Changing Drivers of Economic Growth in Malaysia

Introduction

Malaysia has witnessed strong sustained growth over the last three decades, growing at an average annual rate of 5.8%. This sustained growth performance has been accompanied by significant structural shifts in the economy, reflecting the transformation of the Malaysian economy amid the changing global and domestic environment. From a primary producer with a gradual industrialisation strategy, the Malaysian economy has undergone transformation into a highly-open economy through greater trade and financial integration since the late 1970s. As a result, Malaysia's trade openness is among the highest in the region, reaching a peak of 192% of GDP in 2000. More recently however, strengthening domestic demand has become a key driver of growth, underpinning the continued resilience of the economy despite the challenging external environment.

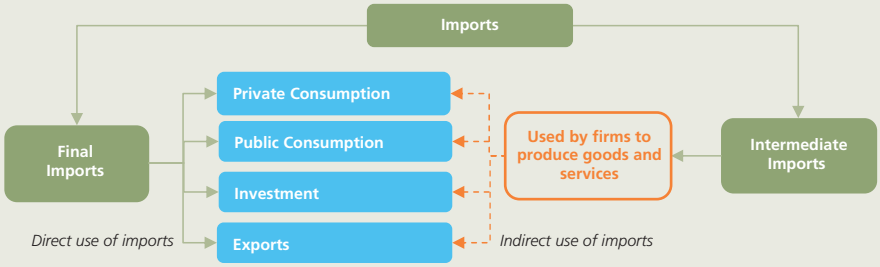
This article aims to shed light on the structural changes in the Malaysian economy in terms of the drivers of its growth. The analysis finds quantitative evidence that while Malaysia remains a highly-open economy, domestic demand has increasingly become an important driver of growth in recent years. This has in turn induced structural changes within the economy, with stronger growth and job creation in the domestic-oriented industries.

Methodology: An Alternative Approach in Estimating the Contribution to Growth

Demand in the economy takes two forms: Domestic demand (private consumption, public consumption and total investment) and external demand (exports). Imports, on the other hand, represent a leakage from the economy. For example, a good that is consumed domestically could be directly imported or produced domestically but contain imported content used in its production (Chart 1). These imports help satisfy domestic demand but do not themselves represent value-added by domestic industries. Domestic demand and exports contain varying degrees of import content which must therefore be subtracted from each of the demand components to better understand their net contribution to the economy.

Chart 1

Final Use of Imports



In determining the sources of growth, the quick conventional method is to use private consumption, investment, public consumption and net exports as a share to GDP. The advantages of this approach lie in its simplicity and the fact that net exports immediately highlight the net contribution of foreign trade to economic growth. However, a limitation of this method is that it is not representative of the true relative contribution of domestic and external demand in driving growth. Imports that help satisfy domestic demand are not netted out from domestic demand, overstating the true impact of domestic demand on domestic value-added.

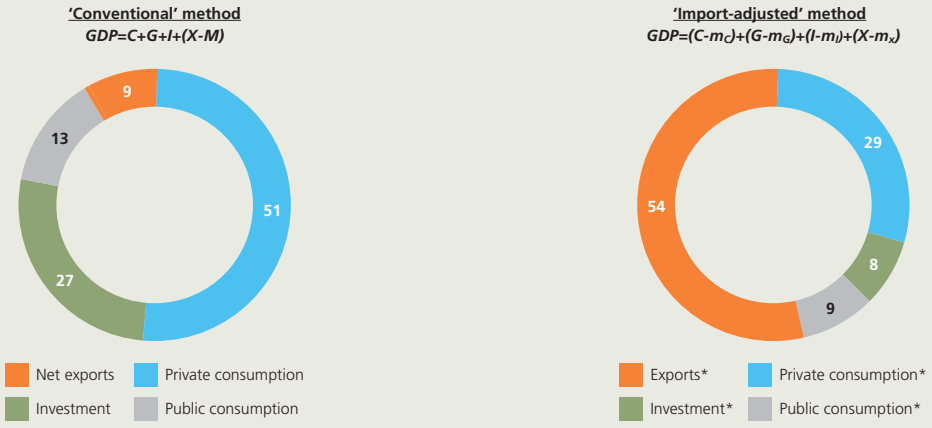
For a more accurate estimation of the net effect of each demand component on value-added, it is necessary to remove, from each component of demand, its import content. In essence, this can be

