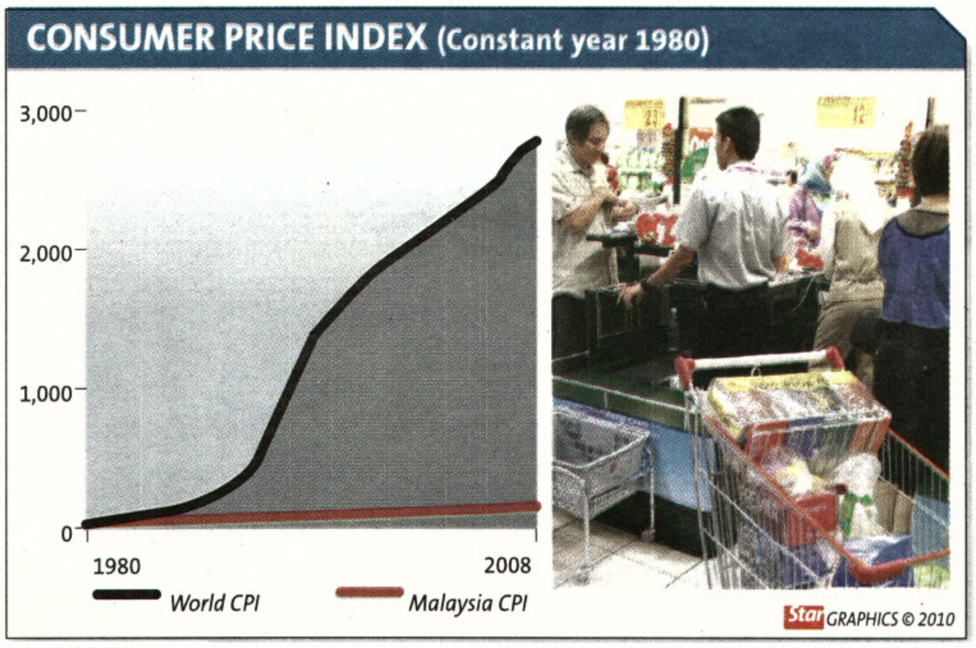

Figure 1

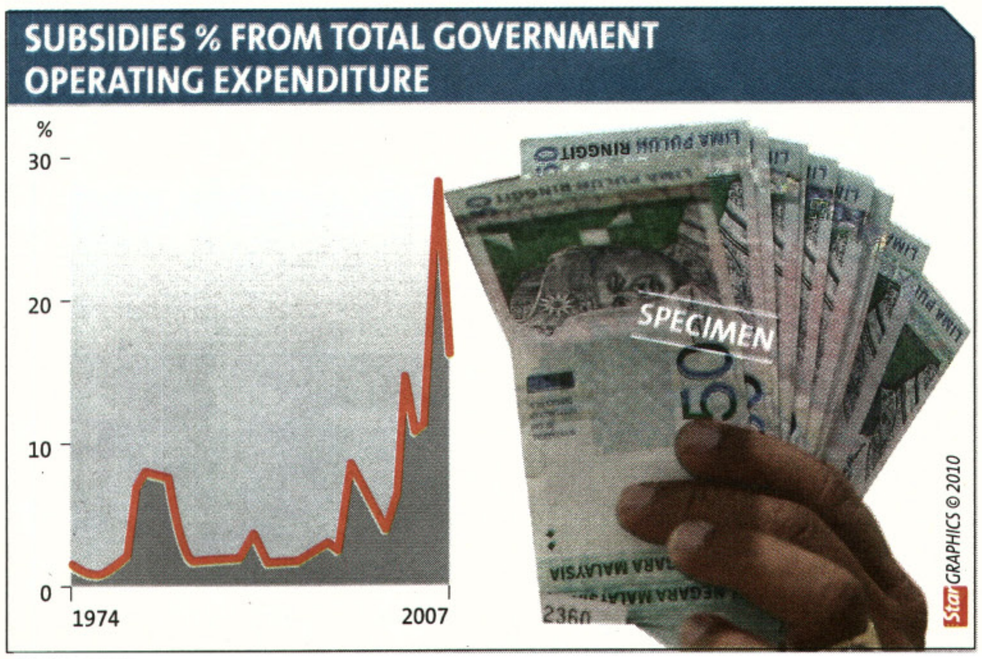

Figure 2

Caught in middle-income trap

A graduate teacher starts at RM2,500 per month in Malaysia, compared to RM6,196 in Singapore and RM15,661 in Hong Kong. Malaysian wages have fallen behind partly due to the gross divergence between the suppressed Malaysian CPI and that of the world.

