

Ladies and Gentlemen.

I would like to thank the Academy for inviting me a second time to give a talk on the current state of the economy. After the presentation of Budget 2014 in Parliament last month and the ongoing debate in the august house, the state of the economy is indeed a relevant question to ask. Economic reality however may not be what it is made out to be when one engages in political debate in respect of the Budget: often it is the unstated issues in the Budget and its underlying strategies and proposals that should be of great concern to thinking Malaysians.

Ladies and Gentlemen,

2. The Budget 2014 projects that GDP growth rate next year will likely be around 4.5 to 5% and 5.5% in 2015. These figures had remained in that range for the past budgets since 2000, reflecting some kind of paralysis of policy given the global economic situation and our own model of growth that depends so much on our external markets and the optimism of foreign interests in our economy. But, these figures conceal some forewarnings that are not highlighted.

3. Take for instance, the budget deficits, which had remained in negative territory for over twenty years; now the Najib government has promised to bring the budget into balance by 2020. The federal deficit has been sustained by borrowings that are now reaching close to the statutory debt ceiling of 55% of GDP. In fact the federal debt levels in absolute terms doubled since Dato' Seri Najib took over as Prime Minister. Coupled with private debt currently at 83% of GDP (an issue I will come back to later), the total debt exposure which will have to be carried over into the next generation will now approach 140% of GDP at current prices by the end of the year.

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4. Of course this is not yet a worrying figure compared to the likes of Greece recently and Ireland previously. We know that the rule of thumb for sustainability (whether it can be funded by current output) of the national debt is something like: for any given year government debt plus outstanding loans of commercial banks must NOT be more than five times the sum of government revenues plus net foreign inflows.

5. Malaysia is not quite near that boundary yet. Or, using another more rigorous (statistically-based) measure to relate government debt to economic growth, the corrected Rogoff-Reinhart-Herndon limit of 90% debt-to-GDP ratio will imply the average growth rate of GDP will be around 2.2% per annum, while the level for countries with debt under 30% of GDP is 4.2% per annum; for countries with debt between 30 and 60% of GDP it is 3.1% per annum; or between 60 and 90% debt, 3.2% per annum. Countries may not hit a wall at 90%, in terms of growth prospects, but the going will be that much heavier if the government is not ever mindful of the consequences of high debt and deficits. By this standard then, the Malaysian situation is still manageable.

6. On this score then, the government's attempt to lower the government deficit by 2020, and cap the debt level to below 55% is a prudent measure. And the broadening of the tax base through the introduction of the flat consumption tax, i.e. the GST, not a popular proposal at this time, could help government raise some revenue, provided it begins at a low rate and provided also it is secured by exemptions for essential items to prevent regressive impact on lower income groups.

7. But what is of greater concern is the fact that a good part of this deficit arises on the operating budget side from tax expenditures to support consumption to achieve growth, for example through the BRIM awards, and to finance the public wage and pension obligations. This consumption-based expenditure, together with the high energy and food subsidies given to industry and the public to sustain aggregate demand, is itself not sustainable. This type of expenditure to boost the economy does not add to the capacity building through investment that is necessary to enhance future economic growth.

8. The issue of subsidies, a major distortion that economists say will lead to considerable misallocation of resources, to me is the biggest problem in the Budget proposals this year. Total subsidies, covering a whole range of tax-funded fiscal support stands this year at RM42 billion, just under 20% of the total expenditure budget. This issue has not been addressed seriously enough in the Budget proposal. While support for the lower income groups have to be maintained, it arguably can be asserted that the subsidies are regressive especially those awarded to industry. This is because it is consumption-based, that is, you benefit more from it

the more you consume, and business and rich households will tend to consume more than the lower income groups in absolute terms.

9. If we are seeking inclusive development, as expressly stated by the government, which means that development policies and programmes must be pro-poor, then the issue of rationalization of subsidies have to be confronted, no matter how unpopular the required measures are going to be. A switch to equity-based considerations is required, with appropriate means test and income verification, and as recommended by the World Bank greater targeting of subsidies to the lower income targets. This is even more urgent than any that this government has to face.

