Strengthening Macroeconomic Resilience for Sustained Growth

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Introduction

The Malaysian economy registered a modest growth in 2016 despite a challenging external environment before rebounding strongly in 2017 with the recovery of the global economy. The gross domestic product (GDP) expanded during the review Plan period, 2016-2017, within the original target of between 5% and 6% per annum. Inflation remained low and stable while the economy continued to be in full employment[1]. The current account of the balance of payments was in surplus, albeit narrowing. In addition, the fiscal deficit of the Federal Government as percentage to GDP continued to reduce as targeted by end of 2017. In line with the economic progress, the wellbeing of the *rakyat* also improved, as measured by the Malaysian Wellbeing Index (MyWI)[2]. However, despite the strong socioeconomic performance at macro level, persistent disparities and structural issues remained.

[1] Based on the definition by the Organization for Economic Cooperation and Development (OECD), an unemployment rate below 4% of total labour force is considered as full employment.
[2] The MyWI is a composite index that measures the wellbeing of Malaysians and is made up of 68 indicators across 14 economic and social wellbeing components.

Past Performance, 2016-2017

External Economic Environment

The global economy moderated in 2016, especially due to the modest world trade expansion, significant slowdown in the economy of the United States of America (the US), further softening of the economy of the People's Republic of China (PRC) and weaker commodity prices. The global moderation has affected the overall achievement in the review period despite a sound rebound in the world economy and trade in 2017. The global economy expanded at an average annual rate of 3.5% during the review period, attributed to firmer domestic demand growth in advanced economies as well as the improved performance of the emerging markets and developing economies in 2017. Meanwhile, world trade moderated at 3.7% per annum and global inflation trend remained quite benign, averaging at 2.9% per annum due to lower oil prices and subdued wage growth.

Domestic Economy

As an open economy, Malaysia continued to face challenges related to external economic risks. These challenges include the moderation of commodity prices, the shifting of the US monetary and protectionist trade policies, economic rebalancing of the PRC and geopolitical uncertainties. Malaysia was considerably affected by the slowdown in world trade and commodity prices in 2016 but recovered in 2017 following the global economic rebound. The resilience of the domestic economy and strong economic fundamentals, supported by diversification and structural transformation policies as well as a sound banking and financial sector, have allowed the economy to withstand the volatilities and register moderate growth, within the original GDP growth target of 5-6% per annum.

Aggregate Demand

The GDP in real terms rose at an average annual rate of 5.1% during the review period, within the range of targeted growth rate corresponding to the global economic performance. Gross national income (GNI) per capita in current prices increased at an average rate of 6.7% from RM36,119 (US$9,248) in 2015 to RM41,093 (US$9,556) in 2017, as shown in *Exhibit 1-2*. In terms of purchasing power parity, Malaysia's GNI per capita reached US$28,650 as estimated by the World Bank. This positioned Malaysia in the top 25th percentile of 217 countries. Based on the minimum threshold of a high-income economy set by the World Bank at US$12,056 for 2017, there was a gap of 21% before Malaysia would graduate from its upper middle-income nation status. Given the current pace of growth parameters, the target of a high-income economy is expected to be achieved post-2020.

Private investment continued to be the driving force of the economy, contributing 67.7% of total investment of RM659 billion in current prices. Real private investment increased at an average rate of 6.8% during the review period, supported by better performance of the services sector as well as sustained growth momentum of the manufacturing and construction sectors. However, **public investment** contracted at an average rate of 0.2%, which slowed the pace of the overall gross fixed capital formation (GFCF) to 4.4%. This was due to the reprioritisation of big-scale projects by the general government[3] and slower investment by the non-financial public corporations (NFPCs), mainly as a result of declining oil prices which began in 2014 and lasted until early 2017.

[3] General government refers to Federal Government, state governments, local governments and statutory bodies.

