Graduating from the Middle: Malaysian Development Challenges

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Book Contents

Mohamed Ariff, Preface
1. Hal Hill, Introduction

INSTITUTIONS AND GOVERNMENT
2. Joan Nelson, Political Challenges in Economic Upgrading
3. Terence Gomez, Ownership & Control of Corporate Malaysia

MACROECONOMIC MANAGEMENT
4. Prema-chandra Athukorala, Managing Economic Crises
5. Michael Yap and Kwek Kian Teng, Monetary Policy and Financial Development
6. Suresh Narayanan, Public Sector Resource Management

REFORM AND UPGRADING
7. Cassey Lee, Microeconomic Reforms and Competition Policy
8. Tham Siew Yean and Loke Wai Heng, Service Sector Reforms
9. Rajah Rasiah, Technological Upgrading
10. Shyamala Nagaraj and Lee Kiong Hock, Education and Skills

SOCIAL AND DISTRIBUTION CHALLENGES
11. Ragayah Haji Mat Zin, Sharing the Pie
12. Gavin Jones, Demographic and Labour Force Dynamics
13. A.A. Hezri and Stephen Dovers, Environmental Challenges
(1) Introduction

Section 2 – looking back
Section 3 – looking forward

Two sub-themes:

Malaysia undeniably a success story.

Is there a disjunction in its development trajectory, the past decade as compared to earlier periods? And if so, is this related to the challenge of ‘graduation’, and particular problems associated with the NEP?
Context

(1) Are there particular challenges associated with upgrading? Eg, World Bank (2007): ‘History shows that while many countries have been able to make it from low income to middle income, relatively few have carried on to high income. ... A lot of complex challenges have to be met, from raising the skills and innovativeness of the labor force to creating sophisticated financial systems, to maintaining social cohesion, to greatly reducing corruption. Without these sorts of tough policy and institutional changes, countries stay where they are, unable to bust out of middle income.’

(2) High level awareness in Malaysia. Eg, Prime Minister Najib, 2009: ‘We are now at a critical juncture, either to remain trapped in a middle-income group or advance to a high-income economy. ... We now have to shift to a new economic model based on innovation, creativity and high value added activities.’
Context (cont)

(3) Academic commentary:
Mohamad Ariff: ‘Multiracial Malaysia’s major structural problems are largely attributed to the NEP. [There needs to be] a clear focus on the poor and the marginalized groups regardless of race, colour or religion.’
Wing Woo: ‘... by focusing too much on the redistribution of income and not enough on the generation of income, the NEP rejects meritocracy and institutionalizes racism, thereby preventing full mobilization of human resources.’

(4) The international economic environment has and is likely to continue to be generally benign:
Joan Nelson (2008): Malaysia’s ‘... economic policy space is surprisingly unconstrained by globalization.’
(2) The Past Record

Unusual in some respects: favourable initial conditions; generally conflict-free; remarkably consistent policy settings.

Choice of comparators?
No longer Ghana!
Thailand, Singapore, Korea, China chosen for illustrative purposes.

The struggle to characterize the Malaysian economy and its political economy: Fisk, Myint, Ariff, Crouch, Gomez and Jomo, etc.

Six Major stylized facts
#1: Rapid economic growth

Consistently high, though not quite stellar (Table 1). Eg since 1980, about half China’s. Similar to Thailand since 1990.

Quite volatile, to be expected. No major differences across administrations (Figures 1 & 2).

Some pronounced episodes, reflecting policy emphases and external shocks.

Some debate about productivity and TFP numbers. Table 2. Substantially input driven, but TFP numbers difficult to interpret.
Table 1: Average GDP per capita growth by decade (%)

<table>
<thead>
<tr>
<th>Decade</th>
<th>Malaysia</th>
<th>Singapore</th>
<th>Thailand</th>
<th>Korea</th>
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<td>1970-79</td>
<td>5.2</td>
<td>7.6</td>
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<td>6.3</td>
<td>5.3</td>
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<tr>
<td>1980-89</td>
<td>3.1</td>
<td>5.3</td>
<td>5.6</td>
<td>6.4</td>
<td>8.2</td>
</tr>
<tr>
<td>1990-99</td>
<td>4.5</td>
<td>4.4</td>
<td>4.1</td>
<td>5.2</td>
<td>8.7</td>
</tr>
<tr>
<td>2000-08</td>
<td>3.5</td>
<td>3.2</td>
<td>3.8</td>
<td>4.3</td>
<td>9.3</td>
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<tr>
<td>Volatility</td>
<td>0.88</td>
<td>0.77</td>
<td>0.84</td>
<td>0.61</td>
<td>0.49</td>
</tr>
</tbody>
</table>

