It is a pleasure and an honour for me to deliver this conference keynote address this morning. Let me first and foremost thank the organisers, in particular, Dr. Zakariah Abdul Rashid, for extending this invitation to me. The timing of this conference could not have been better. As I was thinking about this speech two weeks back, China announced its plan to relax procedures for direct and portfolio investments. This just verifies that Malaysia is not alone in this environment of challenging economic fundamentals. We all have our ailments, some are more numerous than others, some are more serious than others. This is the state of affairs of the Asian region today.

Ladies and Gentlemen,

2. It needs no reminding that Malaysia is at an economic crossroads of sorts. We are faced with a list of challenges, whether internal or external, all of which need to be addressed expediently. We are no longer attracting FDI as freely as we did in the past. We are not investing enough to meet our aspirations. Private investment now makes up a smaller portion of GDP than was the case historically. Although we continue to maintain a relatively high national savings rate, some of those savings have gone overseas. Malaysia has become a premature exporter of capital, a characteristic that is unbecoming of a growing, high potential economy. There is also this silent issue of capital flight, whether it is in the form of over-invoicing by corporates or personal wealth leakages. On the domestic production front, we depend on a relatively narrow spectrum of growth drivers. The government's revenue base is just as limited and on expenditures, we need to quickly address the issue of fuel subsidies. There is widening disparity between the haves and the have-nots, between the urban and the rural folk.

Ladies and Gentlemen,

3. These are serious issues indeed. Any policy response to this structural problem is a multi-year, if not, and I hope not, a decade-plus undertaking. The government is taking constructive steps to address them. The administration is very right to admit that execution risks are large. Considering limited financial resources, the policy-maker's prerogative is to make sure that the prescription is executed well. In my humble opinion, we can do even better

by learning from the successes in other countries. By learning from others, we can mitigate some aspects of execution risk and establish benchmarks. We must take a practical approach to sorting out our economic dilemma. Pragmatism is the theme of my keynote address today.

4. Using observations learnt from elsewhere, allow me to discuss my view on how we can approach some of the issues mentioned. Many of these ideas are long-term in nature, as one would expect when dealing with structural issues.

5. First of all, let me talk about the rural sector, a segment of the economy which I hold dear as I myself am a Member of Parliament for a rural constituency. At 8 million people or so, Malaysia's rural population makes up about 30% of the country's overall population. Yet it has not received as much focus as it should. The rural sector can become a powerful force in driving the nation's economy. Think of it as a potential hedge against the vagaries of globally-linked growth. Look at India today – rural consumption has remained resilient even though the country's traditional sources of growth have moderated. This mixed-cycle attribute is a virtue. Our government's Rural Transformation Programme is a constructive step towards achieving this effective hedge. We should go even further because as it stands, our rural sector is exposed to the gyrations of globalisation thanks to the commodity cycle. What the rural sector needs is a carefully-planned programme to deliver credit to the smallest of businesses. Our financial system needs to be more involved in supporting the rural businessman when experience in other countries shows that it works for both borrower and lender. Indonesia is at the forefront of microfinance for the unbankable population. Bank Rakyat Indonesia (BRI), which once had President Obama's mother as its consultant, has existed as a microfinance specialist for more than a hundred years. With a policy and process refresh from the Harvard Institute for International Development in the 1980s, it is now a global microfinance benchmark and one of the most profitable banks in Indonesia with a return on equity of nearly 30%. No Malaysian bank ROE comes close to that! There is another Indonesian microfinance specialist, Perum Pegadaian. This SOE is perhaps Indonesia's largest bank in terms of branches, and it is only a pawnshop, but a very profitable one with an ROE of more than 30%. Its reach is so broad that it has done business with nearly one in ten Indonesians. Best of all, financial inclusion is accomplished without sacrificing market pricing of loan assets. We in Malaysia cannot speak of such prowess in financing the small businessman. My microfinance example can also be extended to cover urban financing as well. I think micro lending can be an effective tool to encourage small, uneducated borrowers to switch from unorganised, illegal forms of lending to institutionalised, regulated forms. This will help subdue one part of our black economy.

6. While still on the topic of strengthening the low-income segment, I believe that another compelling tool to diversify our growth sources is housing. PR1MA is largely designed to assist in development of affordable homes for the middle-income sandwich class. What I would like to

suggest is that we focus on low-cost homes, built on a scale that is larger than what we've pursued in the past.  Increasing home ownership among the lower income level groups via housing finance availability creates a favourable wealth effect as we've seen in public housing programmes in other countries.  As we all know, it also creates considerable knock-on effects on domestic demand.  We should consider launching large low-cost housing schemes supported by the availability of finance.  From anecdotes in other countries, small-ticket mortgages can be a fairly profitable venture.

7. Specialist housing finance companies in India like GRUH Finance and Dewan Housing Finance, and Indonesia's low-end mortgage specialist Bank Tabungan Negara has had good delinquency track records and the returns are not bad either.  Malaysia's financial system needs to accommodate this for-profit business.

Ladies and Gentlemen,

8. I am sure my next point will be an unpopular one.  I am equally sure, though, that the economists in the audience would agree with my view on petrol subsidies.  Its removal is an imperative.  It is not only a drag on government finances but also an impediment to proper resource allocation.  We cannot live on cheap petrol forever.  We can seek ways to transition into subsidy removal.  In order to protect the average consumer, perhaps we can begin by applying an implicit subsidy cut on large engine capacity vehicle owners via a higher road tax.  That means for many of us in this room, myself included, we should pay higher road taxation to proxy subsidy removal for our bigger cars.  At the appropriate times, the petrol subsidies themselves should gradually be removed.  I know it may be a small start to begin with, but the market needs to be conditioned for an outcome without social upheaval.  This structural fix should ultimately give the government the much-needed elbow room for its spending agenda.