Exhibit 1-1

Highlights
Eleventh Malaysia Plan: Selected Outcomes and Performance

Real GDP growth

5-6%
2016-2020

5.1%
2016-2017

Average real GDP growth compared with world GDP growth at 3.5%

Per capita income

RM 54,100
US$ 15,690
2020

RM 41,093
US$ 9,556
2017

National per capita income in current prices

Average household income

RM 10,540
2020

RM 6,958
2016

Average monthly household income from RM6,141 in 2014

Private consumption

6.4%
2016-2020

6.5%
2016-2017

Average real private consumption growth

Private investment

RM 291 billion
2016-2020

RM 223 billion
2016-2017

Average private investment in current prices

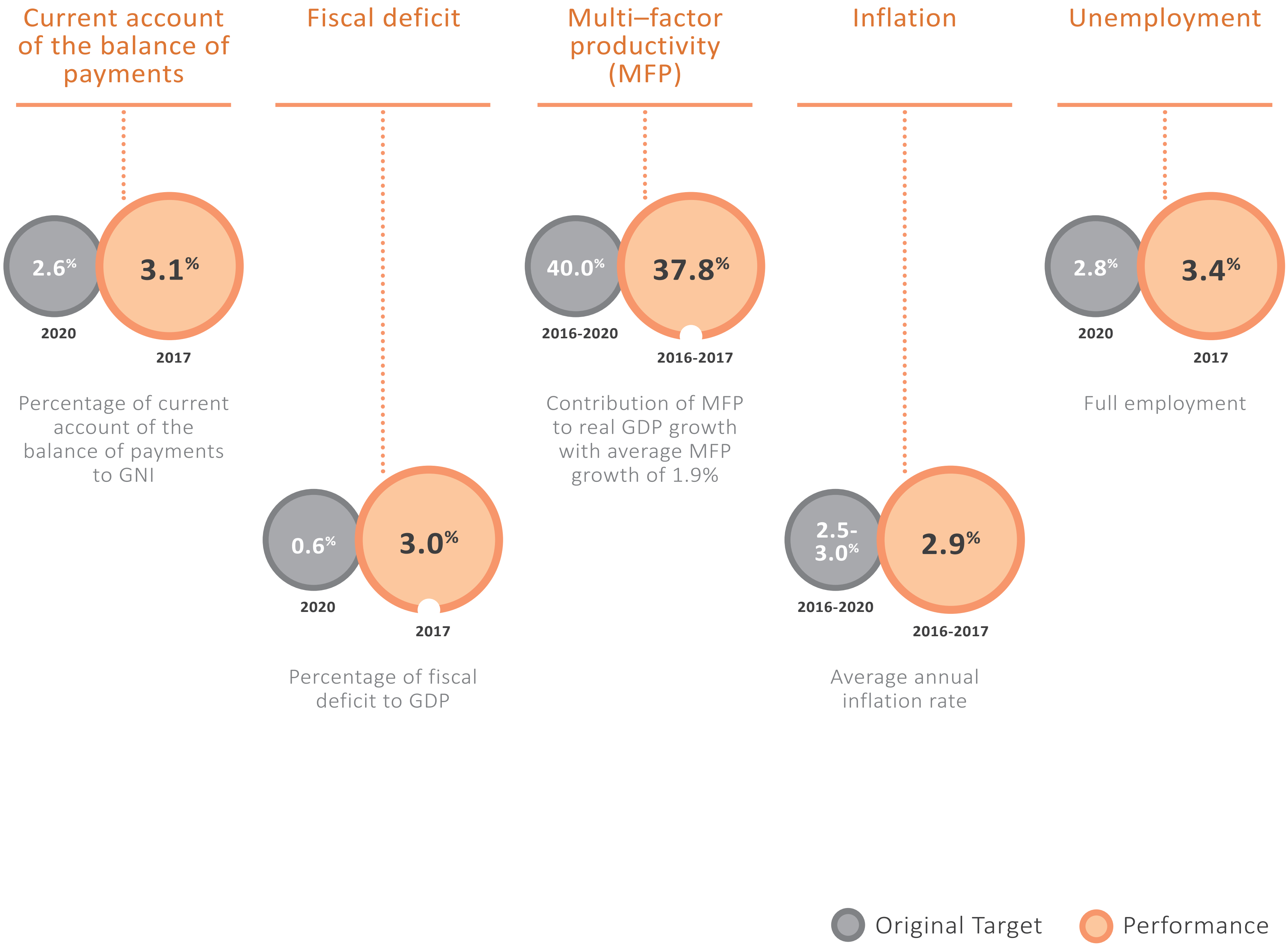
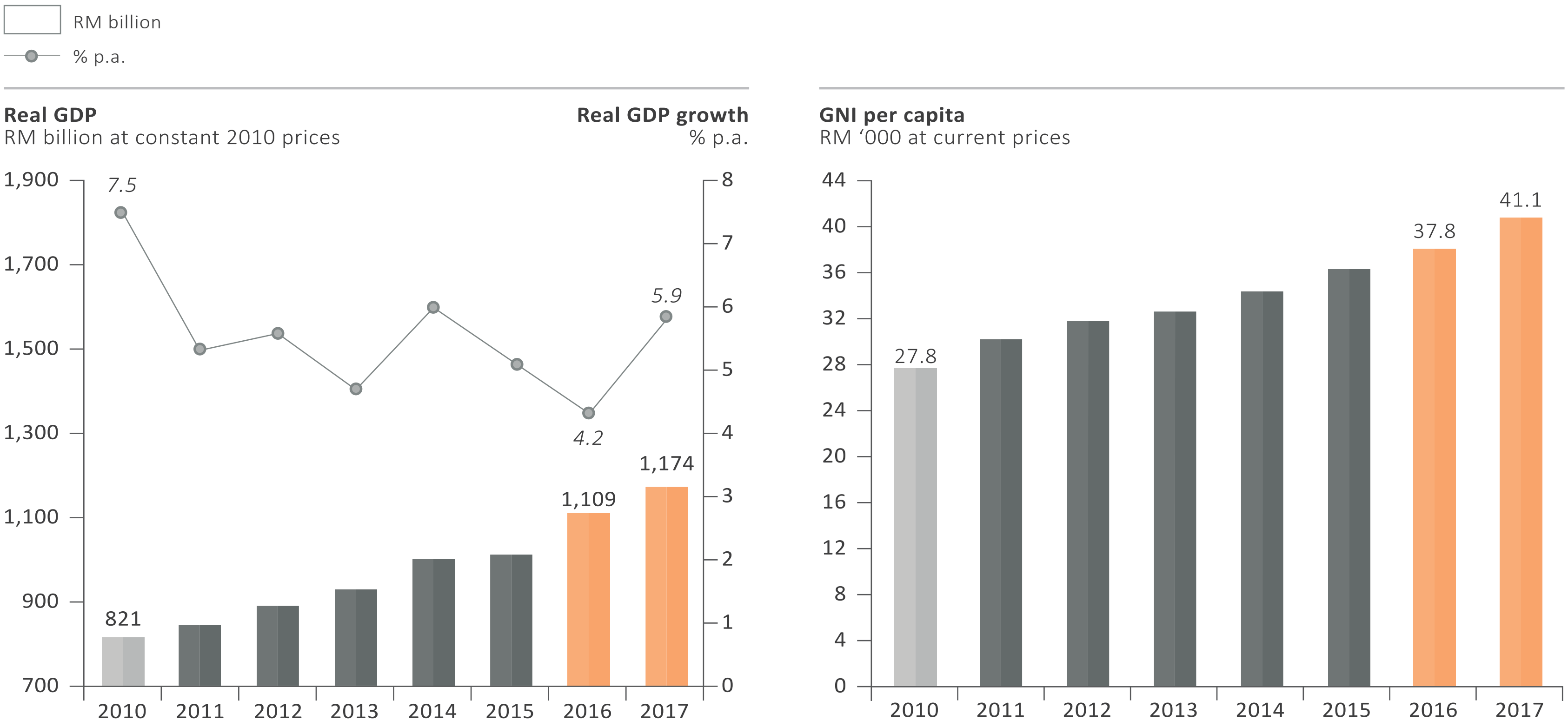

