

A Problem Of Confidence

The present financial crisis started in a speculative housing bubble in the US, inflated on greed and irrational confidence. Shady practices went mainstream under the wing of weak financial governance. When the bubble burst, gold-plated names on Wall Street were implicated. A massive loss of confidence in the financial sector has crippled credit flow worldwide. Consumption has contracted as households put off expenditure out of uncertainty. Investment has retreated. There has been a massive loss of confidence.

2. Sentiments are a central factor in macroeconomic booms and busts. If a sharp loss of confidence is an endogenous part of the problem, a restoration of confidence must be the beginning of the solution. However, if we have learned anything at all from the crisis, this cannot be hollow confidence, but confidence based on a clear appreciation of our prospects. The lesson of the global economy is that false confidence based on irrational hope leads to collapse, disillusionment and pessimism.

3. We need a sound appreciation of our reality before we can dream of changing it. We need to face harsh truths before we can believe in ourselves and inspire others to believe in us. In coming to that sound appreciation here in Malaysia we have run out of time for politically manipulated messaging and sugar coated evasions.

4. Let us just begin by acknowledging that we will not be spared the effects of the global economic crisis.

5. Our leaders only undermine the government's credibility when they paint an alternative reality for us. I understand we don't want to frighten markets and voters unnecessarily, but we do not

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live in an information bubble. Only the most resolutely ignorant can now pretend that all shall be fine while the rest of the world deals with what Jeffrey Sachs has called “a world economy teetering on the brink of unprecedented catastrophe.” Leaders who deny the seriousness of the crisis only raise the suspicion that they have no ideas for coping with it. They undermine the government’s credibility when that very credibility, that confidence, is a key issue.

6. We are a trading and exporting nation. While we were relatively shielded from the first wave of financial failures there is no escape from the sharp demand slump in the global economy. The Government and Bank Negara maintain that our growth rate this year will be 3.5%. I fear it could be well under that. The latest numbers show a plunge in industrial activity, with manufacturing output in November, down 9.4 percent from a year ago. December may well be worse. Exports are down. There has been a dramatic swing in the balance of payments to a RM31 billion deficit in the third quarter, from a surplus of RM26 billion in the second. Anyone looking at the size of the downturn and at its swiftness can only wonder if we will be sailing through. This crisis really “went global” only in the final quarter of last year, but within that single quarter manufacturing both here and in Singapore contracted by more than 10 percent on the previous year. Policymakers in Singapore appear far more alarmed than our own. After having declared a recession, they found that the effects of the crisis were far worse than they thought. We are just at the beginning, and the bottom is not yet in sight.

7. Three and a half percent growth, even if we achieve it, will not create enough jobs to employ the large number who enter the workforce each year from our young population. Given our demographic profile and the fact that we are an oil exporter, our baseline do-nothing growth figure is not 0% but closer to 4%.

8. We do have a problem. Now we need to acknowledge that we are not in good shape to deal with it. After early decades of rapid progress, it looks like that economic growth has flattened, our public delivery system calcified and our economic leadership run out of ideas.

The financial crisis in the context of our developmental path

9. Malaysia is squeezed between being the low cost manufacturer we once excelled as, and the

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knowledge-intensive economy we are failing to become. Our years of sustained high growth ended in 1997 with the Asian Economic Crisis. With the subsequent rise of China and India as low cost producers with giant domestic markets, the manufacturing sector which propelled that growth is being hollowed out.

10. We are in the infamous “middle Income trap”. No longer cheap enough to compete with low cost producers and not advanced enough to compete with more innovative ones. We find ourselves squeezed in between with no economic story. Successful economies, like successful companies, need a compelling story, and we don't have one. With falling communications and transport costs, the skilled engineers, managers and designers of the rich countries are pairing themselves to the cheaper labour of poor countries to extract productivity and cost benefits. The global integration of labour markets favours both rich and poor countries and stagnates the wages of those in the middle that are neither smarter nor cheaper. That means us. Our working people have suffered stagnant wages and a rising cost of living.

11. According to the World Bank, Malaysia's share of GDP contributed by services was 46.2% in 1987. How much did you think it was twenty years later in 2007? 46.4%. How much do you think the real wages of our workers grew between 1994 and 2007? By 2.6% in the domestic sector and by 2.8% in the export sector. Unskilled migrant workers, documented and undocumented, make up 30-40% of our workforce. Meanwhile, alone in East Asia, the number of expatriate professionals here has decreased. Alone in East Asia, private sector wage increases follow government sector increases, not the other way around.