done by decomposing total imports according to the expenditure component that they were eventually intended for. The input-output cumulative production structure[1] (CPS) technique estimates the import content of the goods and services associated with each component of final demand for the economy. The difference between a particular final demand component and its import content is used to derive the net contribution of each demand component to overall GDP. For example, the net contribution of private consumption to GDP is private consumption minus both final imports for consumption and intermediate imports used by domestic firms to produce goods and services that are consumed. Chart 2 compares the conventional method and the import-adjusted method, highlighting the differences in interpretations of the role of domestic demand when each method is used.

Chart 2

Comparison between Import-Adjusted GDP by Expenditure Component with Conventional Practice

(%, share of GDP in 2012)



*Net of imports

Where C= private consumption, G= public consumption, I= investment, X= exports, M= total imports, M_C= imports for C, m_G= imports for G, m_I= imports for I, and m_X= imports for X

Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

Results: Transformation of the Malaysian Economy

1970s to early 2000s: Towards a more export-oriented economy

Applying the import-adjusted method to the various components of demand in the economy[2], there is a clear indication that within three decades, the Malaysian economy had become increasingly open. Chart 3 shows the evolution of the net contribution of each demand component to GDP since 1978. The net contribution of exports to GDP almost doubled from 36% in 1978 to 61% in 2005. In other words, by 2005, external demand accounted for 61% of domestic value-added created in the economy. This increasing openness meant that the Malaysian economy was more dependent on international demand in 2005 than it was in the 1970s.

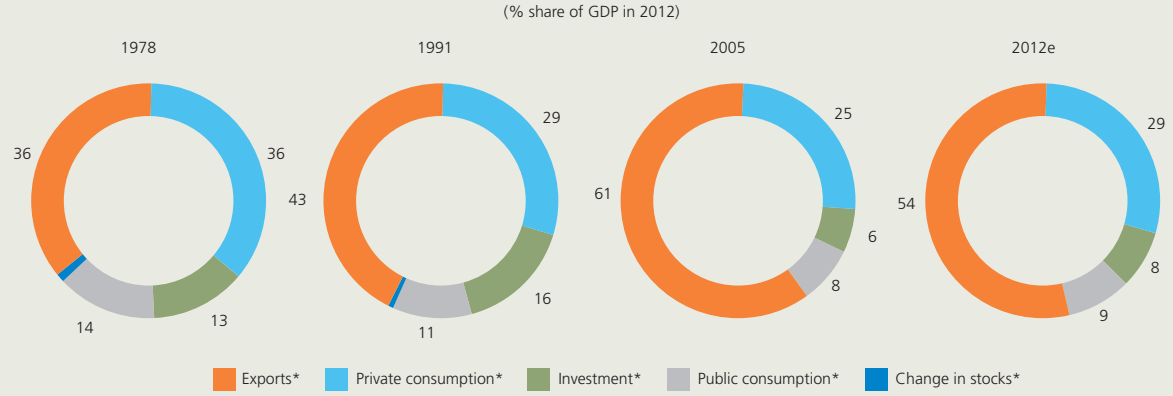
Mid-2000s to present: Emerging strength of domestic demand

Since 2005, domestic demand has emerged as an increasingly important driver of growth. Estimates for 2012 in Chart 3 suggest that the net contribution of exports to GDP has fallen to 54% while domestic demand has increased to 46%. To further analyse this trend, the import-adjusted method is extended[3] to estimate the net contributions of domestic and external demand to GDP from 2005

[1] Klein, 1983.
[2] Using input-output tables published by the Department of Statistics, Malaysia for the years 1978, 1991 and 2005.
[3] Based on Kranendonk and Verbruggen, 2005, 2008.