By Dr FONG CHAN ONN

OVER the last few months, there has been much discussion on the issue that Malaysia has been caught in the middle-income trap. In this article, I will discuss the rationale on why Malaysia has been caught in this dilemma, and some of the steps we need to take to emerge as a high-income economy.

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

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

This is because of the following factors:

Price controls

In 1946, the colonial government enforced price controls in Malaya to avoid economic hardships after World War II. This policy holds until this day.

Price-control items include basic necessities such as rice, flour, sugar, fertilisers, milk, chicken and even bus and taxi fares. Because of controls, these commodities are much cheaper in Malaysia compared to outside.

For example, as of December last year, a kilo of raw sugar in Malaysia was RM1.35, while the world price was RM2.20; that of rice is RM2.75 per kilo compared to world price of RM6.75.

Since basic necessities constitute a large component of the Malaysian CPI, the cumulative effect of price controls for over 60 years has been a gross suppression of our CPI compared to world CPI (see Figure 1).

Workers' annual pay raises are linked to the nation's CPI. The gross divergence between the (suppressed) Malaysian CPI and that of the world has also led to a corresponding significant divergence of Malaysian wage rates compared to that of the world.

This, in reality, is the major reason why since the 1980s, Malaysian wages have fallen behind wages of the rest of the world (see chart on Page 28). As an example, a graduate teacher starts at RM2,500 per month in Malaysia, compared to RM6,196 in Singapore, and RM15,661 in Hong Kong.

Besides restraining Malaysian wages, price controls also severely distort the 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 Malaysian products and, of course, low productivity growths.

Subsidies

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

In the 1970s, when the price of oil was under US$12 per barrel, petrol subsidy was a bearable cost to the Government. However, with the present high oil prices (over US$75 per barrel), this has become a disastrous predicament for the Government to continue bearing.

As Figure 2 shows, the cost of subsidies has ballooned from 3% of government operating expenditure in 1998 to almost 30% in 2008!

The high cost of subsidies in turn restrains 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.

Agriculture sector drag

The dominance of oil palm and rubber in the agriculture sector is unfortunately a significant drag on the nation's ability to leapfrog into a high-income economy.

Given the plantation terrain, oil palm harvesting and rubber tapping remained manual in nature and (unlike grape or wheat harvesting) not easily mechanised. Up to this day, they remained as low-wage activities, fossilising our dependence on foreign labour (about 300,000) for the continued "vibrancy" of the plantation sector.

The unavoidable presence of these foreign workers in plantations also meant that many labour-intensive manufacturing operations could still continue to exist in the countryside (even in face of local worker shortage) because of the easy "mobility" of these foreign workers from estates to factories. This also means that it is very difficult for the Government to disallow or curtail foreign workers in non-plantation sectors, when it sanctions such a large presence of foreign workers in plantations.

The cumulative effect is that there are now about 2.3 million low-skill foreign workers in Malaysia, making up about 20% of the workforce. They are in the manufacturing, petroleum, construction and domestic-help sectors.

> **»Many countries caught in the middle-income trap have deliberately jump-started their economy through a high wage policy«**
>
> DR FONG CHAN ONN

Lately, they have also penetrated into retailing, food and beverage, tourism and hotel industries.

The foreign-based Electrical and Electronics (E & E) firms have already declared, in their dialogue sessions with the Government, that they would be forced to move out if foreign workers were to be limited or stopped! This argument, if accepted, will mean that our economy could remain in the middle income trap for the foreseeable future.

Where do we go from here?