Did we have to learn about this from the World Bank? What has the EPU been doing? Has the cabinet pondered these issues? Have we had a national discussion about our need to reinvent ourselves?

12. The only long term path to prosperity is increased income through increased productivity. Sustained productivity growth is the engine of China's unbroken run of high growth. Our failure to increase productivity and working incomes has been masked by an influx of cheap labour. That cheap labour has become another crutch for us.

13. **Low growth**

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a) The other thing masking our underperformance over the last decade is the fact that in this time the world economy has experienced its biggest expansion in recorded history. We have averaged 4 to 5 percent growth throughout a historic boom over which world economic growth has averaged 4.5 percent. Meanwhile the two most populous nations in the world have been growing at or near double digit rates, multiplying per capita incomes and lifting hundreds of millions out of poverty in the greatest expansion of human welfare in history. That boom is over and we have missed it.

b) By analogy, when we view the report cards of our own children, we set our expectations against what they have been given and what they were capable of in the past. Turning to our own country, so richly endowed with natural and cultural resources, a stable society and good institutions, we see a failing report card. Instead of educating our young to be competitive we have turned out large numbers without the skills and attitudes suited for basic work, let alone for the global economy that is not out there somewhere but on our own shores.

Each decade we have discovered new 'peer-countries' against whom we might look decent because we have fallen out of the league of the last set of peers. We fail to notice we have been relegated. Remember that in the 60's we were classified with Taiwan and Korea, in the eighties with Singapore and Hong Kong. Now we are less "relevant" than Vietnam as an investment destination. I remember receiving delegations from Taiwan and Hong Kong who came to learn from us.

14. Inequality

We cannot comfort ourselves that we have sacrificed growth for social equity. Despite the strong redistributive measures the government has pursued for decades, our Gini coefficient, the standard measure of inequality, has been ballooning. In this region only Papua New Guinea is more unequal. We have the most unequal income distribution in Southeast Asia. If there is supposed to be a trade-off between growth and equity, we have not made it. We are failing on both growth and equity.

15. What does it take to make the leap from middle to high income? The countries that have done it recently, Korea, Taiwan, Hong Kong and Singapore, have one feature in common: they were able to learn from previous crises. Without a buffer of natural resources, each of these economies was more exposed than we were. In relative terms, because they are even more trade oriented than we are, each may be harder hit by this downturn than we are. But we miss

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the picture if we stand by and comfort ourselves that we are 'shielded' because our capital markets have been less open. Our very problem may be that we have been shielding ourselves from learning, which requires systematic change in behaviour or knowledge informed by experience.

16. The criterion of success for making the developmental leap, the key differentiator between the leaders and the also-rans, is not immunity from economic crises (after all, if you have a Stone Age economy, you are completely immune) but the organizational capability of governments to learn and re-organise around new national economic strategies through these crises. Each major crisis is either an important opportunity to transform the economy or a major setback to our ambitions. The question is whether our policymaking and policy implementing apparatus is set up, motivated and led to learn from this crisis. It is a question of the capability of government and governance.

17. We must also retrain and re-skill those who lose their jobs because of this crisis. This cannot be done in the present ad hoc manner. It must be a coordinated program, with courses matched and tracked to learners according to a National Skills Plan which in turns supports a vision for the Economy. Those lost jobs, especially in the manufacturing sector, will not be coming back. We better have a plan and a vision.

18. What are the consequences of sailing into an economic storm in our present condition, after a decade of lacklustre performance and with no plan, no vision for sustained high growth? We can look at two scenarios: breakdown or relegation.

a) **Breakdown**

As a developmental state, the legitimacy of our government is based on its guarantee of social peace and economic development.

As Professor Clive Kessler has observed: "Social peace in Malaysia depends upon the continuation, and the continuing expectation, of economic growth and prosperity; while economic growth and prosperity depend upon the continuation and assurance of social peace." This reciprocal relationship between peace and growth makes us prone to a vicious feedback cycle: if either engine were to fail, the other would fail with it, and take us down a spiral of failure

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with a painful end. Our margin for error is slimmer than we think. Our socio-political setup implies that we don't have a smooth glide down to complete irrelevance. Like a bicycle or an airplane, we need to be running at a certain speed to avoid falling off.

b) *Relegation*

On a second scenario we might just coast through the downturn. However we will emerge with an economy that has failed to gear up to the demands of the global economy, fallen yet further behind along our developmental path and locked ourselves tighter into a long term pattern of low growth. Sooner or later will come that painful reckoning described in the first scenario.