Source: calculated from WDI
Figure 1: The Malaysian GDP Growth (%)

A: TUN ABDUL RAZAK BIN HUSSEIN (1971-1976)
D: DATO’ SERI ABDULLAH AHMAD BADAWI (2003-2009)
Figure 2: Comparative GDP Growth (%)
#2: Rapid structural change

Conventional story, from A to M; note little change in S share. Table 3. Very similar to Thailand. Largely driven by growth. Some policy impacts on shares: aborted heavy industry programs, very open labour market delayed structural change out of LI sectors.

Even faster change in merchandise trade shares. Table 4. Have Malaysian exports become more or less concentrated? Depends on definitions. Table 5. A clear early mover advantage in electronics; 5th largest manufactured exporters among emerging economies.
Figure 1: The Malaysian GDP Growth (%)

A: TUN ABDUL RAZAK BIN HUSSEIN (1971-1976)
D: DATO’ SERI ABDULLAH AHMAD BADAWI (2003-2009)
Figure 2: Comparative GDP Growth (%)

[Graph showing comparative GDP growth for different countries over the years, with Malaysia, Singapore, Korea, China, and Thailand represented by different colored lines.]

Source: WDI
Table 2: Malaysia: Economic growth by Sector and Labour Productivity.

<table>
<thead>
<tr>
<th>Years</th>
<th>Average VA growth by decade (annual growth %)</th>
<th>Growth in Labour Productivity</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Agriculture</td>
<td>Industry</td>
</tr>
<tr>
<td>1971-1979</td>
<td>5.19</td>
<td>7.25</td>
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<tr>
<td>1980-1989</td>
<td>3.55</td>
<td>5.83</td>
</tr>
<tr>
<td>1990-1999</td>
<td>0.15</td>
<td>7.43</td>
</tr>
<tr>
<td>2000-2007</td>
<td>2.96</td>
<td>5.20</td>
</tr>
</tbody>
</table>

Source: calculated from WDI, ILO
### Table 3: A,M,S Value Added as % GDP

#### Agriculture, Value Added (% GDP)

<table>
<thead>
<tr>
<th>Year</th>
<th>Malaysia</th>
<th>Singapore</th>
<th>Thailand</th>
<th>Korea</th>
<th>China</th>
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</thead>
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<tr>
<td>1970</td>
<td>29.4</td>
<td>25.9</td>
<td>29.3</td>
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<tr>
<td>1990</td>
<td>15.2</td>
<td>0.4</td>
<td>12.5</td>
<td>8.9</td>
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<td>2007</td>
<td>10.2</td>
<td>0.1</td>
<td>11.8</td>
<td>2.9</td>
<td>11.1</td>
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#### Industry, Value Added (% GDP)

<table>
<thead>
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<td>1990</td>
<td>42.2</td>
<td>34.7</td>
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<td>2007</td>
<td>47.7</td>
<td>30.5</td>
<td>45.5</td>
<td>37.1</td>
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#### Services, Value Added (% GDP)

<table>
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<td>48.8</td>
<td>44.7</td>
<td>24.3</td>
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<tr>
<td>1990</td>
<td>42.6</td>
<td>64.9</td>
<td>50.3</td>
<td>49.5</td>
<td>31.5</td>
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<tr>
<td>2007</td>
<td>42.0</td>
<td>69.4</td>
<td>42.6</td>
<td>60.0</td>
<td>40.4</td>
</tr>
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</table>

Source: calculated from WDI
Table 4: A,M,S Value Added as % Total Exports (excluding SITC-9)

<table>
<thead>
<tr>
<th></th>
<th>Agriculture</th>
<th>Natural resource (mining products)</th>
<th>Manufactures</th>
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<td>2.3</td>
<td>18.0</td>
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<td>Thailand</td>
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<td>5.7</td>
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<tr>
<td>1990</td>
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<td>72</td>
<td>63.9</td>
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<td>2008</td>
<td>61.2</td>
<td>75.7</td>
<td>72.4</td>
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</tbody>
</table>

Source: Calculated from UN COMTRADE
### Table 5: Concentration of exports (3 largest 3-digit SITC as % of total exports)