Ladies and Gentlemen,

10. Keeping still for a bit more on the Budget, my other concern on the economy is the fact that the operating budget has been secularly rising over the years, except for the recessionary years; I think something more radical needs to be done to rein in the fixed costs in the government spending plans. While growth in the size of the public sector may be due to economic necessity, to provide employment for instance, it would be more prudent to focus on productivity and efficiencies to enhance public sector service delivery. The increase in public sector fixed overhead costs cannot for instance be at the expense of development expenditure. The share of the latter has been decreasing as the operating budget increases, from in excess of 30% a decade ago to 17% of the total budget proposed for 2014. Just as the government debt limit has to be capped I think the share of operating expenditure to total budget must also be capped at some reasonable level. The dangers of financial crowding out will return to rear its head if this matter is not dealt with seriously.

11. When this issue of government overhead costs is set against the various reports of the Auditor-General concerning wastage, profligate spending, unaccountable losses, and sheer incompetency and intransigent corruption, both petty and in high places, we are excused from any restraint to express our anger and intolerance as taxpayers and ordinary citizens at the current state of affairs.

12. The lack of transparency, integrity and accountability in the public sphere, no less than governance issues in the private sector, is something that must engage all citizens of a free and democratic society. It is thus in the public interest that civil society organizations, social movements and other citizen groups, even political parties, continue to agitate for reforms,

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through acceptable and legitimate democratic means. It is for this reason also that a freer press and a freedom of information legislation is required, if we are serious about tackling this cancer in our political system, bureaucracy and society in general.

Ladies and Gentlemen,

13. Now to longer-term issues. We are at a critical juncture in our history, and a preoccupation with the short-term issues of the day will not get us much further forward. The result of the 13th general election (PRU13) and the so-called 2008 “political tsunami” demand a new action plan in order that we may be better prepared to deal with the recurring challenges facing us in the wake of the decisions by the voters. Among these are: the need for a clean government of integrity to combat the rampant and pervasive corruption, the rising cost of living and high personal debt levels, the economic imbalances that remain after 40 years of the New Economic Policy (NEP) and its variants, and the capability of an UMNO-led government to deliver on the economy, in view of the shift in Chinese votes to opposition parties.

14. The PRU13 results saw Barisan Nasional (BN) winning the election by a simple majority for the second time. The victory was achieved through a heavy reliance on the support of Sabah and Sarawak voters as well as that of the rural Peninsular Malay voters. Just as it was in 2008, a majority of the urban Malays, the middle class and the Chinese voted for the Opposition. A simple majority of the popular vote is captured by opposition parties. Moving forward, the national economic agenda will have to be recast to take into account these new political realities and the economic dictates, both domestic and foreign confronting us as a nation.

15. A forthcoming report by the UNDP on Inclusive Growth in Malaysia, analyzing the country’s experience over the last forty years since the launch of the New Economic Policy, has shown that, while real GDP per capita is seen to have steadily increased over the period while the incidence of poverty has dramatically declined from 49% of total households in 1970 to 1.7% overall; the Gini coefficient as a measure of income inequalities had declined from 0.51 in 1970 to 0.43 in 2012, a drop of 15%, while the average real wages have relatively stayed flattish from 2002 onwards. However, over the last twenty years the income disparity measure had actually remained stuck at the 0.43 level, whereas a Gini coefficient around 0.35 would be more desirable reflecting a better income distribution as a result of broad-based economic growth. The 90s and the first decade of the new millennium was a period during which the government had adopted economic measures aimed at liberalizing the market, and promoting the growth of the private sector through privatization and foreign investment.

16. Worse, whether it is a consequence of these policies or not, the distribution of wealth in the country, as expected, is extremely skewed. The wealth of Malaysia's top 10% exceeds those of the bottom 70%, and about 12% of Malaysian households have no wealth at all. In fact, the wealth of the top one per cent is much higher than the whole of the bottom 40% combined.