19. We should view the crisis in the context of our history as a young nation. The last time the world faced a contraction of this size Malaysia did not yet exist. The crisis has broken out at a critical point in the development paths of our economy and our political system. Put these three factors together, and we have a perfect storm: an unprecedented need for leadership at just the moment when our system for selecting and legitimising political leadership appears to be broken.

Where next

20. My reading of where we stand may seem harsh, but perhaps the world is harsher. I don't wish to offend, but I believe we need to grasp the peril of our situation clearly before we know what to do next.

21. In the medium term we need to make a developmental leap. But a leap is not a straight-line projection of the present. It is not about doing more of what we have done. We are not going to get there putting up more highways, declaring more Growth Corridors or planting more oil palm. The way up is a complex achievement that in turn depends on transformative improvements in governance and a successful reform of our political system.

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22. The world recession is a critical opportunity for us to re-gear and re-tool the Malaysian economy because it is a challenge to take bold, imaginative measures. It lights the fire under our feet to make transformative improvements in governance and politics. It also demands that the government spend boldly on the right things, in the right way, to stimulate demand.

23. Two criteria for “the right things” would be those public investments with the widest multiplier effects, over the short and the longer term. Over the short term, there are often tradeoffs between impact on demand and on improved economic capacity. Over the long term, the two are the same. The “long term multiplier” is nothing less than the improved capacity of the entire system.

24. So we must think carefully about what we spend the “fiscal stimulus” on. There is no such thing as a free lunch. We will be going into deficit to finance this stimulus, so it can’t be about just spreading money around. So far there has been no impact from the stimulus package announced in November, nor was it clear what the economic thinking was behind that measure.

25. We don’t need another stimulus “package” of spending here and there. What we need, and what the crisis gives us a chance to implement, is a set of bold projects with an economic story behind them to help Malaysia make the developmental leap we have been missing. We have a once in a lifetime economic challenge. We must meet this challenge with a historic sense of purpose. That means, not with a “stimulus” consisting of ad hoc pork barrel expenditures but a set of public investment projects guided by a vision, designed around a strategy and governed with bullet-proof integrity.

26. Let me suggest two programmes and an enabling set of reforms.

Oil and Gas Centre

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27. Oil and Gas has served us well, but we have still not tapped our strategic strength in this sector despite our unmatched natural and strategic advantages:

a) Malaysia is the leading Oil and Gas producer in the region. Our proven reserves have been augmented by major discoveries in recent years.

b) More than half the world's annual merchant fleet tonnage passes through the Straits of Malacca, with most of it continuing into the South China Sea. Oil flows through the Straits of Malacca are three times greater than that through the Suez Canal and fifteen times greater than flow through the Panama Canal. We live alongside the most important oil shipping route in the world. Our fifteenth century ancestors may have done more to tap that advantage than we.

c) We have in Petronas one of the leading oil companies in the world.

d) We have strong trade links with Middle Eastern oil producers.

28. We could do much better. Consider that despite having no oil resources, Singapore is among the top three global players in trading, refining and manufacture of oil and gas equipment.

29. Three years ago, while Malaysia still held the OIC chairmanship, I proposed a National Strategic Plan with the vision of developing Malaysia into Asia's Oil and Gas centre, with leading capabilities in refining, shipping, distribution, storage and downstream production.

30. We should develop offshore storage facilities for other producer nations with high country risk. Oil and gas exploration, extraction and production are increasingly technology driven, high value operations in themselves as oil becomes scarcer. There will be large payoffs for having our own R&D capability in exploration, extraction and production. We should specialize in energy technology, including alternative energy sources for a carbon-constrained future.

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31. We should form partnerships along the value chain. These could include a network of agreements with Gulf producers and with major consumers to improve oil security. We could form G-to-G partnerships in ASEAN, provide tax incentives and craft innovative Production Sharing Contracts,

32. Here's the exciting thing. For all these ventures to work we need greatly improved capabilities to finance and trade oil and gas. Given our very special geographic and strategic advantages, we should build the first spot and futures Exchange for Oil and Gas in an OIC nation.

33. Whatever the government chooses to do, it should understand that for us to get on a higher growth plane we must specialise, and we must have a government capable of providing the direction, drive and executive capability to foster that specialisation. Globalisation requires a relentless focus on competitive advantage. We need our own story.