<table>
<thead>
<tr>
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<th></th>
<th></th>
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</thead>
<tbody>
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<td>China</td>
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<tr>
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<td>732</td>
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<tr>
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</tr>
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<td>7.1</td>
<td>735</td>
<td>9.7</td>
</tr>
<tr>
<td>Singapore</td>
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<td>24.7</td>
<td>332</td>
<td>17.7</td>
<td>729</td>
<td>23.3</td>
</tr>
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<td></td>
<td>332</td>
<td>23.1</td>
<td>714</td>
<td>17.4</td>
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<td>18.3</td>
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<td>2.7</td>
<td>724</td>
<td>9.4</td>
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<tr>
<td>Thailand</td>
<td>042</td>
<td>17.0</td>
<td>841</td>
<td>12.3</td>
<td>714</td>
<td>9.6</td>
</tr>
<tr>
<td></td>
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<td>6.8</td>
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<td></td>
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<td>12.6</td>
<td>031</td>
<td>5.5</td>
<td>729</td>
<td>6.6</td>
</tr>
</tbody>
</table>

Source: Calculated from UN COMTRADE
#3: Consistent openness

Among the very few ‘always open’ (Sachs-Warner) economies, especially trade. See comparative openness indicators, Table 6. Generally low trade barriers, limited use of NTB’s, except for heavy industry, autos. Also one of the most open to FDI and labour. The latter has pros and cons. Though much slower to open services, owing to NEP and GLC’s presence.

Three major political economy implications:
1) Reflects and reinforces generally good macro management. Malaysia has generally avoided BoP crises.
2) Openness – the presence of a large export constituency – places a check on political excess and policy error, and exposes ‘unreformed sectors’.
3) Links between trade policy and NEP; the latter explains much of the low protection.
Table 6
### Table 7: Openness Indicators

<table>
<thead>
<tr>
<th></th>
<th>Trade /GDP (%)</th>
<th>Stock of inward foreign direct investment/GDP (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Malaysia</td>
<td>Singapore</td>
</tr>
<tr>
<td>1970</td>
<td>78.7</td>
<td>211.7</td>
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<tr>
<td>1990</td>
<td>147</td>
<td>308.4</td>
</tr>
<tr>
<td>2008</td>
<td>211.6</td>
<td>449.6</td>
</tr>
</tbody>
</table>

Source: EIU calculation derived from UNCTAD, FDI statistics, WDI
#4: Competent macroeconomic management


Debt levels always manageable, mostly comfortable. External debt: two cases of rapid build up, early 1980s, 1997-98. Figure 5. Both handled effectively, avoided general debt crisis.

Different circumstances, but some common explanations for successful management: fiscal deficits contained (Figures 6 & 7); high trade so low debt service ratios; macro policy credibility; high domestic savings. 1980’s privatizations assisted, but at cost of poor returns to tax payers.
#4: Competent macroeconomic management (cont)

Note special case of 1997/98: Malaysia the only country not to go to the IMF during the AFC. Successful ‘non-orthodox’ response, again illustrated strength of macroeconomic policy credentials.

Response to GFC also effective; aggressive fiscal and monetary policy responses; financial sector regulation also improved as a result of the AFC. And unlike AFC, causes of GFC entirely external.

But Malaysia much better as a crisis manager than as a macro manager. Some serious fiscal policy challenges:
- a) Since the AFC, deficits have become embedded in the system.
- b) Fiscal policy rarely counter-cyclical.
- c) Large, poorly targeted subsidies.
- d) Large, non-transparent public sector, GLC’s.
#4: Competent macroeconomic management (cont)

Two additional aspects of the macro management record:

a) Malaysia has generally avoided the ‘natural resource curse’, ie that resource-rich economies tend to under-perform.

b) Continuing high savings provide a buffer, allow govts to be more fiscally profligate. Partly owing to the EPF, which provides the govt with access to a large savings pool.
Figure 3: Inflation, Consumer Prices (annual %)

Source: Global Dev Finance

(KDI)
Figure 4: Exchange rates / USD

SOURCE:
Global Dev Finance
(GDI)
Figure 5: External debt stocks (%GNI)

Source: Finance Global Dev

China

Korea

Thailand

Singapore

Malaysia
Figure 6: Public Debt (%GDP)

Source: Finance Global Dev.