17. This finding is consistent with what the International Monetary Fund (IMF) found. In a recent 2013 report, studying the experience of how pro-poor and inclusive Asia's recent growth has been, and what factors have been driving these outcomes, finds that while poverty has fallen across the region over the last two decades, inequality has increased, dampening the impact of growth on poverty reduction. As a result, relative to other emerging and developing regions and to Asia's own past, the recent period of growth has been both less inclusive and less pro-poor. The analysis suggests a number of policies that could help redress these trends and broaden the benefits of growth in Asia. These include fiscal policies to increase spending on health, education, and social safety nets; labour market reforms to boost the labour share of total income; and reforms to make financial systems more inclusive.

18. At the same time, many countries, especially advanced economies, recorded growing concentration of income and wealth in the top one per cent, and the increasing power of finance. The global financial crisis of 2008 has renewed attention to functional distribution – wage and profit shares of national income – with concern that declining wage shares and expanding profit shares correspond with the skewing of economic conditions toward serving short-term financial interests. Inclusive growth warrants attention to the balance of power between elites and masses, and between financial and productive economies.

19. It is on record that Malaysia's wage share of gross national income, at 28% is the worst in the region, compared to the share of profits. A reasonable share as in developed countries is around 45-50%. This means that we have a huge mountain to climb: we may achieve developed status by 2020 as the government hopes with US\$15,000 GNI per capita as the target, but this is pointless if labour's share of the value added growth is skewed in favour of asset owners and the richer classes among us. What may the reasons be for this sorry situation in Malaysia? I would proffer a few factors that might explain the situation: the tax system and incentives that are pro-business, including the absence of a capital gains tax; the existence of monopolies, cartels and lack of competition; the relative weakness of the labour unions in collective bargaining; and corruption and leakages, to name a few. Teachers' wages for instance have to rise (the lowest in the region now), together with plantation labour, and the informal sector as well. The minimum wage is a good move that warrant our support in this instance. The comparatively lower salaries for professionals is the main reason for the brain drain that had led to one million Malaysians working overseas.

20. But moving to a higher wage regime, and away from a cheap labor policy in order to maintain our competitiveness is not an insurmountable task, because data show that productivity especially in the manufacturing sector has been rising steadily over the years, but the wage-productivity gap has also been widening. This is one of the more critical issues if the goal of inclusive development for Malaysia is to be achieved.

21. Being an open economy and well integrated into the world economy through globalization, Malaysia cannot be isolated from these impacts on our national competitiveness. Our task at economic reform will therefore be that much harder. But at the same time more urgent.

Ladies and Gentlemen,

22. Another issue I would like to highlight concern the issue of the rising cost of living which affects everybody, but impacts the middle and lower income classes more than others. While the official figures for the Consumer Price Index, or CPI, as the measure of inflation has been around 3.0-3.5% give or take a few points, over the years, there is a suspicion among economists and some thinking lay people that this might not reflect the real situation on the ground.

23. It is possible that this seemingly acceptable inflation rate, for anything lower than 2% has been adjudged by professional economists as undermining incentives for producers and sellers to bring additional goods and services to market, could be due to the fact that a large proportion of the food items in the basket of goods going into the CPI calculation are control items. The rule of thumb used by MIER in its forecasts of inflation is to add nearly a percentage point to officially stated figures. This exogenous adjustment to their forecasting model for Malaysia perhaps was done to obtain a more realistic cost of living figure.