Current account of the balance of payments
2.6%
2020
3.1%
2017
Percentage of current account of the balance of payments to GNI
Fiscal deficit
0.6%
2020
3.0%
2017
Percentage of fiscal deficit to GDP
Multi–factor productivity (MFP)
40.0%
2016-2020
37.8%
2016-2017
Contribution of MFP to real GDP growth with average MFP growth of 1.9%
Inflation
2.5-3.0%
2016-2020
2.9%
2016-2017
Average annual inflation rate
Unemployment
2.8%
2020
3.4%
2017
Full employment
Original Target
Performance

Exhibit 1-2

GDP and GNI per capita, 2010-2017



Source: Department of Statistics Malaysia

Private consumption remained a mainstay of the domestic economy with an average growth of 6.5% and the share to GDP increased to 53.7% in 2017, driven by favourable labour market conditions and wage growth as well as other income-supporting measures including bigger cash transfers, double annual increment in civil servants' salaries and reduction in personal income tax. In addition, the revision of the monthly minimum wage to RM1,000 in Peninsular Malaysia and RM920 in Sabah and Sarawak had also contributed to the strong growth in private consumption. Meanwhile, **public consumption** expanded slower by 3.2% per annum, mainly due to public expenditure optimisation that led to lower spending on supplies and services.

Sectoral Output

During the review period, the economy registered growth in all sectors with the services and manufacturing sectors continued as the main contributors. The **services sector** expanded at an average annual rate of 5.9%, supported by consumption-related services subsectors, such as wholesale and retail trade, accommodation as well as food and beverages, which rose by 6.8% per annum, on account of strong recovery in the tourism-related activities. Transportation, storage, information and communication subsector also expanded at 7.4% per annum, buoyed by e-commerce activities with the launch of the Digital Free Trade Zone (DFTZ).

Similarly, the **manufacturing sector** grew by an average rate of 5.2%, mainly contributed by export-oriented industries which rose by 5.8% per annum, where the electrical and electronics (E&E) subsector experienced an upcycle since the second half of 2016. Despite the lower crude oil prices, the resource-based industries expanded by an annual rate of 4.9%, amid continued expansion of the petrochemical industry into downstream activities in the Sipitang Oil and Gas Industrial Park in Sabah. Meanwhile, the knowledge-intensive subsectors[4] grew by 5.1% per annum, with the expansion in the E&E, petrochemical and automotive manufacturing activities.

The growth of upstream sectors was subdued, particularly the **agriculture sector** at 0.8% per annum due to lower production of the industrial commodity subsector, particularly oil palm and rubber commodities as both were severely impacted by the slump in prices and the El-Nino effects in 2016. Nevertheless, the agro-food subsector recorded a growth of 2.7% per annum, increasing its contribution to the agriculture sector from 37.4% in 2015 to 38.8% in 2017. Meanwhile, growth of the **mining sector** was slow at 1.5% per annum, due to Malaysia's commitment to the Organization of the Petroleum Exporting Countries (OPEC) and non-OPEC countries to cut production to stabilise global oil prices. However, the natural gas subsector expanded by 3.5% with the operation of, among others, the world's first PETRONAS floating liquefied natural gas offshore Bintulu, Sarawak.

On the **construction** side, the sector recorded an average growth of 7.1% per annum, mainly contributed by large civil engineering projects, such as the Light Rail Transit 2, Mass Rapid Transit 1 and 2, Damansara-Shah Alam Highway, Sungai Besi-Ulu Kelang Highway, Pan Borneo Highway, Central Spine Road and Pengerang Integrated Petroleum Complex. Growth was also spurred by the residential subsector stemming from higher construction for affordable housing, while the development of the Tun Razak Exhange among others, supported the non-residential activities.

GDP by Income

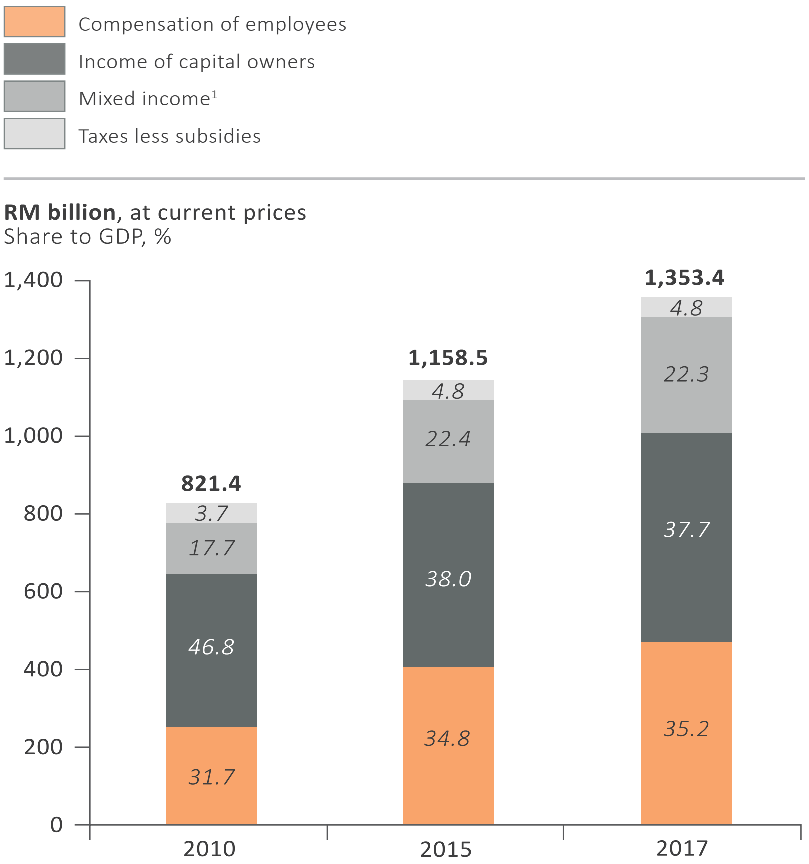
Nominal GDP expanded further by 8.1% per annum during the review period to register RM1.35 trillion in 2017 compared with RM1.16 trillion in 2015, as shown in *Exhibit 1-3*. The **compensation of employees** (CE) continued to rise by 8.6% per annum, higher than that recorded for nominal GDP. However, the share to GDP recorded a marginal improvement at 35.2% in 2017 as compared to 34.8% in 2015. This slow improvement will present a challenge in meeting the CE target of 40% to GDP in 2020. The creation of high-paying jobs remains insufficient despite the increase in the number of jobs, which translated into lower value of CE compared to target. In addition, the evolution into a services-oriented economy, led to the migration of workers to the services sector, particularly into traditional and low-paying jobs.