Housing

34. Let's start a program to bring home ownership to the whole country. The construction sector creates multiplier effects in more than a hundred other industries. It provides work in everything from insurance to advertising to materials supply. Of all the national projects we could undertake, few could have such a large social as well as an economic multiplier effect.

35. Housing builds powerful social capital and gives substance to citizenship. A national housing project allows us to design entire communities and townships with their transportation, communications, educational and recreational infrastructure with a strong set of standards and social objectives. It lets us plan the housing stock to cater to the lifecycle of home ownership, with a good mix of options for different localities and life-cycle requirements. It is a way to grow racial harmony, build integrated schools, and help the poor without creating a crutch.

36. Let's commit ourselves to having each and every Malaysian family own their own home. This vision is a radical challenge to the nation to do better. It will require extraordinary improvements in our ability to design, construct and finance housing projects. It will require the setting up of a statutory board to oversee housing development, administration and management. As land governed by the State powers, the States will have to implement these

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projects. This will require, and hopefully force, improved coordination between the Federal and State governments, especially now that we might no longer expect that the same party is in power in both places.

37. Financing for this investment could come from modifications to EPF, with matched contributions from the government towards the value of the property. Because it comes out of savings, this spending would be non-inflationary. I can think of few better ways to get the economy humming again, give our citizens a focal point of hope and pride, and weave a safety net that also encourages savings and enterprise.

Public sector reform

38. We cannot wait till the crisis blows over to tackle the public delivery system head on. This is because we will need an upgraded public service just to implement such large public programs successfully.

39. The need for improved governance is greater, not less, in challenging economic times. When Franklin Delano Roosevelt implemented the New Deal to push America out of the Great Depression, many feared that this would present a huge opportunity for graft. Confounding these expectations, the New Deal programmes were implemented with unprecedented transparency. FDR did this by building oversight into the implementation of his rescue program.

40. Similarly, the two programmes I have suggested would come to nought if they were derailed by the corrupt practices that have become the norm in this country. Instead of rescuing our economy they would become millstones around our neck. As part of the project management of these programmes we should set up powerful, independent divisions devoted to investigating complaints of fraud.

41. Today the role of the public sector is a lot more complex than anyone could have imagined even a decade ago. A “public delivery system” that was designed for the challenges of the 1950’s cannot possibly cope with the complex demands of the globalised 21st. The current crisis propagated worldwide in internet time as regulators scrambled to catch up. Government now needs to be smarter, tougher and more responsive than before to engage on equal footing with business. We need leadership to change the operating model of the civil service from last

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century's centralized planning approach, driven by budgetary plans, to a model of government as facilitator, aggregator and convener of business. Government that targets economic outcomes rather than accounting quotas.

42. We need to demand as much talent and organisational ability in our public service as the private sector does of its own people. Today the quality government is a core component of national competitiveness. However, there is nothing strange about the expectation that the civil service should be a high performing organisation led by an intellectual elite. It is how the Malayan Civil Service used to operate. Many of us remember it.

CONCLUSION

43. What I have outlined this afternoon are just my suggestions. I am sure there are many other ideas in this distinguished company.

44. Let me end where I began, with the question of confidence.

45. We need to restore confidence in our basic institutions, our leadership, the integrity of the Federation, the rule of law and our national Constitution. This is of a piece with the vital economic confidence needed to unleash credit, investment and consumption, and get everyone working. We need to restore confidence in Malaysia.

46. Real confidence is hope based on an apprehension of the truth. It is social capital and trust in society and its future. It is inspired by leaders willing to take us through an unflinching evaluation of where we are today to a vision of what we are capable of tomorrow. It means owning our own story and banking on it.

47. The country can no longer afford a political class out of touch with reality that trades on

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yesterday's political insecurities and a government that has forgotten its purpose. We need a renewal of leadership as a first step to restoring true confidence.

48. The economic statistics are mere indicators of the activities and expectations of the unique national community we are trying to build, so that building an economy and building a nation, providing good governance and being truthful, are not things that can be achieved apart from one another. To reignite our confidence would be to revitalise the project of building Malaysia.

"HOW MALAYSIA CAN COPE WITH AND OVERCOME THE EFFECTS OF THE GLOBAL ECONOMIC CRISIS"

SPECIAL LUNCHEON ADDRESS BY

Y.B.M. TENGKU RAZALEIGH HAMZAH

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