South Korea's GDP per capita is US$16,450, Singapore US$34,346, Hong Kong US$29,559, while Malaysia is still at US$7,469. It must be remembered that in the early 1970s, we were at parity with these countries. In five years' time they would be even further ahead. What are the bold steps we need to undertake to enable us to leap out of this middle income trap?

I will attempt to elaborate on some of these steps:

Phasing out subsidies and price controls

Price controls and subsidies have created artificial market prices that distort the domestic factor proportions and impede economic efficiencies. The Government has to be bold to find ways to phase out price controls and subsidies; maybe not all at once but over a time frame of say five years. Malaysia is a small country and we cannot live in isolation from the rest of the world economy.

Petrol subsidies, in particular, should be removed within one to two years; while extensive information campaigns are carried out to enable motorists to adjust to living within the context of petrol prices being set in accordance with the world crude prices, as is the practice in many other countries.

In conjunction with the phasing out of subsidies and price controls, the Government must introduce a transparent system of social safety net, providing welfare assistance to the needy, the disabled, the aged, the unemployed and the poor. A coupon-system (together with MyKad) can be introduced where those in need are given subsidies for basic necessities and other essentials such as petrol.

Of course, this implies the need for the Government to create a nationwide data-base of those in need, not unlike the registration system for welfare payments, but more comprehensive in nature taking into account employment status and also proving channels for verification and counselling.

High wage policy

Malaysian wages have been suppressed by market factor distortions for too long. The Government should encourage our wages to be pushed up in line with the rest of the world. When the rakyat can take home more pay, they are then better enabled to adjust to the reality of world prices that will be felt when controls and subsidies are phased out.

Many countries caught in the middle-income trap have deliberately jump-started their economy through a high wage policy. Singapore is a good example; in the 1980s, its economic progress stagnated and the Singapore Government deliberately compelled companies to increase their wages by 50% or more. Though painful at first, this ignited "a second industrial revolution" in Singapore when companies became much more capital-intensive and focused on high-end manufacturing and financial activities. Today, it is a vibrant economic hub of Asia.

We could introduce a similar high wage policy by initially requiring vulnerable sectors such as plantation and agriculture, labour-intensive manufacturing, construction and services (such as restaurants and hotels) to have decent minimum wages.

The plantation companies, in particular, should be required to pay higher wages to

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How our strengths can boost economy

> FROM PAGE 26

attract more Malaysians to work in this sector.

As an example, the 2008 Annual Return of the Asiatic Group – a typical mature plantation company – shows that its total wage payment (RM83mil) constituted only 18% of its before tax profits (RM456mil); and it can certainly even double its wage bills and still remain extremely profitable!

Employers would then have to use more equipment in the new scenario; many of our skilled workers who are now in Singapore can then be enticed to return to these higher skill positions, and in the process uplift the productivity of our economy. The multiplier effects of this would be translated into higher wages for the supervisors, managers and other professionals as well.

Innovative incentives for high-tech activities

The traditional incentives offered by Malaysia in the form of pioneer status and capital investment allowances are not attractive anymore. High-tech start-ups are risky ventures; they need large capital, and hence access to venture capital and government assistance. They also need speedy Internet access and rapid logistics.

They cannot work in an environment where restrictions are placed in terms of equity ownership or employment of expatriates. They, most of all, expect rapid decision-making by us in processing their applications. In early 2000, the Indian information giant Infosys wanted to invest in Malaysia and sought approval for their expatriates to work here; our hesitancy and delay in decision-making caused them to relocate to Mauritius!

We should follow the world trend, and be rapid, decisive and agile in our engagement with high-tech entrepreneurs. We have to introduce innovative incentives to attract them to come here. This includes the offer of cash grants (as a form of venture capital), and R & D research grants to companies to set up their bases here.

In keeping with the common practice of many other countries, the Government must also be willing to offer work permits and permanent resident status to highly qualified scientists and other highly educated individuals to entice them to work in Malaysia not only as a second base but also as a second home.