24. But if you take the core inflation figures covering energy, housing and transport (beside food), surely without subsidies these numbers would be closer to the real cost of living that people are facing. One of our prominent economists says that "the 2.3% estimated inflation rate is generally not taken seriously by the public. People hardly believe that prices are rising by only 2.3% per annum. People think that prices are rising at a faster rate in the real market place! The Budget should in fact have dealt with Structural Issues like Inflation and Corruption and Cronyism and more competition, in a more assertive manner. The main causes of rising prices are insufficient supplies to meet rising demands. Hence more could be done to Liberalise the economy. More licenses, less quotas, greater ease of doing business for

especially the Small Medium Businesses and Traders, should have been be considered. Tenders and Contracts could be made more competitive. We can have lower prices and lower inflation only if supplies of goods and services are increased and we become more efficient. Too many layers for the award of tenders and contracts will only add to distorted pricing and price manipulation. The Cronies will obviously benefit, but the poor businessmen and ordinary consumers will have to pay higher prices and suffer from rising inflation. They will even feel the pain of low quality goods and poor services. Why should the poor and lower income groups pay the price to enrich the unproductive cronies? They will react and resent this unfair system, if not now, then later!" Cost of housing has been rising in major urban centres, and house prices have been accelerating due to demand engendered by foreign and local investors, not just for higher-end properties but also the lower cost categories. The UNDP Study I cited earlier has found that the House Affordability Index for Malaysians is comparatively high; in KL the housing affordability index is close to those of some major cities in the developed countries such as London and New York. The index for Sabah, and the west coast states are much higher than the rest of the country. This presents a particular challenge to young families and the middle class and puts further pressure on financing this important household asset.

Ladies and Gentlemen,

25. This leads me to another critical issue on the economy, and that is concerning household debt, which I had earlier alluded to, which is reaching a worrying level. The household credit exposure in the banking sector has increased by more than twofold over the past decade from RM243.2 billion in 2002 to RM754.6 billion in 2012, which is equivalent to an increase in debt to GDP ratio from 67.2% to 80.5% in the same period. In 2012, about 44% of household income is for debt repayment, which is an increase from 39.1% in 2006.

26. This is cause for alarm, as the rule of thumb suggests that the optimal debt repayment ratio should be kept within 30% and not to exceed 40%. The high indebtedness of Malaysian households, which is higher than optimum levels, means that they are sensitive to income shocks and interest rate adjustments. The lower income group, with lower savings capacity and higher leverage position at about 4.4-9.6 of annual income (as compared to 2.3-3.3 of middle and upper income groups), are most vulnerable to these shocks. More importantly, they will remain in a leverage-vicious cycle due to the nature of credit.

27. This brings us back full circle to the issue of employment creation and income. The high and sustainable growth rate supported by robust investment activities has created job opportunities in the labour market; as a result the unemployment rate in Malaysia has been reducing from 7.4% in 1970 to about 3% in 2012. Cross-country comparison shows that the

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unemployment rate in Malaysia is relatively low compared to regional economies, and even lower than many developed economies. For instance, the unemployment rates in OECD countries and high income countries in 2012 are about 8%, more than double the rate in Malaysia.

28. The challenge going forward, however, is the ability for the economy to create quality and high-paying jobs, especially for new entrants into the labour force who are gaining higher post-secondary and tertiary qualifications; not the low paying jobs that are now being filled by foreign workers in the plantations, construction and assembly-based manufacturing. If we are to move to a higher level of development, indeed to achieve developed status, a different structure of value-added growth and greater productivity is required. Shifting to a service-oriented economy may be part of the answer to this economic restructuring, but we cannot abandon higher-valued manufacturing altogether while maintaining our industrial competitiveness by importing such foreign labour to keep our unit labour costs down. Longer term sustainability of economic growth requires enhancing the knowledge content of our manufacturing, and yes even in the service industry, which all require innovation, technology and new entrepreneurship. Only in this way will we be able to raise wages and salaries, through increasing productivity. Thus, this involves not just up-skilling of our labour force, but also the provision of correct incentives and institutions to support such value-added growth. I wonder whether the New Economic Model is sufficiently geared towards the above tasks.

Ladies and Gentlemen,

29. I would submit that this national task will require new and bold ideas. These ideas need to be implemented over the next five to 10 years with supporting institutional reforms to generate maximum impact and to ensure success. Otherwise we are going to be left behind once again. I say this because South Korea, who in the 60's was behind us, is now three times more in terms of per capita income. Our neighbors Vietnam, Philippines and Indonesia are now ahead on their reform path. If we do not take rapid and serious action, they may get ahead of us again. I am confident that such an action will provide a new impetus to move the country forward.