Gross operating surplus (GOS), which consists of income of capital owners and mixed income, rose by 7.8% per annum during the review period, after recovering from the slower growth of 0.8% in 2015. However, the share of GOS to GDP remained somewhat stagnant at 60% in 2017 compared with 60.4% in 2015. Income of capital owners improved by 7.7% per annum, with double-digit growth of 13.6% in 2017. Meanwhile, mixed income, which represents income earned by self-employed, unincorporated businesses and others expanded at a slower pace of 7.9% per annum despite the higher rate of increase in the number of the self-employed. As a result, the share of mixed income to GDP reduced slightly to 22.3% in 2017 as compared to 22.4% in 2015.

[4] Based on the Malaysia Knowledge Economy III Study 2017 by the Economic Planning Unit, knowledge-intensive subsectors include, among others, E&E products, medical devices, motor vehicles and transport equipment, refined petroleum products as well as chemicals and chemical products.

Exhibit 1-3

GDP by Income, 2010-2017



Notes: [1]Income earned by self-employed, unincorporated businesses and others.
Source: Department of Statistics Malaysia and Economic Planning Unit

GDP by State

In line with economic growth at national level during the review period, all states recorded positive growth. Selangor, Federal Territory (FT) of Kuala Lumpur[5], Sarawak and Johor were the main contributors of economic growth, constituting 57.5% of national GDP. Three federal territories and five states, namely FT Kuala Lumpur, FT Labuan, Sabah, Melaka, Selangor, Johor and Pulau Pinang, recorded higher GDP growth rates than the national average of 5.1% per annum. The growth in these states was primarily driven by the services, manufacturing and construction sectors. However, states which were more dependent on industrial commodities saw their growth affected due to the El-Nino phenomenon.

Economic disparity between states has been widening despite the increasing trend of GDP per capita in all states as a result of different economic activities among the states. In this regard, the states of Kelantan, Kedah, Perlis and Sabah, which were dominated by traditional sectors, recorded substantial gap in GDP per capita as compared to the national average of RM42,228 in 2017. Kelantan recorded the lowest GDP per capita, with a gap of 67.8% below the national average. Disparity of GDP per capita between Kelantan and FT Kuala Lumpur, the state with the highest GDP per capita, widened by 8.2 times in 2017 as compared to 7.9 times in 2015.

International Trade and Balance of Payments

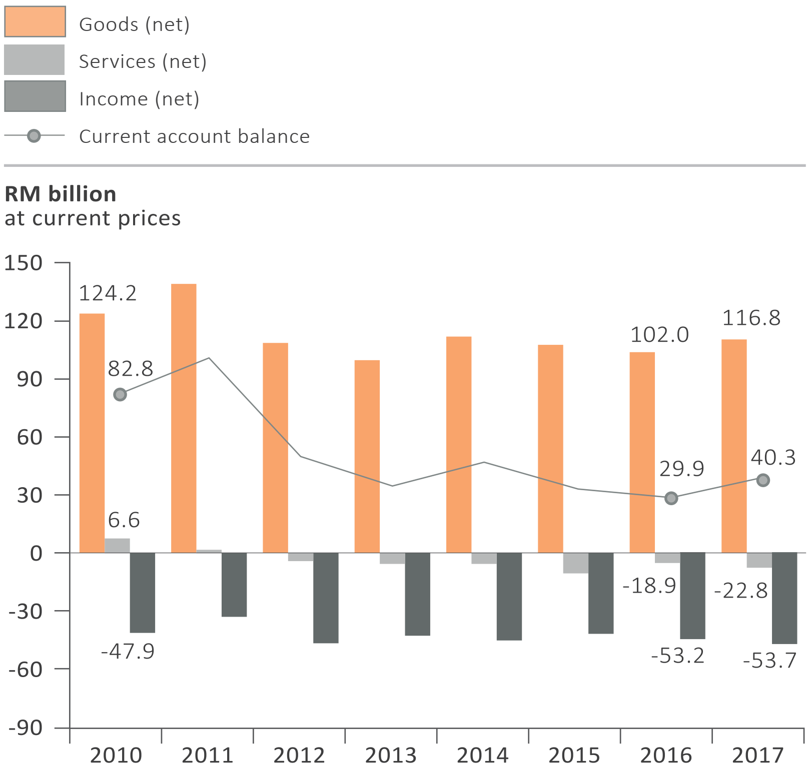
During the review period, total **trade of goods and services** increased from RM1.55 trillion or equivalent to 133.5% to GDP in 2015 to RM1.84 trillion or 135.8% to GDP in 2017, while trade balance remained in surplus at RM186.7 billion. The modest global demand and weak commodity prices in 2016 rebounded in 2017, boosting growth of gross exports at 9.7% per annum. The increase in exports was led by manufactured exports. Exports to major trading partners, such as PRC and Japan, declined by 2.9% and 12.3% respectively in 2016, mainly due to reduced exports of petroleum products, LNG and E&E. Both countries contributed 20.6% of Malaysia's gross exports. However, exports to these countries recovered in 2017 by 27.8% to PRC and 18.6% to Japan. During the review period, Malaysia's exports market diversified with greater access to non-traditional markets such as Belgium, Nigeria and Turkey. In line with strong domestic investment activities, gross imports rose by 10.4% per annum with the increase in demand for capital and intermediate goods, which made up 71.1% of total gross imports in 2017.

