

# ***Understanding the Middle-Income Trap in Economic Development: The Case of Malaysia***

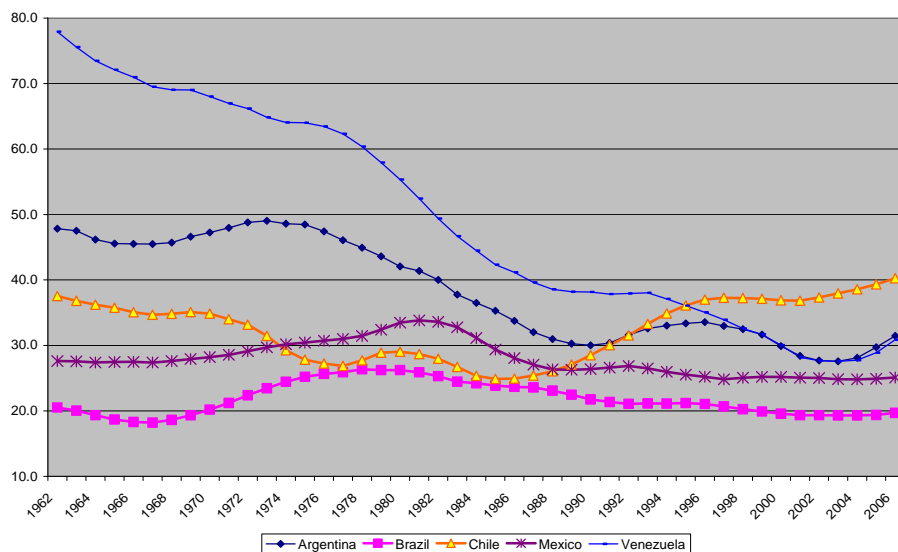
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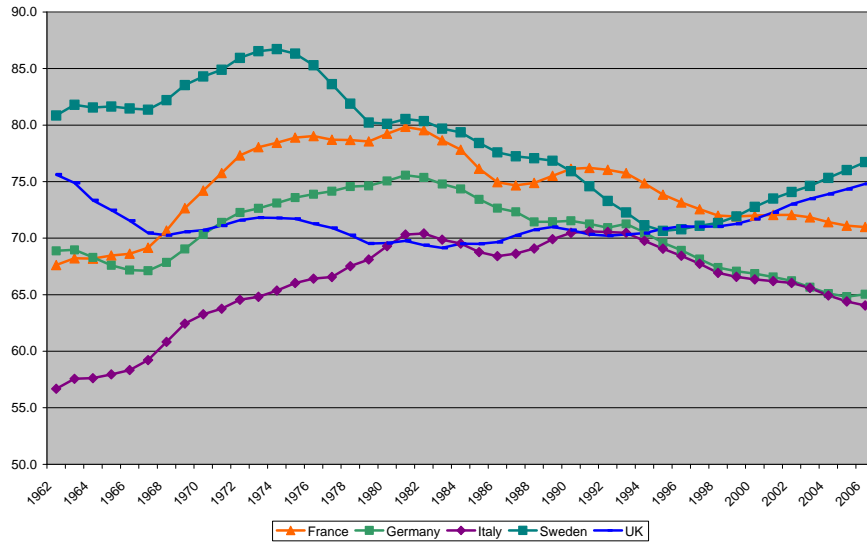
## **Latin America: Stuck at 30%**