China

Korea

Thailand

Singapore

Malaysia
Figure 7: Malaysia - Current Account (CA) and Fiscal Balance (%GDP)

SOURCE: EIU
**Figure: Singapore - Current Account (CA) and Fiscal Balance (%GDP)**
Figure: Thailand - Current Account (CA) and Fiscal Balance (%GDP)
Figure: Korea - Current Account (CA) and Fiscal Balance (%GDP)
Figure: China - Current Account (CA) and Fiscal Balance (%GDP)
Figure 8: Malaysia - Gross Fixed Investment & Gross National Savings (% GDP)
Figure: Singapore - Gross Fixed Investment & Gross National Savings (% GDP)
Figure: Thailand - Gross Fixed Investment & Gross National Savings (% GDP)
Figure: Korea - Gross Fixed Investment & Gross National Savings (% GDP)
Figure: China - Gross Fixed Investment & Gross National Savings (% of GDP)
#5: Mixed social progress

Significant improvement in social indicators, but not as fast growth, continuing high levels of inequality. Comparatively, on a range of indicators, about as expected (Table 6).

Poverty: very rapid reduction, at least for ‘destitution’, and excluding migrant workers. See Table.

Inequality (see Table):
- a) Declined in early years of NEP; no clear trend since late 1970s.
- b) Substantial decline in inter-ethnic inequality, particularly Bumi-China, from 2.3 in 1970 to 1.4 in 2009.
- c) Intra-Bumi inequality appears to have increased, consistent with Malaysia’s political economy.

So evaluation of NEP record depends on criteria.
Table: Poverty trends
Table: Inequality trends

- Chinese
- Bumi
- Indian
- Overall
#5: Mixed social progress (cont)

The keys to rapid poverty reduction have been growth, combined with the nature of this growth (generally labour-intensive, so labour market transformed) and education expansion. In other respects, NEP not well targeted.

Education:

a) Rapid expansion, major expenditure priority.
b) Record mixed on socio-economic targeting, quite high drop-out rates; also quality.
c) Priorities – arguably over-invested in tertiary, at expense of primary.

Public sector tertiary reform agenda: politicized, bureaucratic.
Rapid private sector growth since deregulation. Malaysia set to be the Southeast Asian tertiary hub?
#6: Institutions, political economy & ownership

Highly complex and variable picture!

UMNO the longest serving political party in the world, among ‘quasi democracies’. Still Crouch’s ‘responsive-repressive’? Mixed record on various governance, voice, accountability measures.

Is it a ‘developmental state’ (Embong)?
Yes, in some respects, openness, macro, infrastructure, etc.
But not in institutional quality, civil service capability, capture, etc.

Ownership patterns:
Significant redistribution to Bumi community; though numbers contested.
‘Dualistic’ patterns don’t appear to be changing: large MNE sector in export-oriented manufacturing; Chinese SME’s; GLC’s large in many services.
No clear evidence on whether becoming more or less ‘entrepreneurial’ or ‘rent-seeking’.
#6: Institutions, political economy & ownership (cont)

Micro-economic management less competent, more captured than macro. Slow pace of liberalization in many service sectors. Limited checks on market power, especially for GLC’s. Privatizations selective and politicized. Public sector contracting system extensive and deeply politicized.

Implementation of NEP++ pragmatic, depending on economic and political circumstances. The 2010 NEM unlikely to be any different.

Malaysia unusual in its absence of major U-turns in economic policy. Absence of really major economic/political crisis may be a factor.

Implications for ‘institutions rule’ hypothesis (Rodrik et al)? More likely reverse causality – that openness has preserved reasonably institutional quality.
(3) Challenges for the Future

The general context

Current GNI about $7,000; long term growth rate of per capita GNI about 3.5%, so ‘graduation’ occurs in about 2030?

Very few countries outside East Asia have graduated from middle to high-income status.

Some clear lessons from the literature on innovation and upgrading. See earlier World Bank quote.
Useful insights from evolutionary economics. Eg (Richard) Nelson (2008): The key to catch up is innovation. For followers, both easier and harder than (eg) Korea and Taiwan. ‘Catch up will be impossible unless a country builds up its education system from bottom to top.’ Rapid structural change and the Schumpeterian process of creative destruction may be painful and politically difficult in view of the ‘political power of old firms …’

The Malaysian Context

New economic model? Many things don’t need changing: openness, adept macroeconomic management during crises, infrastructure, universal education, etc.

But growth rates since the AFC have declined. And especially historically low levels of investment (Figure 8 above), the sharpest decline in East Asia.
Malaysian context (cont):

Why the decline in I/GDP?

a) A decline to more ‘normal’ I/GDP, mid 1990s atypical? Only partly. Now back to mid 1980’s recession levels, but for over a decade.

b) Recent years aberrant? No, apart from 2008-09.

c) Fiscally more constrained govt? No, govt I has held up.

