

Is the Lustre Coming off Malaysia's Shine?**Malaysia's Recent Economic Performance and Prospects for Future Growth**

By

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Abstract

This paper reviews the recent economic situation in Malaysia and examines the prospects for future economic growth. The Malaysian economy continues to perform well, although there are risks and uncertainties. There is evidence that economic growth has started to slow recently in response to the falling oil price and low investor confidence. The Ringgit appreciated against the U.S. dollar through to mid-2014, but has subsequently depreciated. The budget deficit has declined in recent years, reflecting fiscal reform and the introduction of the Good and Service Tax (GST). While we express concern about the risks associated with declining commodity prices and uncertainties over capital flows, we conclude that the prospects for continued economic growth in Malaysia are relatively good. In the short-term cheaper crude oil price imports and major public infrastructure investment projects will spur growth. In the longer-term, we emphasize the role of investment in education in moving up the value-added chain into higher value added manufacturing. We also stress that the government must play a key role in restoring investor confidence and reducing ethnic and religion tension, if Malaysia is continue to exhibit strong growth in the longer term.

Keywords: Malaysian economy; Ringgit depreciation; Investor confidence

1. Introduction

Malaysia is a highly open, middle-income economy (Hill et al., 2012). Historically, the Malaysian economy relied heavily on the production of natural resources, such as rubber and tin. However, since the 1980s Malaysia has diversified its traditional commodities export base, transforming itself from an agrarian based to manufacturing based economy (Hill et al., 2012; Menon, 2014; Lean & Smyth, 2014). Malaysia is now a leading exporter of electrical appliances and electronic parts and components, in addition to palm oil and natural gas (World Bank, 2015). In addition, the Malaysian Government has taken steps to broaden the revenue base by introducing a Goods and Services Tax (GST) in 2015. The stated aim of the Malaysian government is to become a high-income country by 2020 (NEAC, 2010). This objective comes on the back of impressive economic growth over a long period of time.

Malaysia is usually regarded as having been successful in raising the incomes of the lowest income groups and, in the course of so doing, reducing extreme poverty (Aslam et al. 2012; Kim et al., 2014). Poverty has fallen from 49.3 per cent in 1970 to 1 per cent in 2014 (World Bank, 2015). Real income of the bottom 40 per cent of households increased by an average 6.3 percent per year between 2009 and 2012, compared to 5.2 percent for the average household, suggesting that the benefits from growth are being shared (World Bank, 2015). The reduction in the incidence of extreme poverty has also been reflected in a decline in inter-ethnic income disparities with a decline in the income ratio between Malays and Chinese by approximately 30 per cent since 1970 (Aslam et al., 2012; Lean & Smyth. 2014).

Despite Malaysia's remarkable growth record, it has not been without its critics. While inter-ethnic income disparities have been reduced, the mean household income gap between Chinese and Malays remains high (Wan, 2011) and income inequality amongst Malays has actually increased. While the New Economic Policy (NEP) was designed to raise the income of Malays as a whole, it has been criticised for rewarding the Malay commercial and political elite, while not benefitting poorer Malay households (Hill et al., 2012; Lean & Smyth, 2014; Wan, 2011). In response to these criticisms, the Malaysian government has reformed the NEP in the form of the New Economic Model (NEM) and Economic Transformation Programme (ETP) (NEAC, 2010). The NEM has as one of its main objectives ensuring that growth is also sustainable and inclusive and, in this respect, is focused on lifting the income of the bottom 40 per cent of the income distribution, irrespective of race (NEAC, 2010).

The prospects for continued economic growth in Malaysia are generally regarded as good, although there are risks and uncertainties (ESCAP, 2015; IMF, 2013; World Bank, 2015). Short term risks for continued economic growth include declining commodity prices, uncertainties over capital flows as the United States normalises monetary policy following the Global Financial Crisis (GFC) and the effect that 1Malaysia Development Berhad (1MDB) is having on investor confidence and the extent to which the government and 1MDB can restore confidence. The longer term prospects for Malaysian growth centre on whether Malaysia is caught in a middle income trap and, if so, is it capable of moving into higher value-added manufacturing (Hill et al., 2012; Lean & Smyth, 2014; Menon, 2014; Woo, 2011; World Bank, 2011).

The rest of the paper is set out as follows. In Sections 2 and 3 we review the main internal and external indicators for the Malaysian economy. In Section 4 we provide an overview of the government's budgetary position, public debt to GDP ratio and expenditure on defence and education. The controversies surrounding 1MDB are outlined in Section 5. We present

both the criticisms of 1MDB and the government and 1MDB response. The prospects for future growth are reviewed in Section 6. The final section concludes.

2. Main Internal Economic Indicators

(a) GDP per capita

Malaysia has had a strong growth rate since achieving independence in 1957. In that period Malaysia's GDP has increased 30-fold and GDP per capita has increased eight-fold (Lean & Smyth, 2014). Malaysia was identified by the Commission of Growth and Development as one of 13 countries that had experienced economic growth of seven per cent or more for the quarter century prior to the publication of the report in 2008 (World Bank, 2008).

Table 1 presents Malaysia's recent growth record. Malaysian economic growth was affected by the GFC in 2009, but has since recovered, posting growth rates averaging 5.7 percent since 2010 (World Bank, 2015, 2015a). GDP per capita in Malaysia is equivalent to 58 per cent of the world's average (World Bank, 2015a).

Table 1: Malaysia's recent economic growth

	2010	2011	2012	2013	2014
GDP Per capita (RM)	28354.95	30985.23	32456.48	33487.89	35783.76
Total GDP (Million RM)	797327	885340	941950	986733	1070006
GDP Growth (%)	7.43	5.19	5.64	4.73	6.03

	2014 Q1	2014 Q2	2014 Q3	2014 Q4	2015 Q1	2015 Q2	2015 Q3
GDP (Million RM)	266,114	272,267	278,828	289,371	277,207	283,244	292,580
GDP Growth (%)	1.4	1.6	0.8	1.8	1.2	1.1	0.7

Source: Department of Statistics, Malaysia, World Bank (2015a)

Table 1 also presents quarterly growth rates between the first quarter of 2014 and the third quarter of 2015. Economic growth was strong in 2014. This reflected a combination of growth in consumer spending, low interest rates, growth in private investment due to infrastructure projects created by the ETP and strong growth in manufacturing exports, such as electronics (ESCAP, 2015). There is some evidence that economic growth is slowing in 2015. In the third quarter of 2015, GDP expanded 4.8 per cent over the same period of the previous year. The figure represented the slowest rate of expansion in two years. The slower growth rate has been attributed to weaker domestic demand following the introduction of the GST and weaker commodity prices, particularly oil prices (ESCAP, 2015; Hill, 2015). The ADB (2015) forecasts GDP growth to be 4.7 per cent in 2015 and 4.9 per cent in 2016. The slight projected rebound in 2016 is based on expected stronger growth in the major industrial economies and some improvement in the demand for commodities and oil (ADB, 2015).