[5] Includes FT Putrajaya.

The current account of the **balance of payments** continued to register a surplus of RM40.3 billion or 3.1% of GNI in 2017, as shown in *Exhibit 1-4*. This was due to a sustained surplus in the goods account that offset the persistent deficits in the services and income accounts. Despite the higher receipts of traditional services and improvement in modern services, the share of services exports to total goods and services exports was lower at 16.5% in 2017 compared to 16.7% in 2015. Meanwhile, the income account deficit widened due to higher net outflows of investment income, contributed by higher repatriation of profits and dividends by foreign investors based in Malaysia.

Exhibit 1-4

Current Account of Balance of Payments, 2010-2017



Source: Department of Statistics Malaysia

Malaysia's **international reserves** position remained strong at RM414.6 billion, equivalent to US$102.4 billion as at end 2017. This was sufficient to finance 7.2 months of retained imports, above the minimum requirement set by the International Monetary Fund (IMF), and was 1.1 times the short-term external debt. The IMF recommends that international reserves be adequate to finance at least three months of retained imports and double the short-term external debt[6].

Federal Government Fiscal Position

The Federal Government fiscal position remained on the consolidation path in reducing the deficit. By end 2017, the fiscal deficit reduced to 3% to GDP from 3.2% in 2015, as shown in *Exhibit 1-5*. This fiscal consolidation was achieved despite lower revenue receipts due to volatile oil market conditions. The dependence on oil revenue continued to decline with the introduction of goods and services tax (GST) in April 2015, where the share to total revenue fell from 20.9% in 2015 to 16.1% in 2017.

A total of RM427.9 billion was expended for operating expenditure during the review period. This was lower than the initial budget of RM430 billion due to the decline in oil-related revenue. The operating expenses accounted for 98.9% of revenue, leaving a small allowance to maintain a surplus current balance and finance development expenditure. A large portion of total operating expenses was locked-in mainly for emoluments at 35.1%, debt service charges at 12.7% and pensions at 10.2%. As a result, the adjustment in operating expenditure was undertaken, particularly with regard to reductions in subsidies, transfers to statutory bodies as well as supplies and services. In addition, prioritisation measures were undertaken, enabling more capacity building programmes and providing greater social assistance to targeted groups.

During the review period, RM92 billion was allocated for development expenditure, lower than the original target in both nominal and real terms. Moreover, the disbursement recorded a shortfall, where 94.4% of total allocation or RM86.9 billion was

[6] Based on the Guidance Note on the Assessment of Reserve Adequacy and Related Considerations, IMF Staff Report, June 2016.

expended. This shortfall was mainly due to delays in securing land and finalisation of project design despite initiatives to further improve the project management process. These initiatives include the introduction of a cost-benefit index for project selection and the continuation of compulsory value management process for projects valued above RM50 million. Development expenditure continued to be financed mainly through debt, as current account balance was insufficient. Although the level of Federal Government debt rose with the continuous fiscal deficit, debt as a percentage to nominal GDP reduced from 54.5% in 2015 to 50.8% in 2017. However, this level of debt excluded contingent liabilities as well as future commitment of payments for projects carried out through public-private partnerships.

The Government has a set of fiscal sustainability guidelines to manage the fiscal account, which comprises legislation and self-imposed rules. Among others, the Local Loan Act (Amendment) 2005 limits Government domestic borrowing to not more than 55% to nominal GDP while the External Loan Act 1963 limits Government foreign borrowing at RM35 billion at any one time. In addition, Government has self-imposed fiscal rules to limit debt service charges at 15% to total revenue. In spite of the increasing debt burden, the Government continued to meet the debt obligations. Federal Government foreign borrowing stood at RM21.3 billion while the debt service charges were at 12.6% to revenue, at the end of 2017. Nevertheless, these charges continued to increase, compared with 9.8% to revenue in 2010. Despite increasing concerns about the rising debt, Malaysia continued to be rated favourably with a stable outlook by major international rating agencies, backed by strong economic fundamentals.