Ladies and Gentlemen,

30. It is unfortunate, however, that this needed reset of our economic policy comes at a time when the Malaysian economy is facing internal budget constraints and external structural

adjustments in the world economy consequent to the financial crisis of 2008 that will have an impact on our growth prospects in the short and medium terms. While the government had forecast a growth rate of 5-5.5% next year, the needed recovery from the US and Europe is still in their nascent phase, though there are encouraging signs. Meanwhile we will have to look at our internal resources to create an alternative path forward with continued dynamism in our region, respectively in China and the prospect of AFTA in 2015.

Ladies and Gentlemen,

31. At the Official Launch of the Economic Roundtable sponsored by the Mahkota Foundation on 26th September, 2013, I had proposed such a new Plan, I called it the Amanah Plan. Let me stress that what we need, today, is a new economic plan that will ensure Malaysia's future economic growth is accompanied by an equitable development of the nation's wealth and prosperity; one that guarantees that all segments of the Malaysian society have a stake in the economy. I would like to propose that we establish a stakeholder economy for Malaysia over the next decade; an economic system that will ensure an equitable sharing of the benefits of development for all stakeholders and for future generations, under the protection of the Federal Constitution.

32. There is no space here to go into details on the Amanah Plan. You may want to go into the Economic Roundtable website to get access to the speech. I can say here that the Amanah Plan involves four strategic components. These are an Accelerated Infrastructure Development (AID) Strategy, a Human Capital Development (HCD) Strategy, an Agriculture and Industry (AI) Growth Strategy, and a Comprehensive Islamic Financial (CIF) Strategy to complement the ongoing implementation of the Financial Sector Master Plan. The question that was raised is how are we going to finance this Plan.

33. I had proposed that we adopt the Public-Private Partnership model (PPP) as a means to provide critical infrastructure service delivery. Previous Malaysian administrations have adopted this financing model including privatization vehicles and the aborted Private Finance Initiatives (PFI) funding model. But these have been marred by accusations of mismanagement and corruption due to the lack of an open tender system. It is unfortunate for us that private infrastructure investments merely provide political insiders with a disproportionate share of the investment returns leaving the public to hold on to the increased costs.

34. I think there are successful PPP/PFI models in other countries especially the United

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Kingdom which we can follow and learn from. I believe that this is the way we should move forward. I am suggesting that these PPP financing models using the conventional system be enhanced by adopting new Islamic financial instruments such as an Islamic version of PIPEs (Private Investment in Public Equities) and similar innovations, to enable wider participation in investment that currently are available only to asset-surplus players in the market, and thus enhance and broaden the asset acquisition game to the larger population.

Ladies and Gentlemen,

35 At the conclusion of the Amanah Plan speech, I had said that we, as an economy and society, do not have much time on our side to dilly-dally and fiddle on the margins of our great national concerns. We cannot afford the luxury of idly gazing at our political navels. The people expect bold changes. We certainly cannot deny them the answers to their concerns and aspirations. Leaders will have failed the mandate given to them if we are only toying with political slogans and creating myths about our development experience in the NEP and post-NEP years that do not hold up to the facts. We – you and I, and every Malaysian – must renew our resolve to build a united and prosperous nation on the foundation that the founding fathers had built, which are now threatened by political gamesmanship, empty promises and policy obfuscation. Only with this commitment to fundamental reform of our policies and the institutions that support them will we be able to restore the people's trust in the government. Only with this resolve will we be able to offer our good people a secure feeling about Malaysia's future.

Thank you.

A speech by

Y.B.M. Tengku Razaleigh Hamzah

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The Perak Academy, Perak Lectures in Ipoh: 15th Series 2nd Talk

At the Symphony Suites, Jalan Raja Dr. Nazrin Shah (Gopeng Road), Ipoh, on Saturday, 23rd November, 2013 , at 8.00 p.m.