(b) Unemployment

Overall, the labour market in Malaysia is relatively strong and unemployment low and this has been a factor fuelling growth. The unemployment rate in Malaysia averaged 3.26 percent

over the period 1998 to 2015. During this period, it reached a high of 4.50 per cent in March 1999 and a low of 2.70 percent in August 2012 (Trading Economics, 2015). Table 2 presents information on the unemployment rate over the period 2010 to 2014. Over these five years, it was fairly steady at, or around, three per cent. The unemployment rate was recorded at 3.2 per cent in August 2015, consistent with market forecasts (Trading Economics, 2015).

Table 2: Malaysia’s recent unemployment rate

Unemployment Rate	2010	2011	2012	2013	2014
	3.2	3.0	3.0	3.0	3.0

Source: Department of Statistics, Malaysia

(c) Inflation

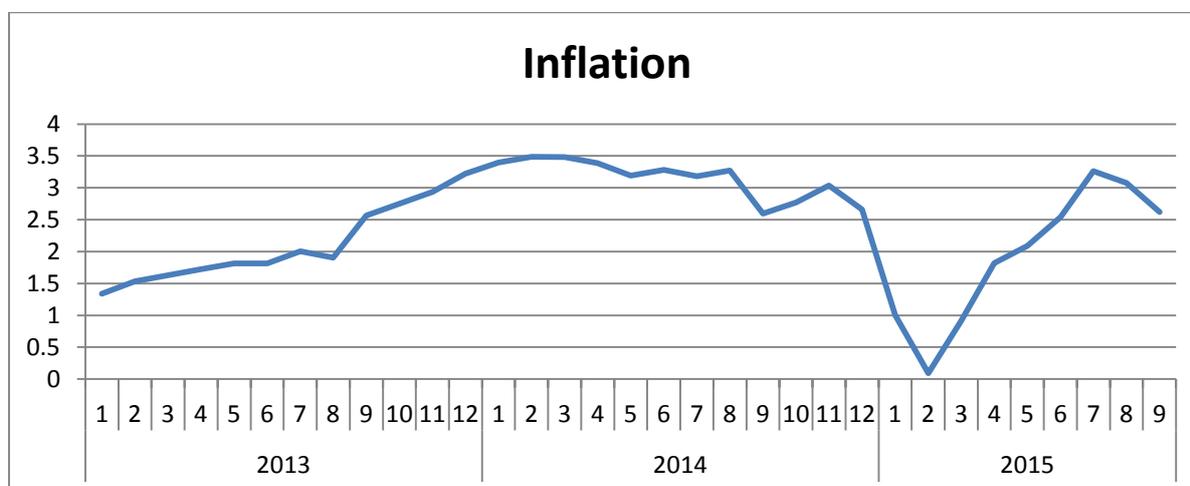
The inflation rate in Malaysia averaged 3.67 per cent between 1973 and 2015, peaking at 23.90 percent in the OPEC oil crisis in March of 1974 and a low of -2.40 percent in the GFC in July 2009 (Focus Economics, 2015). Table 3 presents Malaysia’s inflation rate over the period 2010 to 2014. Figure 1 graphs the monthly inflation rate between 2013 and September 2015. Over this period, the inflation rate has fluctuated between 1.6 per cent and 3.2 per cent. Inflation rose 2.6 percent year on year in September of 2015, slowing from 3.1 percent in August, which was below market expectations (Focus Economics, 2015). There are a series of factors putting upward pressure on prices. These include the sharp depreciation in the ringgit, a series of increases to regulated prices, removal of fuel subsidies and introduction of the GST. This said, inflation has still been relatively modest throughout 2015, primarily reflecting low commodity prices (Forecast Economics, 2015). Bank Negara (the central bank) has forecast inflation to peaking in the first quarter of 2016 (Forecast Economics, 2015).

Table 3: Malaysia’s recent inflation rate

Inflation (%)	2010	2011	2012	2013	2014
	1.6	3.2	1.7	2.1	3.1

Source: WDI

Figure 1: Malaysia’s monthly inflation rate 2013-2015



Source: Bank Negara Malaysia

3. Main External Economic Indicators

(a) Trade

The Balance of Trade in Malaysia averaged RM3035.11 million between 1970 and 2015 (Focus Economics, 2015). Malaysia's trade surplus over the period 2012 to the third quarter of 2015 is graphed in Figure 2. The trade surplus has generally declined since the beginning of 2014. This reflects contracting exports. Year on year, exports declined 18.5 per cent in September 2015, following a 19.5 per cent decline in August. While the contraction was less severe than expected, exports have contracted for 12 consecutive months (Focus Economics, 2015). This outcome reflects indicates that declining oil and gas exports have not been completely offset by stronger manufacturing exports (Focus Economics, 2015).

Figure 2: Malaysia's trade surplus 2013-2015



Source: Department of Statistics (Million RM)

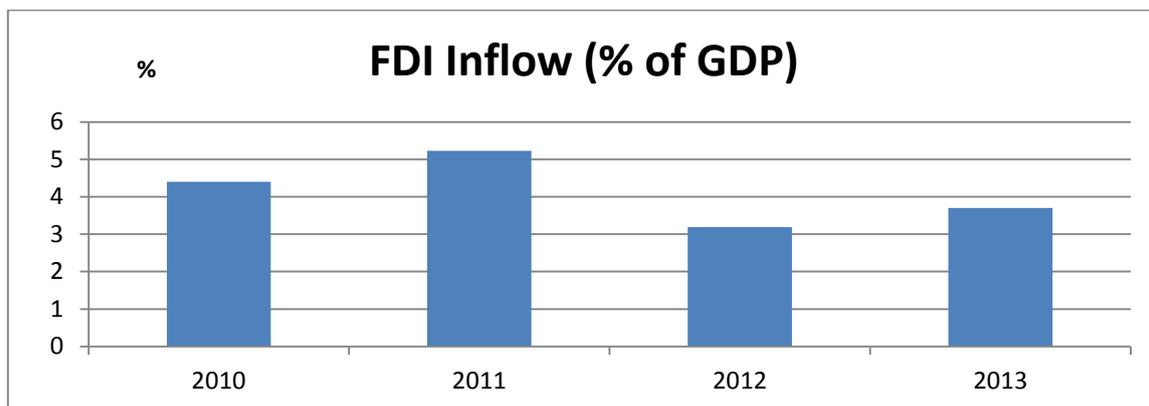
(b) Foreign Direct Investment

Foreign direct investment fuelled manufacturing export growth in Malaysia prior to the Asian financial crisis (AFC) (Lean & Smyth, 2014; Menon, 2014). Similar to other ASEAN countries, FDI in Malaysia underwent a sharp contraction in FDI in the AFC. However, unlike other affected countries, FDI did not rebound in Malaysia following the AFC (Menon, 2014). There has only been a slight recovery in FDI since the GFC, although it is difficult to know if this is a permanent trend or transitory phenomena (Menon, 2014).