Chart 3

Evolution of Malaysia's GDP by Import-adjusted Components



* Net of imports

e Estimates based on 2005 Input-Output table

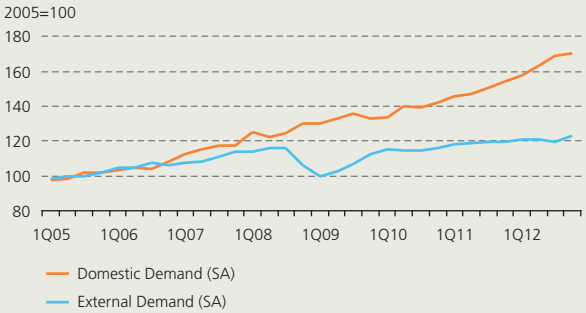
Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

onwards (Chart 4). Chart 4 depicts the strength of domestic demand which began to gain momentum in 2007, even before the external sector was affected by the financial crisis in the advanced economies. Since the crisis, it is evident that the growth of domestic demand has strengthened significantly while the performance of external demand has remained sluggish. From an overall growth perspective, the relative resilience of domestic demand has partly cushioned the economy from the adverse effects of the slowdown in exports.

The net contribution of each demand component to the growth of domestic value-added is estimated in Chart 5 using the import-adjusted method. Private consumption has played an increasingly important role in driving growth, particularly since late 2006 while investment has recorded markedly higher contributions to growth since 2011.

Chart 4

Net Contribution of Domestic and External Demand to GDP



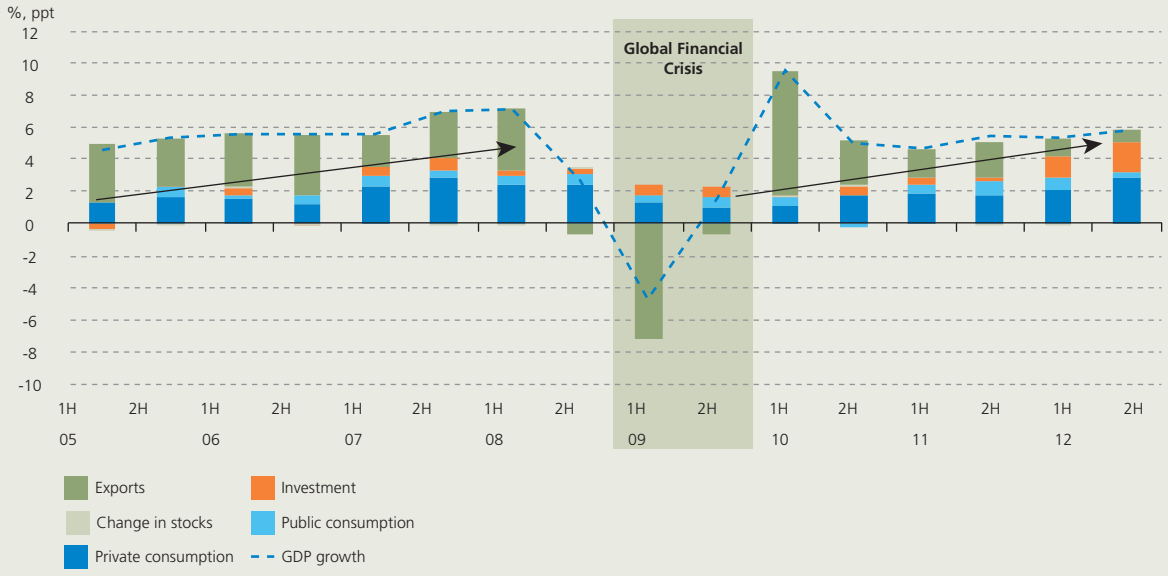
CAGR, %	2005-06	2007-08	2009-10	2011-12
Domestic demand	4.8	9.2	5.2	9.1
External demand	5.6	3.2	1.0	2.5

Source: Bank Negara Malaysia estimates

Real GDP has continued to record an annual growth of over 5% since 2011, with domestic demand growing at a compounded annual growth rate of 9.1%, contributing a significant 74% of GDP growth. These trends all point to domestic demand emerging as a key source of growth in recent years.