GDP per capita (PPP) of Latin America as % of US Level



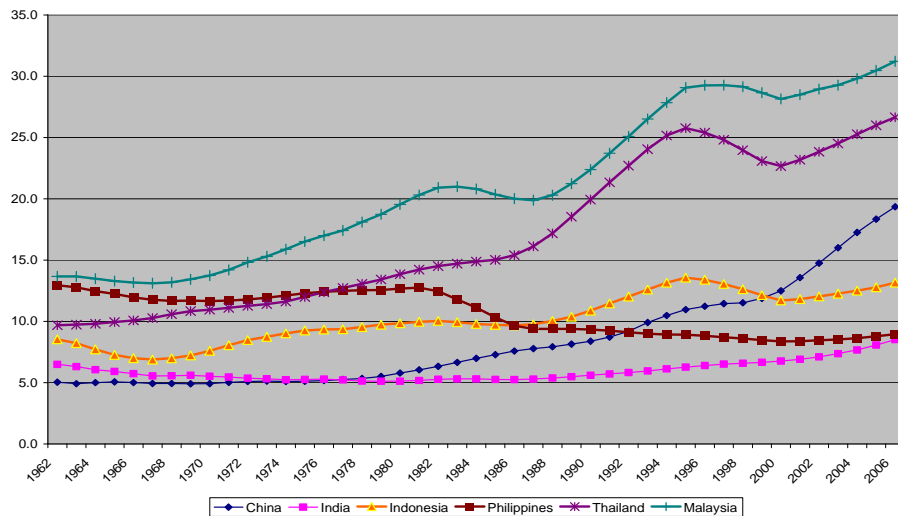
## Western Europe: Maintain 70%

GDP per capita (PPP) of Western Europe as % of US Level



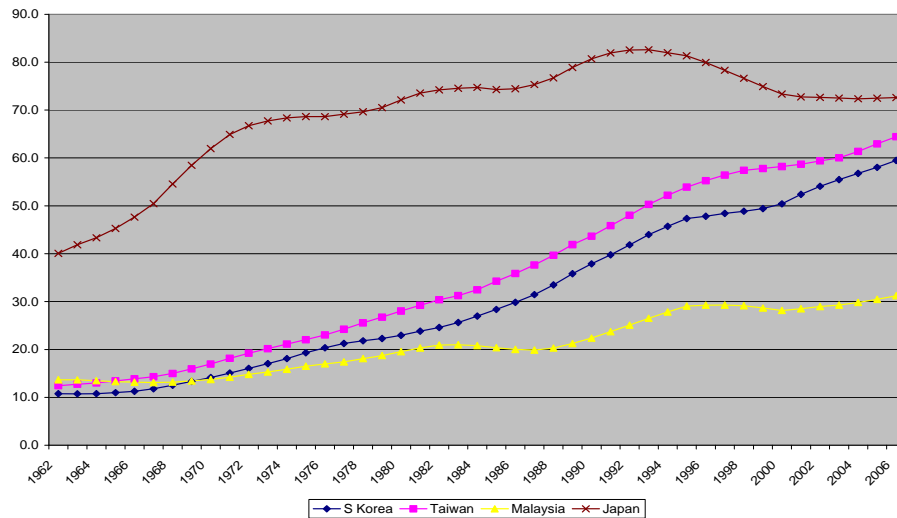
## Developing Asia: Moving Along, Now 20%, Malaysia best performer

GDP per capita (PPP) of Asia-6 as % of US Level



## Low Expectations --> Happy? Malaysia was richer than South Korea and Taiwan in 1965

Japan, S. Korea, Taiwan and Malaysia: Living Standard as % of USA Living Standard



## 10<sup>th</sup> Malaysian Plan predicts: GDP growth in 2011-15 will be 6%

9<sup>th</sup> Malaysian Plan had also predicted average growth rate of 6% but outcome was 4.2%: Economist Intelligence Unit (January 2011) has predicted average 5% growth in 2011-2015 period. 10<sup>th</sup> M-P target is possible but it is dependent on

- strong US recovery: likely only if its exports soar (Federal Reserve just launched Quantitative Easing II because of continued weak consumption and investment)
- continued strong growth in China (2010, 10.5%). Likely if no serious inflation and no protectionism (PBOC is tightening credit tightened; Davos barrage – Sarkozy, Kuwait CB governor, Soros -- against dollar peg)

**Present discussion about 6% growth target is BIG CHANGE in national expectations**

### Optimism in 2001 Upon Recovery from the Asian Financial Crisis

	GDP (percent)	source of growth (in percentage points)		
		labor	capital	TFP
1971-1990	6.7	2.4	3.4	0.9
1991-2000	7.0	1.7	3.5	1.8
2001-2010	7.5	1.6	2.7	3.2

#### investment as percent of GDP

	<u>total</u>	<u>private</u>	<u>public</u>
1990	33.0	21.9	11.2
1998	25.8	14.4	11.4
2000	25.7	12.6	13.0
2010	28.7	21.4	7.3

Data are from The 3rd Outline Perspective Plan, 2001-2010 (2001) and the Midterm Review of the 7th Malaysian Plan (1999?)