Since the GFC, FDI as a percentage of GDP has been in the range 3-5 per cent (see Figure 3). FDI declined 41.8 per cent in the first half of 2015, compared with the corresponding period in 2014, mainly reflecting a series of high profile investments in 2014 that inflated the FDI figure for that year (Malaysian Insider, 2015). The bulk of FDI inflows into Malaysia are from other East Asian economies, such as Singapore, Japan, Hong Kong, China, South Korea

and Taiwan (RM7.4 billion), followed by North America (RM2.3 billion) and Europe (RM1.9 billion) (Malaysian Insider, 2015). The contribution of FDI to total investment differs across sectors. In 2015 FDI represents just over one fifth of total investment in manufacturing and 12 per cent of total investment in services (Malaysian Insider, 2015). Much of the FDI into services has been in real estate (Menon, 2014).

Figure 3: Malaysia’s FDI as a % of GDP 2010-2013

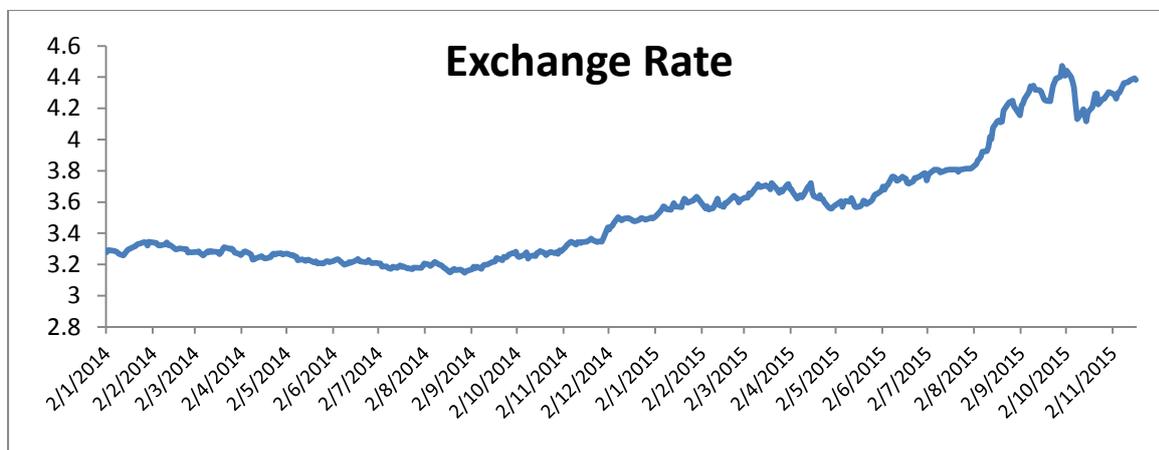


Source: World Bank (2015a)

(c) Exchange Rate

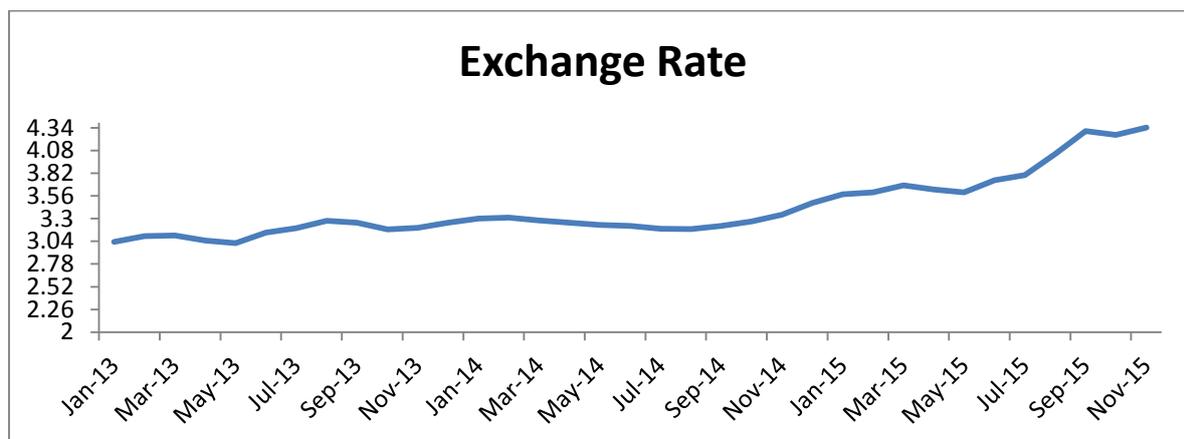
Figures 4 and 5 show movements in the ringgit USD exchange rate in 2013-2015. The ringgit has depreciated sharply relative to the USD, peaking at RM4.46 per USD on 29 September 2015. A major reason for the sharp depreciation has been the strength of the USD. Over the period September 2014 to August 2015, the ringgit depreciated 20.1 percent. The corresponding numbers for other economies heavily dependent on commodity exports included New Zealand (20.8 per cent), Australia (21.6 per cent) and Brazil (35 per cent) (Abidin, 2015). Other reasons for the depreciation of the ringgit included low oil and natural gas prices, investor uncertainty surrounding 1MDB (McCully, 2015).

Figure 4: Malaysia’s daily exchange rate over the period 2014-2015



Source: Bank Negara Malaysia

Figure 5: Malaysia’s monthly exchange rate over the period 2013-2015



Source: Bank Negara Malaysia

As is evident in Figure 4, the sharp depreciation in the ringgit was halted in late September 2015 by government intervention. Since 29 September, the ringgit has appreciated 6.2 per cent, reflecting government intervention in the stock market and a temporary rally in oil prices. On 16 September, Najib announced that the government would inject USD 4.6 billion into the Malaysian stock market via state-owned investment funds in an effort to restore investor confidence and halt deterioration of the ringgit. Expectations over the inflow of this money into the stock market over the course of October stabilized the currency and was the catalyst for some bullish sentiments in the foreign exchange market (MIER, 2015).

(d) Oil prices

Oil and natural gas account for 22 per cent of exports for Malaysia and income from oil and gas accounted for just under one third of government revenue in 2014 (McCully, 2015). Hence, movements in oil prices have important consequences for the exchange rate, balance of trade, government spending, inflation rate and economic growth.

Figures 6 and 7 show recent movements in oil prices. Following four years of relative stability at around USD105 per barrel, oil prices have declined sharply since June 2014, falling to around USD41 in November 2015. The cumulative oil price decline between June 2014 and January 2015 was the third largest of the past 30 years (Baffes et al. 2015).

Several factors are responsible for the decline in oil prices. These include weak global demand, the stronger USD, increased focus on renewable resources and shifts in OPEC policies. Baffes et al. (2015) note that while the relative importance of each factor is difficult to pin down, OPEC’s renouncement of price support and rapid expansion of oil supply from unconventional sources appear to have played a crucial role since mid-2014.

Falling oil prices have had several effects on the Malaysian economy in 2014 and 2015. First, it has adversely affected government revenue. Oil and gas related revenues are projected to be 14.1 per cent of total revenue in 2016, down from 19.7 per cent in 2015 (Reuters, 2015). It

is expected that lower oil revenues will hinder the government’s efforts at fiscal consolidation and increase the fiscal deficit to over three per cent of the GDP in the next few years.