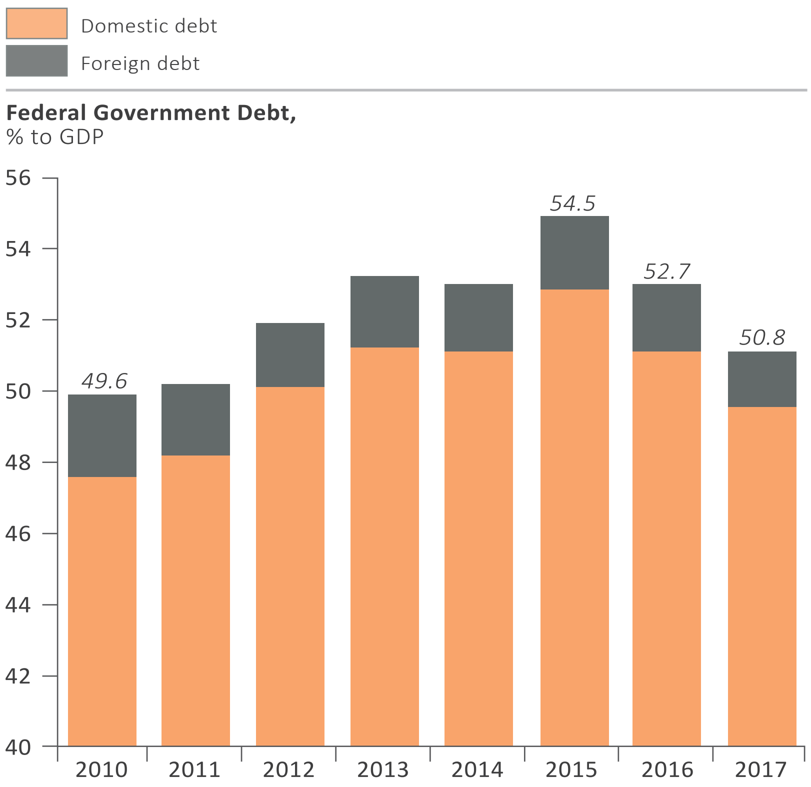
Exhibit 1-5

Federal Government Fiscal Position and Debt, 2010-2017

RM billion

Item	2010	2015	2016	2017
Revenue	159.7	219.1	212.4	220.4
Operating Expenditure	151.6	217.0	210.2	217.7
Current Account	8.0	2.1	2.2	2.7
Development Expenditure	52.8	40.8	42.0	44.9
Overall Balance				
• RM billion	**-43.3**	**-37.2**	**-38.4**	**-40.3**
• % to GDP	*-5.4*	*-3.2*	*-3.1*	*-3.0*
Total Federal Government Debt[7]				
• RM billion	407.1	630.5	648.5	686.8
• % to GDP	*49.6*	*54.5*	*52.7*	*50.8*

Source: Ministry of Finance, Malaysia



[7] Limited to borrowings and debt securities issued by the Federal Government.

Inflation and Labour Market

The price pressures in the economy remained moderate with **inflation** averaging at 2.9% (2016: 2.1%, 2017: 3.7%) amidst higher domestic fuel prices, recovery in global commodity prices and weaker exchange rate. The inflation rate was further contained with supportive monetary policy responses and administrative measures by the Government. However, increase in prices of certain items, such as food and transportation, remained as a concern. Malaysia maintained its full employment level as the **unemployment rate** remained stable at 3.4% of the labour force in 2017.

Malaysian Wellbeing Index

In line with the economic progress, the wellbeing of the *rakyat* also improved. The MyWI showed an overall increase in the wellbeing of the *rakyat*, with the index improving from 121.8 in 2015 to 122.8 in 2016. Based on the economic wellbeing sub-composite index under the MyWI, Malaysians enjoyed higher income, conducive working conditions and improved transportation infrastructure. Likewise, based on the social wellbeing sub-composite index, Malaysians' social wellbeing was enhanced through better housing, amenities and public safety as well as more leisure activities. However, there were areas of concerns which needed to be addressed, including family life, environment and health. These concerns are reflected by several indicators such as juvenile crime, non-communicable diseases, household debt and domestic violence, which show an increasing trend.

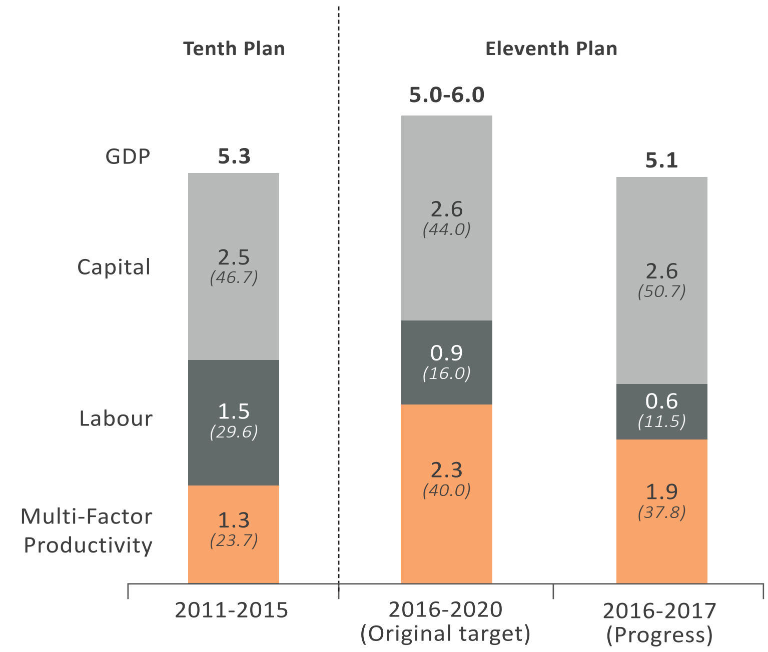
Performance of Game Changer: Unlocking the Potential of Productivity

Unlocking the potential of productivity has been underscored as a game changer in the Eleventh Plan. Hence, the Malaysia Productivity Blueprint (MPB) was launched in 2017 to boost labour productivity. During the review period, economic growth was mainly driven by the traditional factor inputs of labour and capital, contributing an average of 62.2% to the economic growth, as shown in *Exhibit 1-6*. Correspondingly, the share of multi-factor productivity (MFP) to GDP growth was at 37.8%, lower than the target of 40%, due to its slower growth at an average rate of 1.9% per annum. Nevertheless, the share of MFP improved as compared to 23.7% in the Tenth Plan.

Exhibit 1-6

Factors of Production, 2011-2020

Growth, at constant 2010 prices, % p.a.
Share to growth in brackets, %



Source: Department of Statistics Malaysia and Economic Planning Unit

Malaysia's labour productivity increased from RM75,634 per worker in 2015 to RM81,268 in 2017, at an average growth rate of 3.7%, achieving the Eleventh Plan target, as shown in *Exhibit 1-7*. The productivity improvement was driven by higher capital-intensity in the economy resulting in lower employment expansion, particularly in the semi-and low-skilled categories.