Almost all the decline has occurred in private I/GDP. World Bank (2009): ‘Malaysia’s large private surplus on the current account suggests that investors find it more attractive to invest overseas than domestically.’

FIGURE 44. INVESTMENT LEVELS IN MOST COUNTRIES IN THE REGION ARE LOWER THAN IN JAPAN AND THE NIES IN THE PAST AT SIMILAR INCOME LEVELS

(In percent of GDP)

Sources: Datastream and World Bank staff calculations.
Major challenges

(1) **Upgrading and innovation** – some key considerations:

**#1 R&D, industry policy:** Mixed record, public sector R&D small but rising quickly. Industry policy history disappointing; eg, autos, Thai success.

**#2 Universities:** Substantial investments, but generally slipping in East Asian rankings. Mismatch with the labour market. Also somewhat politicized and bureaucratic – quotas, language policy, etc.

**#3 Dependence on foreign labour:** One of the highest in the developing world. May weaken incentives for upgrading. But depends whether foreign labour is competitive or complementary with local labour. Singapore shows that upgrading with very large foreign labour is possible.
Major challenges (cont)

#4 the large GLC sector: These firms have a broader ‘developmental mission’. Some have contributed with scholarships, especially Petronas. But no evidence that they are major technological innovators.

#5 Impact of the NEP: NEP doesn’t have a technological objective. But indirect effects are large.
Eg (1), Chinese SME’s seem to prefer to stay under the ICA employment threshold.
Eg (2), Most large, non export-oriented large firms seem to owe their existence substantially to patronage (Gomez).

#6 Brain drain: Difficult to estimate, but Malaysia continues to have a large exodus of skilled professionals, many one-way migrants.
FIGURE 49. ACCESS TO TERTIARY EDUCATION IN DEVELOPING EAST ASIA LAGS THE OECD

(tertiary gross enrolment rate, in percent)

Major challenges (cont)

#7 Institutional reform: Has microeconomic and institutional reform slowed, Malaysia become ‘sclerotic’ (a la Olson)?
Eg, in the contract system, subsidies; the legal system; development of independent regulatory agencies acting in the public interest; competition policy and regulatory reform (though Malaysia scores well on some, see table). Does the civil service meet international benchmarks and attract the best & brightest?

(2) Macroeconomic Management

Generally competent, especially BNM and monetary policy. Public debt/GDP about 55%, relatively modest by current OECD standards.
Table 3: ASEAN Trade and Commercial Policy Regimes

<table>
<thead>
<tr>
<th>Country</th>
<th>Trade/ GDP, 2007 (%)</th>
<th>FDI Stock/GDP, 2007 (%)</th>
<th>Average Tariff, 2006 (wtd, %)</th>
<th>Econ Freedom (rank)</th>
<th>Reg Quality (% rank)</th>
<th>Doing Business (rank)</th>
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<tbody>
<tr>
<td>Brunei</td>
<td>95</td>
<td>82</td>
<td>na (v low)</td>
<td>na</td>
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<td>145</td>
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</table>
Major challenges (cont)

But significant, increasing fiscal policy challenges, as noted:

a) FP rarely counter-cyclical.
b) Subsidies about 20% of revenue, poorly targeted, strong ‘entitlement culture’.
c) Fiscal incentives and tax loopholes extensive; little conditionality.
d) Heavy dependence on oil & gas, 40% of revenues, but declining.
e) Extensive ‘institutionalized leakages’ (Narayanan), cost padding, patronage.
f) Large GLC sector subject to little public accountability and scrutiny.
g) Fertility beginning to decline, period of ‘demographic burden’ will end after 2025.
Major challenges (cont)

(3) Social policy and affirmative action

NEP very successful in narrowing ethnic gaps, diffusing post-1969 tension.

But urgently needs a sunset clause.
Note the balanced Meerman (2008) critique:
‘remarkable success ... [alongside worries about the strategy’s] high costs in financial losses, [and the] accelerated deterioration of institutions in public life and workplace behaviour’.
Challenge is how to reformulate the NEP++ so they become ‘pro poor’ policies.

Deeply complex political economy challenge for PM Najib and UMNO:
imperative for major reform to restore growth and business confidence, while confronting powerful vested interests. Will historic pragmatism triumph?

Or Wang Gungwu (2010): ‘Communalism is getting worse and ... there is lack of communication between the communities. The lack of trust is growing.’
TERIMA KASIH BANYAK!