This said, at least part of the adverse effect of lower oil prices on government revenue will be offset by the introduction of the GST, which broadens the revenue base and shifts reliance away from energy exports as well as removal of fuel subsidies (McCully, 2015). In the 2016 budget, the GST was expected to raise RM39 billion in 2016, compared with RM27 billion collected in the first eight months of 2015 (Reuters, 2015). Second, falling oil prices has resulted in a decline in export revenue, although the effect on the balance of trade has been partially offset by reduced energy import bills because of lower global oil prices. Third, lower oil prices are the primary reason for moderate inflation (MIER, 2015; World Bank, 2015).

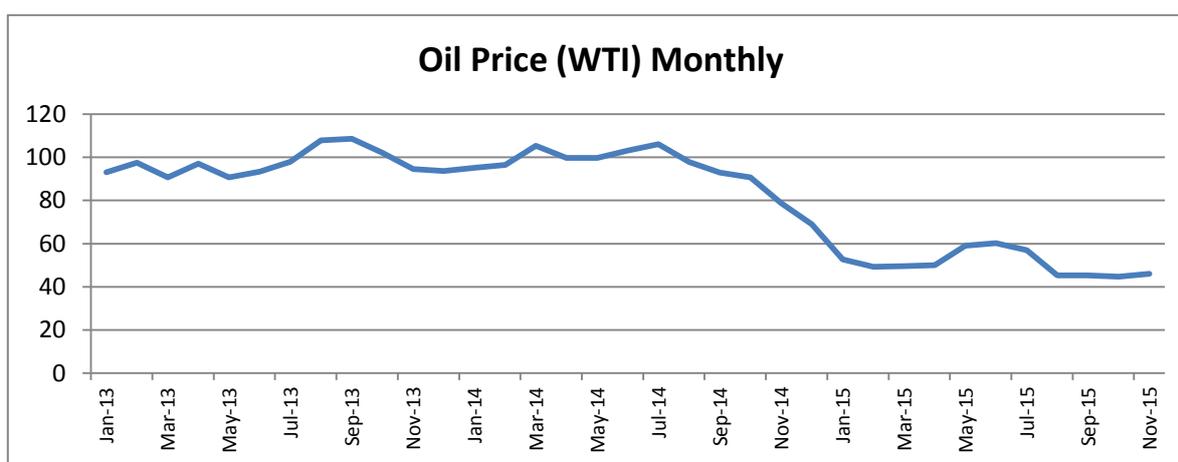
4. Budget

(a) Fiscal balance

Malaysia’s government budget was, on average, 2.95 per cent of GDP in deficit between 1988 and 2014, ranging between a surplus of 2.40 per cent of GDP in 1997 and a deficit of 6.70 per cent of GDP in 2009 (Focus Economics, 2015). Table 4 shows Malaysia’s recent and projected fiscal balance (as a percentage of GDP) between 2012 and 2016. Table 4 shows a decline in the actual and projected fiscal deficit over this period.

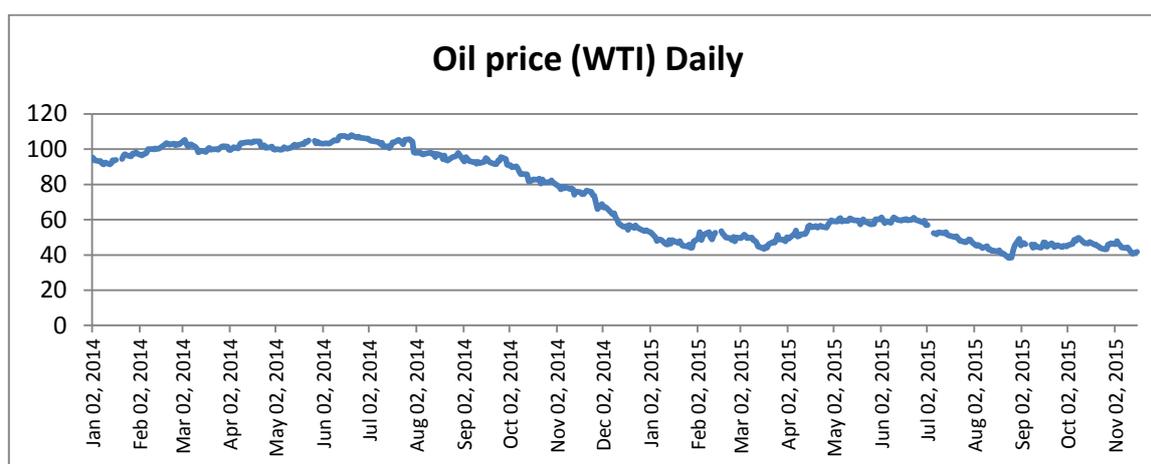
This reflects the Najib government’s efforts to eliminate the budget deficit and restore a balanced budget by 2020. There have been two aspects of this strategy. First, a program of subsidies reform, commencing in 2010, introduced progressive cuts to subsidies for products such as fuel, sugar and cooking gas. The reform to fuel subsidies has been aided by the drop in fuel prices. The second is the introduction of the GST in April 2015, designed to broaden the revenue base. Public investment that prioritizes non-import intensive projects is also expected to contribute toward eliminating the fiscal deficit (Kim et al., 2014).

Figure 6: Monthly oil price over the period 2013-2015



Source: EIA

Figure 7: Daily oil price over the period 2014-2015



Source: EIA

Table 4: Malaysia's recent and projected fiscal balance (as a % of GDP)

<i>Fiscal Balance (RM)</i>	2012	2013	2014	2015	2016
	-4.5	-3.9	-3.5	-3.2	-3.1

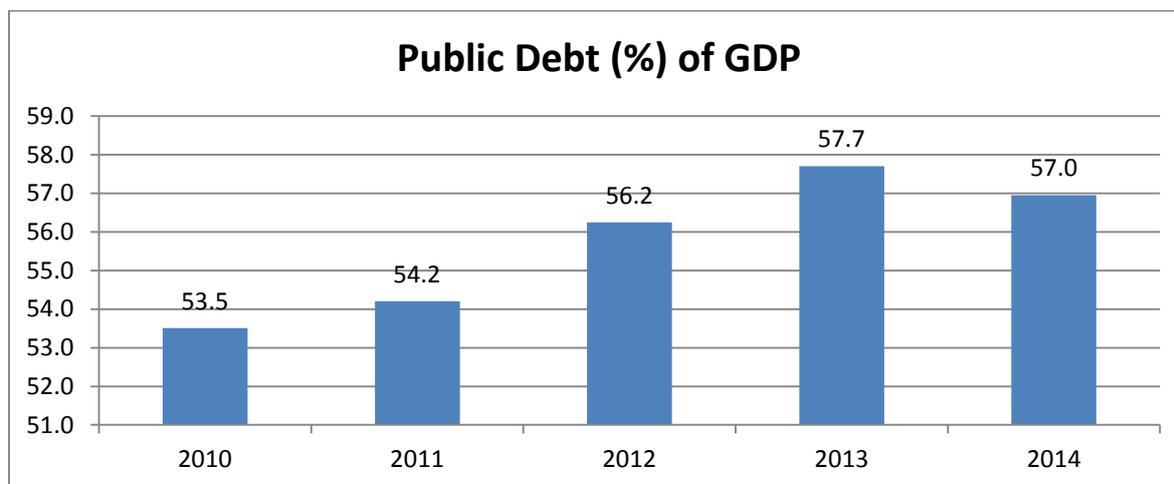
Source: Ministry of Finance Malaysia.