IT infrastructure and public R & D centres

Malaysia was among the first to recognise the importance of IT by the establishment of our Multi-Media Super Corridor in 2001. But other countries have since superseded us in IT infrastructure. Consider this: our Internet download speed is only 2.2 Mbps, compared to South Korea's 23.6 Mbps and Singapore's 8.0 Mbps; our broadband penetration rate is only 30% compared to South Korea's 97%!

Entrepreneurs now expect to be able to work through their notebooks while commuting in rapid trains and cars. They expect to be able to do video-conferencing while on the move. Our current download speed does not allow for these, and more importantly does not allow the functioning of many of the new IT applications.

Bigger role: Petronas can play a more significant part by helping to develop a downstream oil and gas sub-sector.

Salary comparisons

Occupation/Nation		UK	Hong Kong	Singapore	Malaysia
Policeman (high school diploma)					
	RM	10,615	9,509	3,788	1,481
		£1,939	HK$21,645	S$1,559	
Teacher (graduate)					
	RM	11,864	15,681	6,196	2,500
		£2,167	HK$35,693	S$2,550	
Accountant					
	RM	22,813	12,814	6,561	2,310
		£4,167	HK$29,167	S$2,700	
Clerk (high school diploma)					
	RM	7,757	3,954	2,916	1,000
		£1,417	HK$9,000	S$1,200	

Based on 29/01/2010 exchange rate

The Government needs to quickly bring the state of our IT infrastructure up to parity with the global standard as a precondition for pushing Malaysia towards a high-income economy.

Further, one of the most effective methods for rapid societal debuts of new scientific ideas and innovations is the availability of public R & D centres for niche areas, where high school and university students can be encouraged to experiment with their ideas.

This was how Steve Jobs was stimulated to design the first Apple personal computer in the 1980s in Silicon Valley. And a major reason for the success of the present Korean film industry is the Seoul Animation Center; a centre where Koreans who have interest in animation for movies, computer games, or digital advertising could drop in, play around with their scripts and hopefully end up with viable commercial products.

The Government should follow this trend by setting up R & D centres in 3-D Animation, Computer Accessory Inter-face, Micro and Nano-Technology, Horticulture, Aquaculture and others deemed suitable to our resource endowment. With the proper involvement of schools and colleges, this could lead to the formation of interest groups focusing around the availability of facilities at the centres. Ultimately, this will lead to more passion for science and technology among the young, and the germination of new ideas for products and services.

Leverage on Malaysian professionals and experts overseas

According to an estimate by MEF, there are at present more than 500,000 Malaysian professionals working abroad; and they are in major cities such as New York, London, Paris, Tokyo, Beijing, Hong Kong, and Singapore working and doing research in areas like medicine, financial services, engineering, accountancy, logistics, construction, venture capital and other services.

In my interaction with many of them, they said that they very much want to contribute to Malaysia's progress. Given the right conditions, I feel that they could be persuaded to set up base here. Unfortunately, often times, we have not engaged them sufficiently.

As an example, the renowned UK liver transplant surgeon Datuk Dr Tan Kai Chah wanted to set up base in Malaysia but could not do so because, as a Malaysian, he was required to do a compulsory three-year government service. Singapore, having gotten wind of this, headhunted him. His liver centre in Singapore is now very much sought after by patients near and far.

Learning from this, we should attract our Malaysian professionals to return to Malaysia, by the Government setting up a Special Group to identify them and then engaging those who are interested to return or at least set up base here.

This engagement should be done discreetly so that their individual requirements can be assessed and met, and their problems resolved. If their foreign spouses want to work, if their children need special education, if they need R & D grants, etc, all these we should be able to resolve. Then and only then can we gain leverage on the large pool of brainpower that we already have.

We should act quickly in this respect, for such talents are being aggressively headhunted by other governments. The Government should do all it can to ensure that our professionals, with their wide international exposure, will end up on our shores and not become other societies' assets.

Strategic location

Kuala Lumpur's location at the heart of Asean and its multi-cultural environment enhance its attraction for many emergent high-income activities. We have often forgotten that KL is only 300km away from Singapore and it also has access to deep seaports and airports. Fortunately, AirAsia did not forget this and, riding on the wave of budget air travel, has developed KL as the low-cost air hub of Asia-Australia. With our current lost-cost structures, KL could similarly be developed into the low-cost shipping and logistic hub of Asia.