Chart 5

Net Contributions to Growth by Expenditure



Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

Implications: Structural Changes in Industries

The changing drivers of demand can lead to structural shifts in the economy as industries respond to the changing sources of demand. Given that a key source of demand is from the domestic market, industries that are domestic-oriented are likely to grow faster than export-oriented industries. Profitability of domestic-oriented firms will increase, attracting new firms and encouraging existing firms to expand capacity. Resources will shift towards these industries, leading to structural changes in the economy as firms respond to meet this new source of demand.

To verify this hypothesis, the domestic orientation of an industry is estimated. Input-output coefficients allow the estimation of the proportion of output of an industry that is consumed domestically (final goods and services) or indirectly used as an intermediate good for goods and services consumed domestically.

Table 1

Domestic Orientation of Industries

Sector	Domestic share (%)
Agriculture	**33.7**
Mining	**19.2**
Manufacturing	**19.3**
E&E-related industries	*6.7*
Primary-related industries	*21.6*
Consumer-related industries	*36.7*
Construction-related industries	*31.6*
Construction	**87.1**
Services	**52.9**
Wholesale and retail trade	*34.5*
Hotels and restaurants	*92.5*
Transportation	*41.0*
Communication	*59.4*
Finance and Insurance	*37.7*
Other services	*70.7*

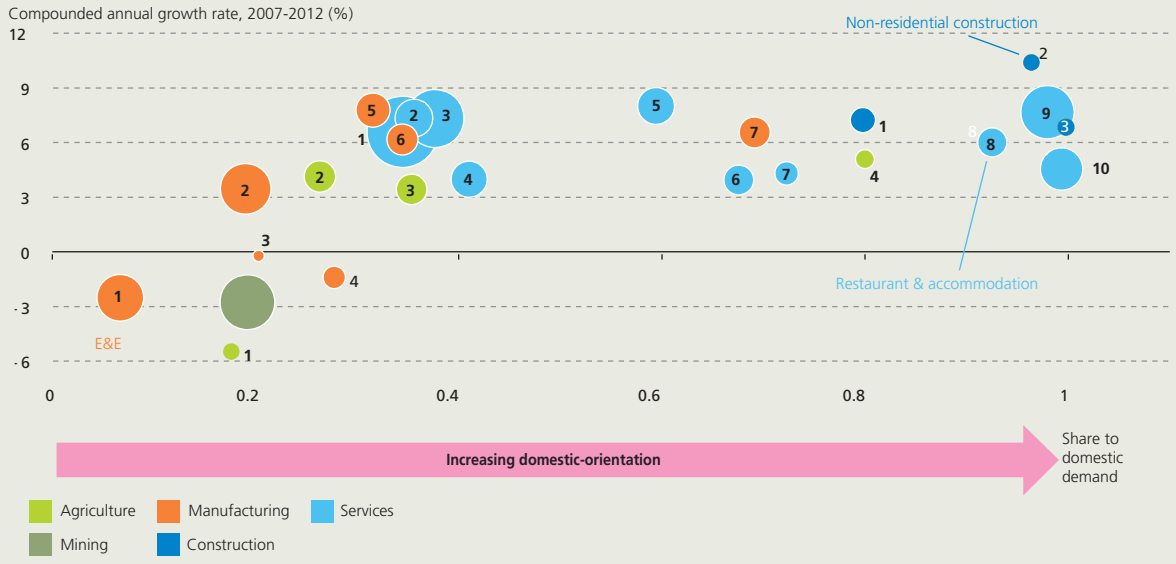
Source: 2005 Input-Output tables and Bank Negara Malaysia estimates

These estimates reveal the proportion of an industry's value-added that relies on domestic final demand. From Table 1, it can be seen that manufacturing and mining are more export-oriented while construction and services are more domestic-oriented.