The government's targets for eliminating the budget deficit are generally regarded as achievable on the back of the removal of fuel subsidies. In the short-term savings generated from the introduction of the GST and removal of fuel subsidies assist to offset the loss in oil-related export revenue. More generally, the removal of fuel subsidies has also had a positive influence on investor confidence in signaling to the markets the government's intention to channel funds to more productive areas that can be catalytic for economic growth. This is particularly important given the need to avoid the middle-income trap.

(b) Public debt

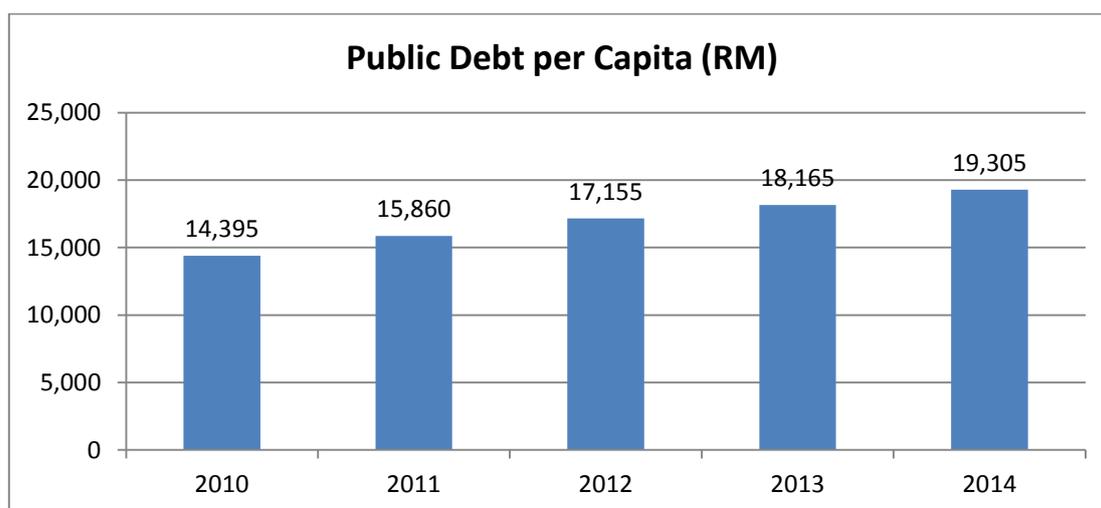
Figure 8 shows Malaysia's recent public debt as a percentage of GDP. It increased from 53.5 per cent in 2010 to 57 per cent in 2014. Figure 9 shows public debt in per capita terms. Public debt per capita increased from RM14,395 to RM19,305 over the same period. In one respect, increasing public debt in Malaysia reflects a worldwide trend. In 2000 average world public debt was 22 per cent; in 2007 it was 33 per cent and in 2014 it was 58 per cent (McKinsey, 2015). The global trend toward rising public debt reflects governments borrowing heavily to fund bailouts in the GFC and offset falling demand in the recession (McKinsey, 2015). The GFC was also an important contributing factor in Malaysia. The first and second stimulus packages in Malaysia in the GFC were worth RM7 billion and RM60 billion respectively, funded through borrowings (Kim et al., 2014). Nevertheless, while there has been a global trend toward higher public debt, Malaysia's public debt is relatively high among similar nations. In 2014, Malaysia's government debt to GDP ratio was the equal second highest (equal with Pakistan and less than Sri Lanka) among 13 emerging Asian markets (Hazis, 2015). Malaysia's public debt to GDP ratio is expected to hover around 55 per cent throughout 2016, which is generally higher than the regional average (McCully, 2015).

Figure 8: Public debt as a % of GDP



Source: World Bank (2015a)

Figure 9: Public debt per capita



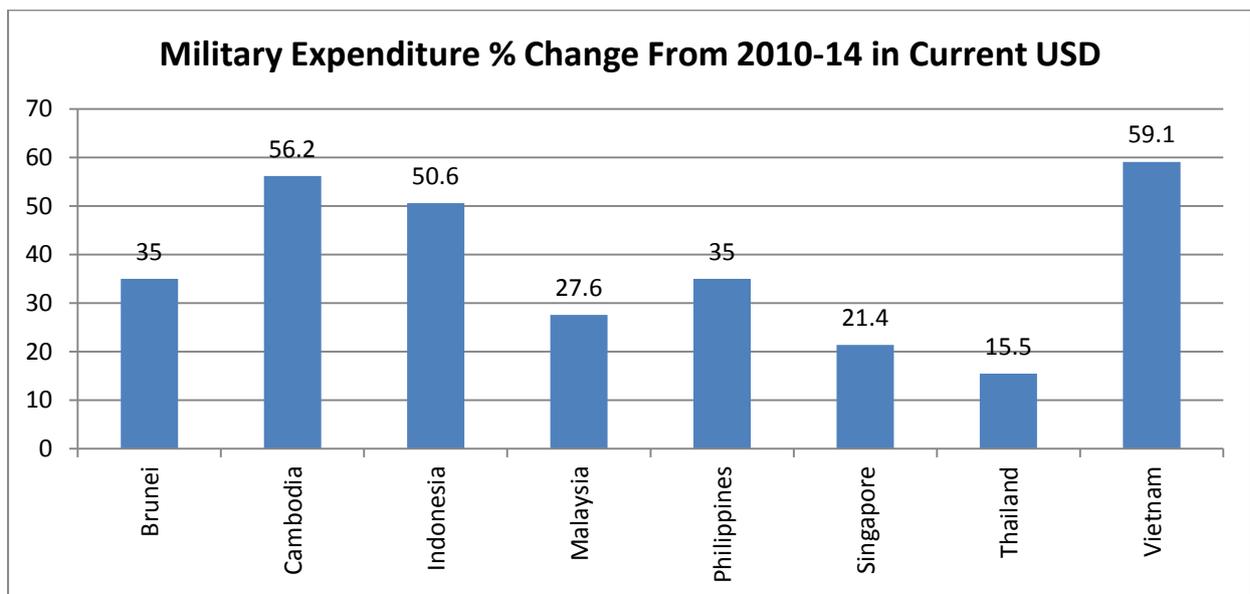
Source: IFS

(c) Military expenditure

Figure 10 shows change in military expenditure among ASEAN nations over the period 2010 to 2014. Malaysia's military expenditure increased by 27.6 per cent over this period, which was considerably less than Cambodia, Indonesia and Vietnam and below the regional average of 37.7 per cent. Figure 11 shows defence spending in ASEAN in 2014 as a percentage of total government spending and of GDP. Malaysia has the fourth highest defence expenditure in ASEAN, representing 13 per cent of the total (Parameswaran, 2015). However, as a percentage of GDP and government spending it is relatively modest. In 2014, defence was 5.4 per cent of government spending and 1.5 per cent of GDP, which was below the regional average. Malaysia increased its defence budget by 10 per cent in 2015, but reduced its defence expenditure for 2016 by 2.25 per cent. The 10 per cent increase in 2015 was in response to security threats from the southern Philippines and increased Chinese