### **Slowdown after recovery from 1997-1999 Asian Financial Crisis, and before the 2008-2009 Global Financial Crisis** (average GDP growth rate in period, %)

	8th Malaysian Plan: actual	9th Malaysian Plan: actual
<u>1987-1997</u>	<u>2001-2005</u>	<u>2006-2010</u>
9.4	4.5	4.2

## Composition of Investment by Ownership in Malaysia

(actual value of category as % of GDP)

	<u>1990</u>	<u>1995</u>	<u>2000</u>	<u>2005</u>	<u>2010</u>
total investment	33.9	45.7	25.6	20.0	20.2
private investment	21.9	32.7	12.8	8.9	9.5
public investment	12.0	13.0	12.7	11.2	10.7

Data are from 7th, 8th, 9th and 10th Malaysia Plan (MP),  
and 9th Midterm Review (MTR)

## **Why the Investment Collapse? (1/4)**

For foreign investors (Inward FDI)

- International environment has changed since first semi-conductor firms came to Penang in 1971, e.g. China has cheaper labor and a larger domestic market
- Inadequate human capital e.g. university graduates unemployable because of poor command of English; immigration policy favored inflow of low-skill labor
- Potential for religion-based terrorism, e.g. church burning, ban on traditional translation of the word “God”, courts upholding forced conversion of children to Islam
- Poor infrastructure outside of Klang Valley, eg broadband
- Capricious legal system, e.g. pioneering court ruling that buyer could keep stolen property; police corruption and police violence; worsening street crime

## Why the Investment Collapse? (2/4)

For true domestic private investors

- **A high tax on growth (until June 30, 2009)**
  1. 30% shares be sold to Malays on MITI's list (most times with discount) at IPO; also applies to privately-held firms with capital above MR 5 mil.
  2. at each future share offering, 30% rule must also hold (most times, Malays already sold off the 30%, requiring the firms to buy back shares for re-allocation e.g. in August 2009, only MR 2.4 billion of shares were held by Malays out of MRG 54 billion allocated to them)
- Natural exhaustion of extremely high-yield investments; now cannot cover the high 30 percent NEP tax on expansion of business.

## Why the Investment Collapse? (3/4)

For true domestic private investors (cont.)

- June 30, 2009: condition (1) repealed with status of condition (2) not clear. New requirement is that half of shares offered at IPO would be allocated to Malays. Since minimum share that has to be offered to public at IPO (the spread) is 25%, at least 12.5% of firm's share would be allocated to Malays .. ***but still no such tax amongst Asian competitors!***
- The 30 pct NEP tax on assets has in fact been inducing capital flight since 1972, but negative effects been hidden by large inward FDI.
- High input costs from state-created monopolies, like pricey broadband service, business licenses and closed tenders for cronies (e.g. toll roads)

## **Why the Investment Collapse? (4/4)**

For true domestic private investors (cont.)

- Shortage of high-level staff made worse by outward migration of Malaysian professionals because of NEP race-based promotion and university acceptance
- Slowdown due to Asian Financial Crisis, Mahathir initiated vicious cycle of NEP intensification leading to worse investment climate and further slowdown.

For government-linked-companies

- No funds because mismanagement has emptied the kitty e.g. Sime Darby (Has Petronas really been free from politically-motivated development missions that had sunk Pertamina and PetroMexico?)

## ***Now to Check Validity of Growth Narrative with Growth Accounting***

1960-1968: Before New Economic Policy (NEP), turning point: May 13, 1969 elections

1971-1982: Export-led Growth in Penang and its peninsular-wide ripples & NEP Phase 1 (proliferation of sprawling state-owned conglomerates with monopoly privileges in growing number of activities)

1982-1996: Mahathir-NEP Phase 2 (privatization of state companies to create Malay tycoons and state-directed megaprojects) & Globalization Era accelerated with Yen-induced FDI into Southeast Asia

2000-2008: Post-Asian Financial Crisis, **NEP has now become No Economic Progress**

### **Growth before NEP, 1960-1968**

	<u>S. Korea.</u>	<u>Taiwan</u>	<u>Malaysia</u>	<u>Thailand</u>
Output per worker	3.64	7.18	3.69	5.03
<u>Source of growth in percentage points</u>				
Capital per worker	0.55	4.95	1.96	4.57
Education	0.64	0.41	0.40	-0.01
TFP	2.42	1.71	1.29	0.46
capital share of income=0.5				

