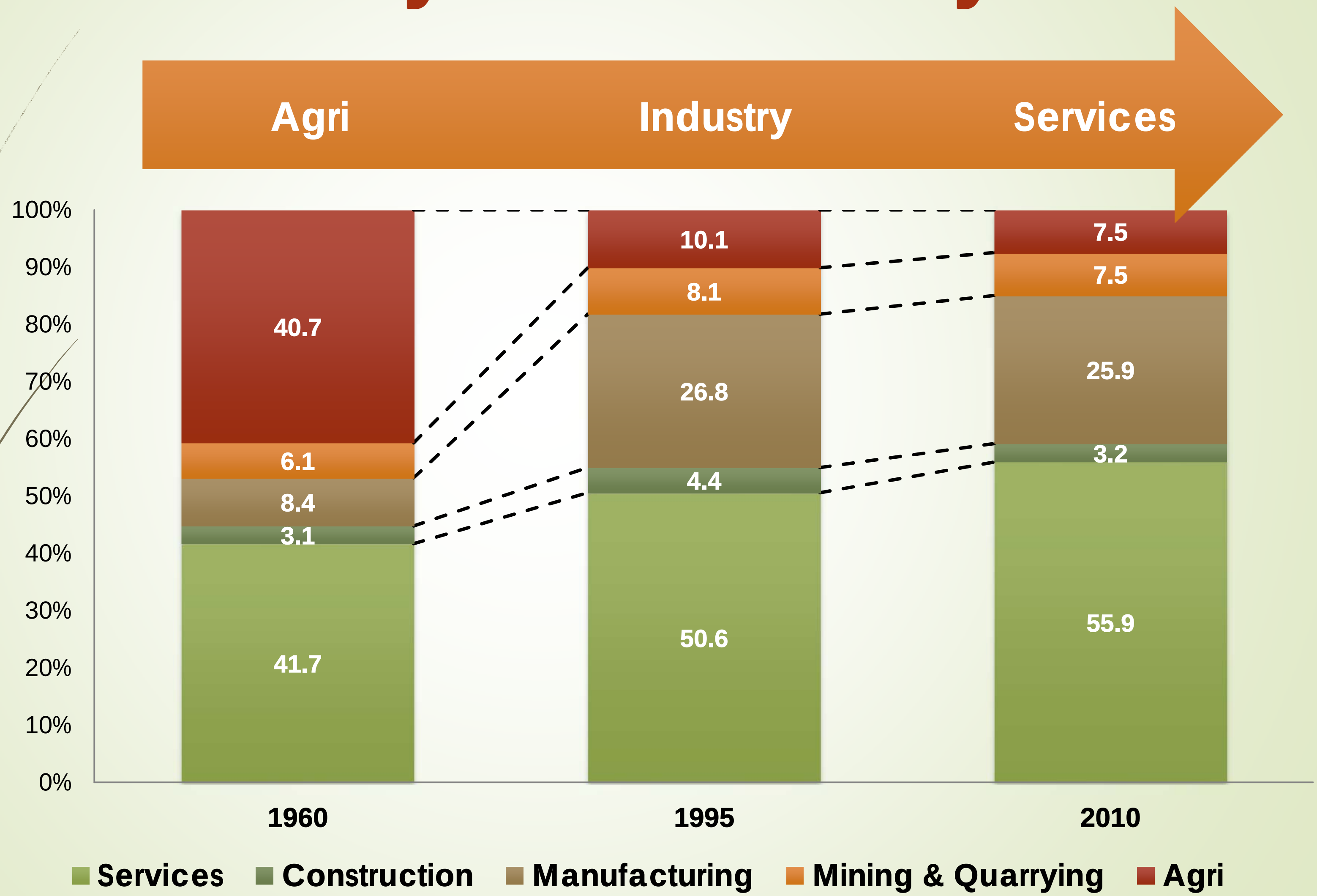
9. Malaysia's economic structure

- More importantly, Malaysia's economic structure is keeping it in middle-income status.

- The Malaysian economy continues to be very dependent on low-tech, low-skilled assembly-type FDIs. However, as alluded to earlier, these types of FDIs are now flowing into regional competitors rather than Malaysia for reasons of lower costs.

- On the other hand, Malaysia does not yet have the capacity for high-tech, highly skilled creative and innovative industries; as such, it has not been able to attract FDIs in these areas.

Structural Changes in Malaysian Economy



Case Study

- The objective of this case study is to investigate Malaysia's economic structure and compare it with those of selected developed economies.