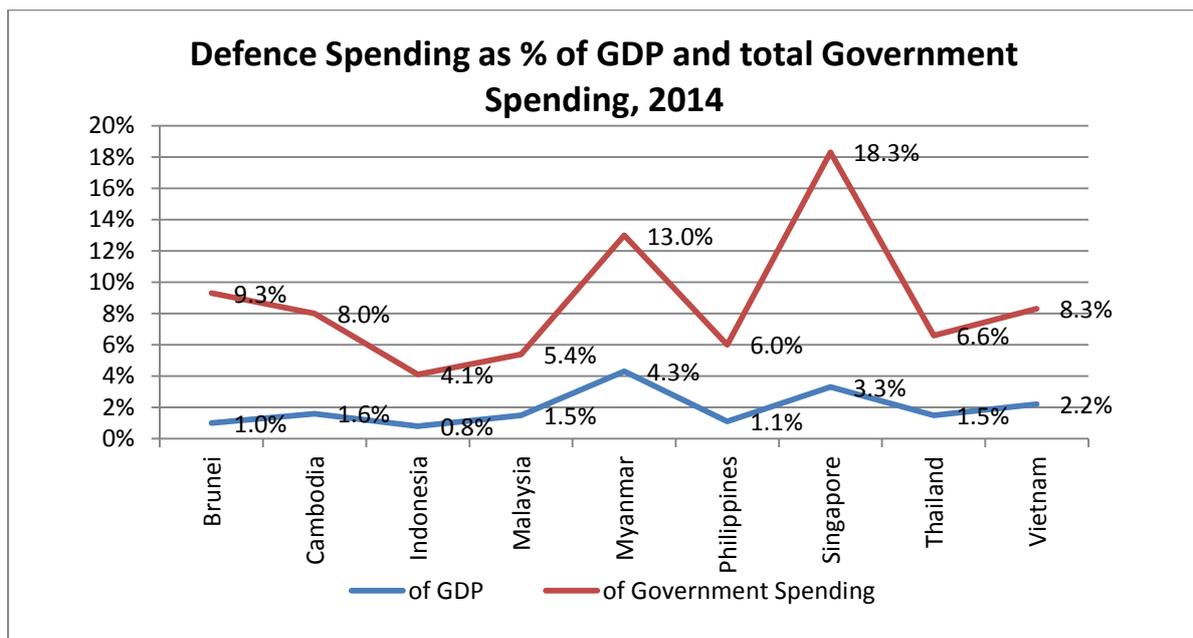
assertiveness in the seas around James Shoal (Parameswaran, 2015). The defence cuts in 2016 are as part of the broader strategy to eliminate the budget deficit by 2020. Najib's critics argue that budget constraints are putting Malaysia's defence capabilities at risk in the face of threats from illegal fishing, kidnapping, smuggling, terrorism and territorial encroachments from China as well as regional neighbors, Indonesia and the Philippines (Parameswaran, 2015).

Figure 10: Change in military expenditure in GDP (2010-2014)



Source: The Stockholm International Peace Research Institute (SIPRI)

Figure 11 Defence spending in ASEAN 2014

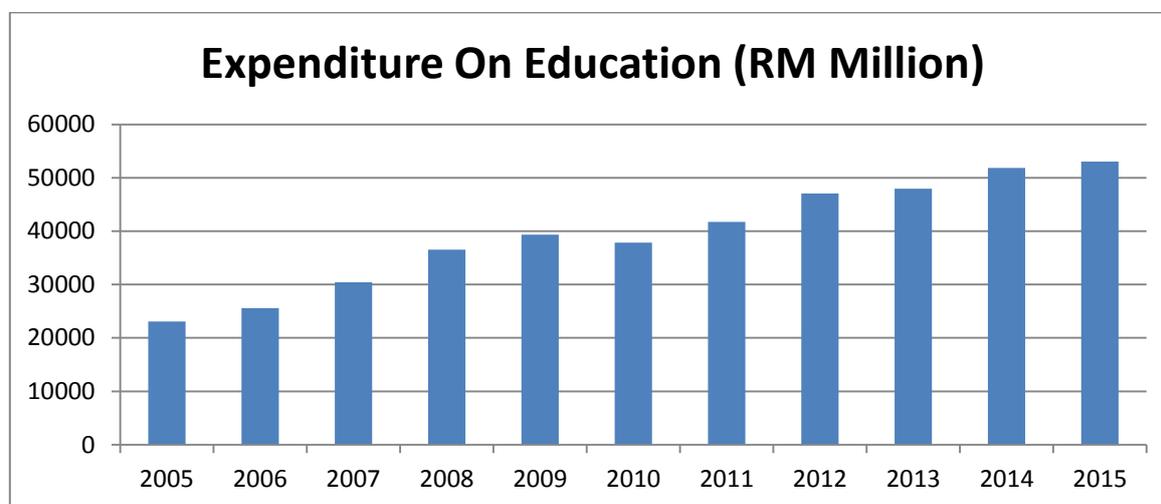


Source: The Stockholm International Peace Research Institute (SIPRI)

(d) Education Expenditure

Malaysia has punched above its weight when it comes to investing in education. It has traditionally allocated a relatively large share of its government budget to education. As long ago as 1980, Malaysia's spending on primary and secondary education, as a percentage of GDP, was the highest in East Asia (MoE, 2013). Figure 11 shows that Malaysia's expenditure on education has increased each year over the last decade. In the 2016 budget Malaysia allocated 16 per cent of government spending to education at all levels, which is higher than most high-income countries (Ennew, 2015). Figure 13 puts Malaysia's expenditure on education in comparative perspective. The amount Malaysia spends, at 3.8 per cent of GDP or 16 per cent of total government spending, was not only higher than the OECD average of 3.4 per cent of GDP and 8.7 per cent of total public spending respectively, but also at par, or higher than, countries with high-performing education systems in Asia, such as Singapore, Japan, and South Korea (MoE, 2013). In higher education, a focus has been to create a regional hub that will attract students from countries, such as China (Lean & Smyth, 2016). The Universitas21 Ranking of National Higher Education Systems places Malaysia twelfth in the world in terms of resources committed to higher education and third in the world once adjustment is made for the level of economic development (Ennew, 2015).