At the sector level, labour productivity in almost all sectors recorded positive growth, led by mining, which expanded by an average rate of 10.9%. This was supported by higher production in natural gas coupled with the sharp contraction of employment in the sector following the prolonged low crude oil prices. This was followed by construction at 6.1%, services at 4.6% and manufacturing at 3.9%. However, labour productivity of the agriculture sector contracted by 1.8%, with lower production due to adverse weather conditions.

The MPB aims to drive the initiatives in boosting labour productivity in a holistic manner at the national, sector and enterprise levels, as shown in *Exhibit 1-8*. At the sector level, these initiatives will be mainly driven by productivity champions appointed from industries with support from the Government.

Exhibit 1-7

Labour Productivity by Economic Sector, 2010-2020

Sector	RM '000 value added per worker, at constant 2010 prices				Average Annual Growth Rate, %		
	Actual				Tenth Plan	Eleventh Plan	
					Actual	Original Target	Progress
	2010	2015	2016	2017	2011-2015	2016-2020	2016-2017
Agriculture	52.9	53.9	51.3	52.0	*0.4*	*3.6*	*-1.8*
Mining and Quarrying	2,752.3	984.9	1,133.4	1,210.8	*-18.6*	*1.1*	*10.9*
Manufacturing	87.6	102.6	106.3	110.9	*3.2*	*2.6*	*3.9*
Construction	27.5	35.7	39.3	40.2	*5.4*	*9.6*	*6.1*
Services	59.4	66.8	69.5	73.0	*2.4*	*4.1*	*4.6*
Overall	**69.0**	**75.6**	**78.3**	**81.3**	***1.8***	***3.7***	***3.7***

Source: Department of Statistics Malaysia and Economic Planning Unit

Exhibit 1-8

Game Changer: Unlocking the Potential of Productivity

Component	Issue	Progress, 2016-2017	Targeted Outcome
Approach	Fragmented productivity initiatives, typically at national level	Under the Malaysia Productivity Blueprint (MPB), strategies have been developed to boost productivity at all levels: • 10 national-level initiatives with 16 key activities (28 key performance indicators with specific milestones have been set for implementation) • 42 sector-level initiatives for 9 selected subsectors • Enterprise Productivity Diagnostic (EPD) framework at the enterprise-level	Focused and comprehensive strategies at all levels–national, sector and enterprise
Champion	Led by the Government	Implementation of MPB is spearheaded by industry champions through the Productivity Nexus with strong support from the Government: • 9 Productivity Nexus have been established in 2017 to drive the implementation of initiatives at the sector level	Spearheaded by industry champions and industry associations and supported by the Government via the National Productivity Council (NPC)
Industry focus	Focused on manufacturing sector and selected services subsectors	• The MPB covers 3 main sectors: agriculture, manufacturing and services • 9 subsectors have been identified as priority subsectors, namely retail and food & beverages; electrical and electronics; chemicals and chemical products; agro-food; professional services; tourism; information and communication technology services; machinery and equipment; and private healthcare	Covers all sectors, including agriculture, construction and the public sector
Programme design	Generic programmes without clear targets	The MPB was developed through comprehensive engagement with stakeholders in the public and private sectors: • 15 workshops, 3 roundtable sessions, 6 focus groups, online enterprise-level survey (1,107 respondents)	Programmes closely aligned with industry needs as per relevant industry master plan
	Incentives not linked to performance	Initiatives have been identified to realign key grants, incentives, soft loans and other funding mechanisms to productivity metrics and outcomes	Incentives linked to outcomes
Regulation	Absence of or little linkages between policies or regulations with productivity	• The Guillotine approach has been adopted to remove non-tariff measures (NTMs) that impede business growth • 668 out of 713 NTMs have been reviewed	Linkages established between government policies or regulations with productivity
Oversight	Oversight only at the national level	A strong governance model has been established to strengthen oversight at all levels with clear role and responsibility: • NPC, chaired by the Prime Minister, to provide strategic oversight at national level • The Delivery Management Office to coordinate, monitor and evaluate implementation of productivity strategies at sector and enterprise levels with close collaboration with the respective Productivity Nexus	Increased oversight across national, sector, and enterprise levels

Issues and Challenges

A number of long-standing structural economic issues remain unresolved affecting the pace of economic reforms towards becoming a developed and inclusive nation. Among others, the economy is more dependent on traditional factor inputs and less on productivity to drive growth. Investment is more focused on physical structures instead of machinery and equipment, of which is crucial to boost the productive capacity of the economy. Meanwhile, many industries are still in the low-end to mid-range of the value chain for products and services, creating limited number of high-income jobs. The tight fiscal space continues to constrain public sector financing for development programmes and projects.

Productivity

National productivity has recorded significant improvements in recent years. However, there are still common challenges across all sectors that impede further productivity improvements, namely related to talent, technologies, industry structure and accountability, business environment, and mind set. Among these, talent is the most important factor needed to boost productivity. Industry players are faced with skill gaps among local graduates, which is partly due to the mismatch between industry demand and the supply from the institutions of higher learning as well as technical and vocational education and training institutions. In addition, industries are largely dependent on semi- and low-skilled workers and foreign labour[8]. Semi- and low-skilled workers made up 72.5% of total employment in 2017 whereas foreign workers made up 15.5%. The overdependence on low-skilled foreign labour, has perpetuated a labour-intensive economy, suppressed wages and served as a disincentive to automation, thus impeding efforts to increase productivity.

Investment in the adoption of technology and digitalisation is still relatively limited among enterprises, despite initiatives to boost the adoption of digital innovation. Hence, Malaysia is at risk of losing out on potential productivity gains in comparison to its regional peers. The situation is exacerbated given the rapid intensification of digital technology driven by the Fourth Industrial Revolution. Despite the significant improvements in ease of doing business, burdensome regulatory measures persist across sectors including inconsistent interpretation and application of regulations, have affected enterprise productivity. In addition, the complex and lengthy licensing application processes have resulted in high costs and delays, further stifling productivity improvements.