The Government should also aggressively promote KL as the focal centre for business transactions between East (China, Korea and Japan) and West (India and Middle East) Asia.

A few enterprising Taiwanese direct-sale companies have already established processing centres and warehouses in Malaysia for export of their products to the Middle East because Malaysian-labelled products are more easily accepted in these markets. This is only the beginning of a new wave of opportunities, as East and West Asia get better connected.

Green energy

Flooded with sunshine, strong winds and free from natural disasters, Malaysia is an ideal location for green renewable energy R & D and manufacturing. Renewable green energy has to be promoted to be Malaysia's new strength. The world's top three solar companies have now located themselves in Malaysia. One of them (Sun Power) is building the world's largest solar power manufacturing plant in Rumbia, in my constituency in Malacca.

The Malaysian Industrial Development Authority (Mida) must work hand in hand with the solar companies to come up with incentives and a strategic policy to match that of China, which is currently the world leader in solar power. We must seize this opportunity to nurture a cluster group of ancillary suppliers to provide materials and supporting services to the solar companies, just as we did when we started with E & E in 1972. We must not miss this boat to build a "Solar-con" manufacturing base to equal that of the silicon hub of Penang.

Medical care and pharmaceutical trials

With an aging population all over the world, high quality medical care has become an emergent high-value economic sector. Highly-trained Malaysian medical specialists are working by the hundreds in Singapore, London and Dublin. More importantly, they are highly respected in their fields. They could and should be encouraged to set up base here and transform Malaysia into a world-class international medical centre. The big advantage is that our cost is half that of Singapore, and one-third of that of Hong Kong, the United States and London.

If we reorganise ourselves, we can be among the top in this area. The urgent necessity is for the Government to reconsider compulsory government service for recognised Malaysian medical experts. Isn't it better to allow them, already in their late 30s, back to create employment and build up our medical base, as opposed to rigidly requiring them to work for three years in government service at great personal and family sacrifice to themselves?

Malaysia, with our multi-ethnic population and extensive bio-diversity, is an ideal place for R & D in pharmaceutical products, particularly in the conduct of trials for new drugs, before their formal acceptance by the authorities. This can be in the area of cancer, Alzheimer's, osteoporosis, bone conditioning, and heart diseases. The Health Ministry and Mida should quickly formulate a new strategy to attract pharmaceutical companies to seriously consider Malaysia as their new destination for R & D and trials.

Oil and gas activities

Petronas is known worldwide for being a successful national petroleum company. Petronas has done really well for the country in terms of generating oil and gas revenue from both Malaysian and non-Malaysian fields. Unfortunately, unlike the E & E sector, up-stream oil and gas production has not resulted in the emergence of a corresponding vibrant downstream oil and gas sub-sector. We are still very dependent on foreign oil and gas ancillary suppliers for many of the specialised downstream services, such as rig and platform maintenance and repairs, safety training, search and rescue, and other related R and D activities.

Kemaman, Miri and Bintulu are now vibrant oil-related towns. Petronas can play a more significant nurturing role and spin off more of these related activities (which are now sub-contracted to foreign suppliers) to independent Malaysian entrepreneurs of all races, so that we can begin to transform these towns into mini Houstons. Besides its economic benefits to the country, this would also greatly endear Petronas to the hearts of the average Malaysians.

In this article, I have argued that Malaysia has been inhibited from fulfilling its true potential by distortions (in the domestic economy) caused by various policies since independence; by phasing out these distortions and focusing on our strengths in new areas, we can and would emerge as a high-income economy in the not too distant future.

Datuk Seri Dr Fong Chan Onn was Prof of Applied Economics and Dean of Faculty of Economics and Administration, Universiti Malaya. He served in the Government as Deputy Minister of Education (1990-1999) and as Minister of Human Resources (1999-2008). Currently, he is the MP for Alor Gajah.