Figure 12: Malaysia's expenditure on education 2005-2015



Source: Ministry of Finance

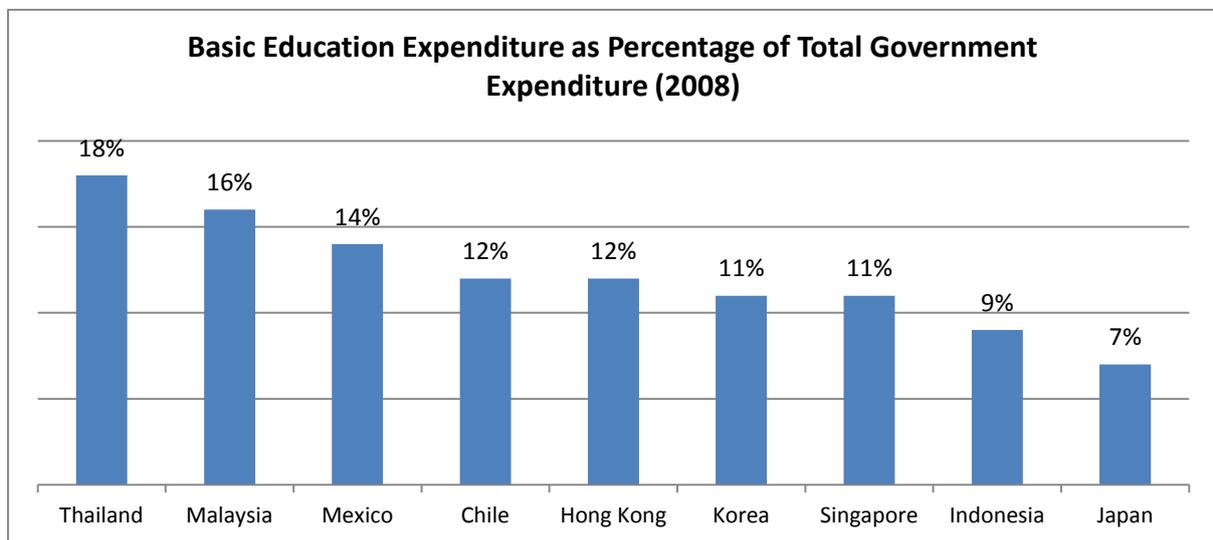
The problem is that, despite investing heavily in education, the returns on that investment have been relatively low. Jiminez et al. (2012) emphasize that the key to Malaysia avoiding the middle-income trap is to continue to move surplus labor into higher value added manufacturing and that investment in education is crucial in this process. They note that while Malaysia stacks up relatively well in terms of access to basic education, it falls down in the quality of education. Similarly, Ennew (2015) suggests that the higher education system in Malaysia is not producing the sorts of workers that Malaysia needs.

Results from the Programme for International Student Assessment (PISA) and Trends in International Mathematics and Science Study (TIMSS) place Malaysia in the bottom third of the international league table of schools (Asadullah, 2014). A comparison of PISA scores suggest that an average 15-year old Malaysian would take three years extra schooling to catch up with their peers in South Korea and Singapore.

The returns to investment in higher education have similarly been disappointing. There is currently no Malaysian university in the QS World top 200 or the top 200 in either the Shanghai Jiaotong Rankings or Times Higher Education (THE) rankings (Ennew, 2015).

The Malaysian response to the PISA and TIMSS rankings has been to launch the Education Blueprint and Higher Education Blueprint (MoE, 2013, 2015). The objective of the Education Blueprint is to move Malaysia into the top third of countries by 2025 (MoE, 2013).

Figure 13: Education expenditure in select countries



Source: MoE (2015)

(e) The effect of government expenditure on economic growth

The effect of government expenditure on economic growth is unclear. Conceptually there are competing hypotheses. Wagner (1890) hypothesized that government spending is an endogenous variable that is a consequence, rather than a cause, of growth. Hence government spending has no role in stimulating growth. The competing hypothesis, proposed by Keynes (1936) is that government spending is exogenous and that increasing government spending promotes economic growth. The empirical evidence for Malaysia is mixed with support for both Wagner’s law (see eg. Sinha, 1998; Dogan & Tang, 2006; Tang, 2009) and Keynes’ hypothesis (Ghani et al., 2005; Goh et al., 2013; Govindaraju et al., 2011).

These findings can mask the results for specific types of government expenditure. We now turn to specifically consider government expenditure on education and defence. With respect to education, a large literature attests to the positive relationship between expenditure on education and economic growth including studies for Malaysia (see eg. Hussin et al. 2012; Goh et al., 2013). However, as discussed earlier, it is not just a matter of access to education,

but also the quality of education, which is a reflection of how the funding is being spent. Thus, while education expenditure is undoubtedly contributing to economic growth in Malaysia, the returns have been less than they would otherwise have been. Expenditure on defence can conceptually be positively or negatively related to economic growth. The conceptual argument for a positive relationship is that defence expenditure can promote economic growth through a Keynesian multiplier mechanism. The conceptual argument for a negative relationship is that defence expenditure can divert resources from more growth-oriented activities. Among the few empirical studies for Malaysia, Hirnissa (2009) and Pardhan (2010) found that military expenditure had no effect on economic growth.

5. 1Malaysia Development Berhad (1MDB)

The 1MDB is a private corporation wholly owned by the Ministry of Finance, Malaysia. Najib Razak is its chairman. It was established in 2009 by converting a state sovereign investment fund, the Terengganu Investment Company, into a federal entity. 1MDB serves as a strategic investment company with the mission “to drive sustainable economic development by forging strategic global partnerships and promoting FDI”. To realize its mission 1MDB has invested primarily in the power and real estate sectors.

In the power sector it has acquired three power plants, costing approximately RM12 billion plus invested in a greenfield project for RM8.1 billion. In real estate it purchased land for the construction of the Tun Razak Exchange for RM2 billion and is investing in commercial and affordable residential housing projects (Gee, 2015; Lee, 2015).

The manner in which 1MDB has operated has been controversial and it has become a major political issue for the Najib government. The main issue has centred on how it has been financed, how it has used the funds and alleged lack of financial transparency.

The first concern is the high cost of borrowings and concerns about its solvency (Gee, 2015; Lee, 2015). 1MDB borrowed RM41.9 billion in the year ending March 31, 2015 (Lee, 2015). Former Prime Minister, Mahathir Mohamad has alleged that there appears to be a gap of RM27 billion between 1MDB’s liabilities and assets. This has affected its ability to service its debt with annual debt repayments exceeding cash flow. As a result, 1MDB has twice sought extensions to its repayment schedule and sought the assistance of a local business person, Ananda Krisnan, to meet its debt obligations (Lee, 2015).

The second concern, which has exacerbated the first, is the lack of financial transparency and alleged financial impropriety. In 2015 Najib was accused of misappropriating RM2.7 billion from 1MDB into his personal bank account, leading to calls for his resignation not only from opposition leader, Anwar Ibrahim, but former Prime Minister Mahathir Mohamad. Some of the 1MDB debt results from a state-guaranteed bond issue led by Goldman Sachs, for which it is believed that Goldman Sachs received USD300 million in fees (Wright & Brown, 2015). Another controversy for 1MDB concerns the reasons for placing USD2.3 billion from 1MDB redeemed investments in the Cayman Islands. These issues have dovetailed into broader allegations of corruption and fraud (Khahir et al., 2015; Vighneswaran & Gomez, 2014).