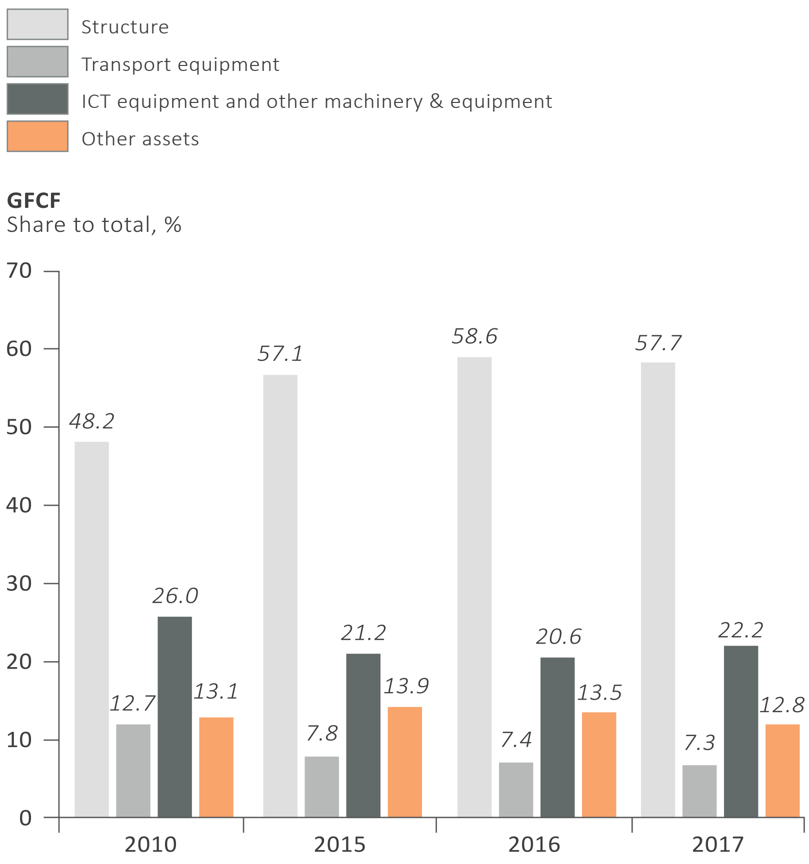
Investment

Investment as reflected by GFCF has risen over the last decade to reach 25.3% to GDP in 2017 in supporting the rapid socioeconomic development of the nation. Nevertheless, share of GFCF by type of assets showed that investment was more focused on physical structures, which increased from 48.2% in 2010 to 57.7% in 2017, as shown in *Exhibit 1-9*, while investment in information and communications technology (ICT) equipment as well as other machinery and equipment decreased from 26% to 22.2% during the same period. The lower share of investment in ICT equipment as well as other machinery and equipment in Malaysia impedes greater adoption of advanced technologies and automation by industry. This has limited improvements in production processes and productivity gains. In contrast, developed countries, such as the US and Republic of Korea (ROK) had invested more than 20% in machinery and equipment persistently over a decade at the peak of the countries' industrialisation phases.

[8] Refers to Labour Force Survey 2017, Department of Statistics Malaysia.

Exhibit 1-9

Gross Fixed Capital Formation by Type of Assets, 2010-2017



Source: Department of Statistics Malaysia

Sectoral Output

Notwithstanding broad-based growth in all sectors and approaching the economic structure of a developed nation, services and manufacturing sectors continued to dominate the economy. However, there is a need to diversify activities within the sectors from traditional economic activities. The services sector is still being dominated by the traditional services subsectors while technology-driven modern services subsectors have stagnated during the review period. Meanwhile, the manufacturing sector is often faced with lack of investment in machinery and equipment as well as innovative capacity. The sector continued to focus on the assembly of products rather than embark on high value-added design and product development. In the agriculture sector, the industrial commodity subsectors continued to be the mainstay in spite of greater emphasis given to increase agro-food production to reduce food imports bills and increase food self-sufficiency levels.

Fiscal Space

Government revenue has not kept pace with the economic growth as evident by the downward trend of tax buoyancy since 2012, dropping from 2.2 in 2011 to 0.5 in 2017. Hence tax-based revenue, which made up the major share of total revenue, fell from 13.8% to GDP in 2016 to 13.1% in 2017. This was lower than that of OECD average of 20.6%. Direct taxes, which contributed 51.6% of total revenue in 2016, remained as the main source of revenue for the Government, higher than that of Thailand at 33.9% and ROK at 20.5%. Meanwhile, the share of indirect tax at 28.1% was lower than ROK and Thailand with a contribution of 57.6% and 49.8%, respectively, highlighting the need for tax reforms. The lack of revenue impedes the ability to deliver quality services to the *rakyat*.

The fiscal consolidation efforts have been supported mainly by the enhancement in spending efficiency, despite the lagging revenue performance. Even though spending efficiency measures such as reprioritisation of programmes and projects, reduction in discretionary expenses and rationalisation of public sector administration have been undertaken, the effect was subdued by the cost of mega projects. Compounding the situation, majority of the mega projects were financed through off-budget arrangements, guaranteed by the Federal Government and reflected in rising contingent liabilities. Such financing method has contributed to the accumulated fiscal exposure of the Government. In addition, the financial commitment from the public-private partnership projects in the form of availability charges and lease payments, added further strain on Government finances. Rising debt as a result of continuing deficit, coupled with increasing liabilities from guarantees and leases, requires a comprehensive reform of public finances.

Conclusion

Malaysia's economy continued to expand, albeit at a moderate rate, during the review period as a result of slower world economic growth and modest global trade expansion in 2016. Even though the economy fully rebounded in 2017, the slowdown in the previous year has affected the medium-term growth trajectory and posed an added challenge for Malaysia to meet the developed and inclusive nation goal in line with Vision 2020. Notwithstanding the robust growth recorded during the review period, a number of long-standing disparities and structural economic issues remain unresolved, affecting the pace of economic reforms.