Chart 6 plots the domestic orientation of sub-sectors in the economy against the average growth rate of each industry sub-sector between 2007 and 2012. As predicted, industry sub-sectors that are more domestic-oriented performed relatively better than those that are more export-oriented. There appears to be a positive correlation between the domestic orientation of an industry and its growth in 2007-2012. Of significance, the electrical and electronics manufacturing sector (export-oriented) experienced an average contraction of 2.5%, although industries catering to regional demand (construction-related and food and beverage manufacturing) had continued to record strong growth[4]. Meanwhile, the non-residential construction and accommodation and restaurant sectors (domestic-oriented) experienced strong growth of 10.4% and 6.0% respectively.

Chart 6

Faster Growth in Domestic-Oriented Industries



*The bubble size represents the relative size of value-added of the industry[5] in 2012

Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

The performance of the domestic-oriented sectors has in turn supported favourable employment conditions, with the unemployment rate remaining stable at about 3%. The strength of domestic-oriented sectors has more than offset the weakness in the export-oriented sectors. This has allowed for sustained job creation, especially in the domestic-oriented sectors, and supported income growth over the last few years.

[4] Mining recorded a contraction due to depleting oil reserves that have affected production.

[5] Agriculture: 1=Forestry & logging, 2=Others, 3=Oil palm estate, 4=Fishing ; Manufacturing: 1=Electrical & Electronics, 2=Petroleum, chemical, rubber and plastic products, 3=Textiles products, 4=Wood products 5=Construction-related products, 6=Food, beverage and tobacco, 7=Transport equipment ; Services: 1=Wholesale and retail trade, 2=Business services, 3=Finance and insurance, 4=Transport and storage, 5=Communication, 6=Utilities, 7=Real estate, 8=Restaurants and accommodation, 9=Government services, 10= Others; Construction: 1=Civil Engineering, 2=Non-residential, 3=Residential.

Conclusion

Over the last few years, domestic demand has emerged as a key driver of growth. Private consumption and total investment have been resilient, enabling the economy to expand despite the sluggish performance of exports. Growth and employment have been supported by the domestic-oriented sectors, offsetting the weakness in export-oriented industries. In part, this has been achieved following years of structural reforms and sound economic policies.

Nevertheless, Malaysia remains a highly-open economy for which exports are a key source of demand. Therefore, investing strategically in the right growth industries is crucial to ensure that Malaysia is well-positioned to leverage on new opportunities in the changing global landscape. Encouragingly, export products and markets have become increasingly diversified, orientated towards new growth industries and fast-growing regional economies. This has enabled Malaysia to move up the value chain while capitalising on global growth centres.

Going forward, creating strong, sustainable and balanced growth would entail further reforms. Sustainable growth must be underpinned by productivity improvements and innovation, enabling the transition into a higher value-added and higher-income economy. Recent measures such as the introduction of the minimum wage policy and further liberalisation in selected industries will incentivise this transition, contributing to higher incomes, which would in turn support sustained growth in consumption. Developing a comprehensive social safety net, which includes improvements to the pension and healthcare systems, together with continued efforts to promote financial inclusion, will alleviate the need for precautionary savings and raise consumption. Success in sustaining the magnitude and quality of investments will depend on the progress of structural reforms, continuous financial sector development, favourable business conditions and the availability of skilled labour. These reforms, coupled with diversification in export markets and products, will have to continue to ensure sustained growth going forward.

Reference

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