- Differences between Malaysia's economic structure and those of selected developed economies (structural economic gap) can be taken as one of the reasons why Malaysia remains caught in the middle income trap.

Results & Discussion

- An economy's economic input structure has a critical role in ensuring economic impact.

- As shown in Table 1, the proportion of Total Intermediate Input for the Malaysian economy is higher than that of Japan and Korea but slightly lower than Poland's.

Table 1: Input Structure: Malaysia Compared to Poland, Japan and Korea , 2005

Sectors	Malaysia				Poland			Japan			Korea		
	TOTAL INTERMEDIATE	IMPORTS	VALUE ADDED	OTHERS	TOTAL INTERMEDIATE	VALUE ADDED	OTHERS	TOTAL INTERMEDIATE	VALUE ADDED	OTHERS	TOTAL INTERMEDIATE	VALUE ADDED	OTHERS
Oil, Gas and Energy	0.437	0.004	0.423	0.136	0.626	0.365	0.009	0.607	0.393	0.00	0.648	0.352	0.000
Education	0.287	0.000	0.467	0.066	0.162	0.811	0.027	0.138	0.862	0.00	0.195	0.805	0.000
Tourism	0.625	0.001	0.288	0.086	0.559	0.388	0.053	0.456	0.544	0.00	0.583	0.417	0.000
Wholesale & Retail Trade	0.392	0.002	0.389	0.218	0.429	0.562	0.009	0.301	0.699	0.00	0.404	0.596	0.000
Electrics and Electronics	0.398	0.001	0.148	0.454	0.720	0.276	0.003	0.680	0.320	0.00	0.744	0.256	0.000
Healthcare	0.508	0.000	0.341	0.150	0.313	0.650	0.037	0.376	0.624	0.00	0.441	0.559	0.000
Palm Oil	0.657	0.000	0.275	0.068	-	-	-	-	-	-	-	-	0.000
Communication	0.447	0.000	0.499	0.054	0.479	0.515	0.006	0.398	0.602	0.00	0.503	0.497	0.000
Agriculture	0.363	0.000	0.561	0.075	0.529	0.446	0.025	0.465	0.535	0.00	0.420	0.580	0.000
Business Services	0.330	0.000	0.579	0.091	0.497	0.500	0.003	0.372	0.628	0.00	0.000	0.000	0.000
Financial Services	0.524	0.002	0.457	0.017	0.381	0.580	0.039	0.313	0.687	0.00	0.373	0.627	0.000
Others	0.472	0.003	0.305	0.220	0.599	0.387	0.014	0.507	0.493	0.00	0.000	0.383	0.000
Intermediate Input (average)	0.455	0.002	0.318	0.225	0.481	0.498	0.020	0.419	0.581	0.00	0.392	0.461	0.000

Results & Discussion

- However the proportion of Value added for Malaysia is lower than those of Poland, Japan and Korea.
- This implies that Japan and Korea have higher productivity levels than Malaysia. Less intermediate inputs are being utilized in Japan and Korea though there is higher value added.

Results & Discussion

- In the case of Poland, the proportion of total intermediate inputs requirement is almost equal to that of value added.
- As for Malaysia, the proportion of value added is still lower than those of Poland, Japan and Korea. This shows that Malaysia needs to transform its economic structure if it is to increase efficiency levels and productivity. This will lead to higher total economic output.

Table 2: Total Output, Income & Employment

	Malaysia	Japan	Poland	Korea
Total output generated	1,603,906,680 **(100)**	1,777,007,265 **(110.79)**	2,058,696,475 **(128.36)**	2,217,640,689 **(138.26)**
Total household Income generated	138,365,009 **(100)**	150,346,758 **(108.66)**	178,909,817 **(129.3)**	184,210,567 **(133.13)**
Employment creation	9,784,800 **(100)**	10,250,733 **(104.76)**	13,658,230 **(139.59)**	12,293,942 **(125.64)**

Conclusion

- This paper investigates factors that cause Malaysia to be caught in middle income trap.
- This paper examined Malaysia’s economic input structure and then compared it with those of selected high income countries - Japan, Poland and Korea.
- It shows that there is indeed a ‘structural gap’ between Malaysia’s economic structure and those of the mentioned high income economies.

Conclusion

- Malaysia needs to transform its economic structure to mirror those of the mentioned high income countries if it is to achieve high income status.
- This implies that, all ASEAN Countries, like Malaysia, will need to do the same if it is to achieve high income status. And that, if all ASEAN Countries do not transform its economic structure, it will, like Malaysia, get caught in the middle income trap.

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