### **1971-1982 Growth: Start of NEP and Electronic Exports**

	<u>S. Korea.</u>	<u>Taiwan</u>	<u>Malaysia</u>	<u>Thailand</u>
Output per worker	3.53	5.07	4.25	3.18
<u>Source of growth in percentage points</u>				
Capital per worker	5.08	4.99	3.46	2.88
Education	0.64	0.71	0.57	0.32
TFP	-2.11	-0.63	0.19	-0.03
capital share of income=0.5				



**1982-1996 Growth: Mahathir's NEP  
and Yen Appreciation from 1985**

	<u>S. Korea.</u>	<u>Taiwan</u>	<u>Malaysia</u>	<u>Thailand</u>
Output per worker	5.72	5.82	3.85	6.22
<i><u>Source of growth in percentage points</u></i>				
Capital per worker	4.32	3.38	3.02	3.67
Education	0.47	0.49	0.55	0.45
TFP	0.85	1.86	0.25	2.01
capital share of income=0.5				

**2000-2008 Growth after Asian  
Financial Crisis**

	<u>S. Korea.</u>	<u>Taiwan</u>	<u>Malaysia</u>	<u>Thailand</u>
Output per worker	2.96	1.99	2.62	3.25
<i><u>Source of growth in percentage points</u></i>				
Capital per worker	1.90	1.63	0.89	0.39
Education	0.30	0.54	0.34	0.36
TFP	0.74	-0.19	1.37	2.49
capital share of income=0.5				

## **Big Picture: Stage-Specific Obstacles**

- Growth process creates new challenges that have to be overcome in order for growth to continue. Each stage of economic development has its own set of obstacles to moving on to the next stage
  - Soviet catch-up
  - Japan's lost decade
  - new circumstances require new growth policies; doing more of the same will not work, e.g. in USSR, there was replacement of central planning market allocation, state ownership by private ownership, and autarky by globalization
- Latin America in middle-income trap, sub-Saharan Africa in poverty trap

## **Malaysia at Turning Point?**

- Malaysia has moved from being raw commodities exporter to industrial products exporter, from making banana chips to making computer chips
  - Social conditions have changed, social expectations of government's performance now higher; competence, accountability, and transparency are valued attributes.
- Knowledge society is next development stage. Post-2001 slowdown is result of NEP → No Economic Progress, signs of middle-income trap:
  - Unlike in Taiwan, few import-substituting industries in Malaysia have become world-class export industries.
  - Most world-class exporting firms in Malaysia are foreign-owned or joint ventures with foreigners
  - flight of world-class Malaysian firms abroad

## **The Return of High Growth Requires a New Malaysian Policy Framework Policies of 1970-2010 and the actual New Economic Model are inconsistent with knowledge-led growth.**

Must remove institutional distortions that discourage investment and realization of full potential output:

- NEP tax now 12.5% but 0% in most other countries
- Only 60% of national brain power utilized, mobilise fully by entrenching culture of excellence universally
- Education system is still more a socio-political instrument than an economic instrument even though nation-building goal has been achieved
- Over-centralization of management=sluggish response, federal bureaucrats consumed by turf expansion; EPU has monopoly on economic policy initiatives. Lim Chong Eu shows importance of independent initiative.

## **Fiscal Federalism for Growth**

- To turn China's provinces into independent engines of growth, central government had scheme that is analogous to profit-sharing between owners and managers. Growth also generated positive spillovers across provinces.
- States need independent fiscal base to develop according to local conditions, e.g. build needed infrastructure without approval delays. Indonesia instituted fiscal decentralization, and growth has accelerated. Small country case: Belgium
- Federation of Malaysia was formed on an agreement among states. What has happened to state rights? Trengganu has unreliable access to its oil revenue. Low-income Kelantan has long been punished. No synergy, so lower average national growth rate

## **More measures for knowledge-led growth**

- Entrench a culture of excellence to maximise human potential and attract knowledge workers, especially in civil service and educational and research institutions
- Mobilise universities for growth 1. establish university-state-business coalition e.g. missed opportunity in Penang with USM weak in computer science; 2. implement foreign language requirement; 3. cooperate with foreign universities and allow their branch campuses; 4. become regional research hub on tropical biological sciences and tropical diseases
- Reform Police-Judiciary and State Procurement Systems.