9. Please allow me to spend a moment to talk about our household debt issue.  Much has been said about the high household debt to GDP ratio and the need to contain it.  I appreciate that the authorities are also sensitive to this issue and they have appropriately intervened.  I also appreciate the fact that about half of individual borrowing is in the form of residential property finance.  Some people say that a mid-70% household debt to GDP ratio is all right – I must add that this comes with a disclaimer.  So long as global interest rates stay low, it's fine.  If we see an uptick in rates, it's not the asset quality issues that I worry about as I hope the banks are prudent enough to filter their loan applications.  We need to be sensitive to the accompanying cutback in general consumption that would drag domestic demand.  This phenomenon, as you would imagine, will play itself out in every single Asian country that has taken on more leverage at the same time as when the US has de-levered.  In Malaysia specifically, it would add more

strain on public finances to keep growth steady.

10. My next subject is on developing a sovereign wealth fund. No, I am not referring to Khazanah. Many years ago, while I was a member of the administration, we had mooted the idea of creating an entity that separately, and professionally, manages proceeds from our oil and gas endeavours. Back then, the concept of a sovereign wealth fund never really existed. Had we pursued that idea then, we would have been one of the first countries in the world to have created a sovereign wealth fund. We might even have been wealthier as a nation considering the bull market in both bonds and equities for a good part of the past 30 years. Interestingly, Norgesbank Investment Management (NBIM) was set up only in 1997 to manage Norway's government pension fund and its oil profits. Today, it is a model for others to follow. NBIM is subject to high governance and disclosure standards with reporting requirements to Norway's parliament. The idea of a sovereign wealth fund still appeals to me just as it did back in the 1980s. This sovereign wealth fund must be professionally managed and committed to performance, governance and transparency standards that would give the public greater confidence in the government's effort to save for our future generations.

11. Let me briefly touch upon the services sector contribution to GDP. Broadly speaking, it has contributed about 50% to our GDP this past decade. I am not certain what portion of this services sector contribution comes from real estate activities, which many of you would agree, is a less productive form of economic activity. Taking that into account and comparing ourselves against more developed economies such as the US, UK, Australia and Singapore whose ratios range between 70 and 80%, the upside for our services sector is certainly large. It might help to picture our loss in competitiveness in low-skilled manufacturing activities as our gain in competitiveness in services, with one caveat which I will explain a little later on. For example, with labour and other costs being a fraction of Singapore's, surely arbitrage opportunities in the services sector exist for enterprising businessmen? First there was PTP, now Marlborough College Malaysia. What could come next?

12. As I had mentioned earlier, our loss in manufacturing competitiveness must somehow imply a potential gain in services jobs but there is one caveat. This caveat is education. Education is perhaps the single-most important factor to rehabilitate Malaysia's competitiveness in the longer run. Education is a key building block to making Malaysia a favourable investment destination. Do you know that Malaysia has 21 public and 61 private tertiary institutions that confer degrees today? Are they producing the right graduates for our future? Perhaps an answer can be found in the motives of a US private equity fund's recent acquisition of a local tertiary institution. Buying into a fragmented market says a lot about the fund's view of tertiary education in our country. Raising education standards must be an immediate priority for us – education as a business opportunity is secondary. I am also fascinated by what the consultants at McKinsey term "global employability" to describe the effectiveness of tertiary education in various

countries. McKinsey says only 10% of each year's engineering graduates in China are "globally employable". That figure is 25% for India. I don't know what that number would be for Malaysia. Vis-a-vis these Asian giants, we know we are losing the quantity war but I have a suspicion that we may also be facing challenges on the quality front despite China's and India's low globally employability scores.

Ladies and Gentlemen,

13. Let me conclude. I know what I have shared with you in this keynote address is quite sobering. This is not a cheer-leading pep-talk nor is it a political rally speech. It is a candid assessment of the environment and a sampling of what I think needs to be done urgently. This is not about checklists and targets. We need pragmatism to succeed. Be forewarned though. The environment is not static. There are many moving parts. Other countries are reacting too. China, as I had mentioned at the start of my address, was compelled to react because of continuously disappointing investment data. At another extreme, Indonesia apparently does not need to work so hard to woo investors. Last year's Thai floods created a deluge of investor queries despite the country's awkward labour laws. Industrial estate land prices in Greater Jakarta are skyrocketing. All these moving parts make our growth plan that bit more challenging. Time is of the essence. Learn from others to make the transformation effective and accelerated.

14. The optimist in me says that Malaysia will resurface from these challenging times, as it had following past difficulties, with a stronger and more competitive base to operate on. It is incumbent upon us all to make sure that we get our beloved country there as soon as we can. Be frank, speak without fear, without favour in your discussions over the next two days. Thank you and have a productive conference ahead.

**Keynote Address by Y.B.M. Tengku Razaleigh Hamzah at the MIER National Economic Outlook Conference 2013-2014 on Tuesday, 4.12.12 at 10.00 a.m. at Hotel InterContinental, Kuala Lumpur** **Video** {youtube}atosudeIhlk|600|450|0{/youtube} {youtube}uJGWwD74FvY|600|450|0{/youtube}