The response from the government and 1MDB has been multipronged. At one level, the focus has been on improving short-term liquidity. The government provided a RM970 million loan to 1MDB in March 2015 and 1MDB has sold some of its real estate assets to improve short-

term cash flow (Lee, 2015). At another level, Najib has posted a defence of his record and that of 1MDB. Najib denied any wrongdoing with respect to misappropriating funds from 1MDB. He conceded that the funds were a donation to UMNO, while UMNO leaders emphasised that depositing political donations into a private fund is not forbidden (Ufen, 2015). Najib blames the accusations on his political opponents. In particular, he accuses Mahathir, who has been one of the fiercest critics of Najib's involvement in 1MDB, of "political sabotage" and attempting to unseat him (Wright & Brown, 2015).

Najib has attempted to restore the confidence of international investors through pointing to international accolades for his government's financial record. At an *Invest Malaysia 2015* seminar, Najib pointed out that *Bloomberg* rated Malaysia the fifth most promising emerging market in 2015, while Transparency International's *2015 Index of Economic Freedom* ranked Malaysia 31 of 178 countries (Chong, 2015). 1MDB has consistently said that all of its investments were proper, its finances are in order and that it is cooperating with all investigations. It has called on Mahathir to stop posting what, it argues, is misleading information. Goldman Sachs have said that while its fees were high, this reflected appropriate compensation for the risk it took to execute the sale of three bonds totaling USD6.5 billion at short notice and was not out of the ordinary (Wright & Brown, 2015).

6. Prospects For Future Growth

The prospects for continued economic growth in Malaysia are generally regarded as good. For example, ESCAP (2015) suggests "the overall outlook remains bright", the IMF (2013 p.4) suggests "robust pace of recent economic activity is expected to continue" and the World Bank (2015) states "Malaysia's near term economic outlook remains overall favorable". In providing this positive assessment, ESCAP (2013), for example, noted that the Malaysian economy will benefit from cheaper crude oil imports and that non-commodity exports will benefit from the improving state of the US economy and depreciation in the ringgit. ESCAP (2015) also argues that investment growth will remain strong on the back of major public infrastructure investment projects commenced under the ETP. This said, not all assessments of Malaysia's near term economic growth have been positive (see eg. Tan, 2015) and even those who are overall bullish about Malaysia's future growth prospects point out that there are risks and uncertainties (ESCAP, 2015; IMF, 2013; World Bank, 2015).

One important short term risk for economic growth centres on declining commodity prices and, in particular, declining oil prices, given that oil-related taxes still account for around 30 per cent of public revenue (World Bank, 2015). A second short term risk relates to uncertainties over capital flows as the United States normalizes monetary policy following the GFC (World Bank, 2015). The US recovery was relatively strong throughout 2015 (IMF, 2013, MIER, 2015) and is showing strong signs. For example, in December 2015 the United States Federal Reserve raised interest rates for the first time since 2006.

A third short term risk is the effect that the controversies surrounding 1MDB is having on investor confidence. The fallout from 1MDB has created political instability within UMNO. Najib dismissed his Deputy Prime Minister, Muhyiddin Yassin, in the aftermath and there is ongoing conflict between Mahathir and Najib. As one political commentator put it: "The flight of foreign investors in July-August [2015], the fall in the value of the ringgit and sustained public dissatisfaction all brought into question the survival of the government, even though the next elections are only due in 2018" (Gee, 2015). The effect of 1MDB on future

growth depends on the extent to which the government and 1MDB can restore confidence.

A fourth short term risk is to private consumption. Economic growth in 2015 reflected strong growth in consumer spending. But, there is increasing concern about rising household debt. The household debt to income ratio in Malaysia at the end of 2014 was 146 per cent, which is one of the highest in Asia (Malaymail, 2015). Some expect that rising household debt, combined with the GST, will slow consumption and impede growth (Tan, 2015).

Considerable income disparities persist in Malaysia across ethnic groups (Saari et al., 2015). The longer term prospects for Malaysian growth depend on whether the NEM can address this income inequality (Jomo & Wee, 2014) and implications of income inequality for economic growth. Commentators on Malaysia's growth prospects have tended to imply that if NEM cannot reduce income inequality this will have a negative effect on long-term growth (see eg. Kim et al., 2014), but this is not necessarily the case. There are competing hypotheses concerning the effect of income inequality on long-term economic growth.

There are two channels through which a positive growth inequality relationship is thought to evolve. One is that since high income individuals have a higher propensity to save, and given saving equals investment, more unequal societies should experience a higher growth rate (Kaldor, 1957). The other is that higher inequality may lead to favorable behavioral responses, incentivizing individuals to work harder and invest more (Mirrlees, 1971). There are three channels through which a negative growth inequality relationship is thought to exist. First, a high concentration of economic resources can create incentives for rent-seeking behavior and lead to the exploitation of political power. This fosters a general lack of trust in government, creating civil unrest and disincentives to invest (Hibbs, 1973). Second, Banerjee and Newman (1991) and Galor and Zeira (1993) show that when income distribution is highly concentrated, many individuals do not possess the collateral needed to borrow freely against future income in credit markets. This creates a binding constraint on the household sector, limiting the ability for poorer individuals to invest in either physical or human capital. Finally, there may be political economy channels, through which voters may regard inequality beyond a critical threshold unacceptable, forcing governments to implement redistributive policies. Such redistributive policies often lead to a misallocation of resources and a loss of economic efficiency as a result of the costs inherent in taxing income, as well as the disincentive effects on the labor-supply decision of high-income individuals (see eg. Perotti, 1993, 1996; Alesina & Rodrik, 1994; Persson & Tabellini, 1994).

Longer term prospects for growth depend on whether Malaysia is caught in a middle income trap or capable of graduating from the middle (Hill et al., 2012; Lean & Smyth, 2014; Menon, 2014; Woo, 2011; World Bank, 2011). The NEM contains a number of reforms designed to strengthen private sector investment and move Malaysia into higher value added activities (NEAC, 2010). While Malaysia invests a lot in education, returns to that investment have been low. Malaysia's ability to build a human capital base to sustain long term growth will depend on the ability of the Education and Higher Education Blueprints to deliver. The jury is still out on this (see eg. Ennew, 2015). Malaysia's longer term growth prospects will depend on whether structural reform can strengthen medium term fiscal planning and build the institutions capable of transitioning Malaysia from a middle income to high income country. Standard & Poors, Moody's and Fitch responded positively to the 2016 budget. Each of the ratings agencies were positive about measures to reinforce fiscal consolidation; however, Moody's noted that the budget "does little to deliver structural reform that could provide

longer lasting support to the government's finances" (Damodaran, 2015).

Ostry et al. (2015) consider optimal public debt in the aftermath of the GFC, noting "what constitutes a safe level of debt is, needless to say, very difficult to pin down precisely" (Ostry et al., 2015, p. 1). Never the less, while Malaysia's public debt (57 per cent of GDP) is relatively high among similar nations in Asia and has attracted much comment, it is below any critical threshold. A problem with having high debt levels is the need to refinance regularly (McKinsey, 2015). Importantly, though, the government has minimal external debt with over 95 per cent raised domestically. Hence, there is no immediate concern of a Malaysian sovereign debt crisis (Hussein, 2013). Should Malaysia's public debt be reduced? Most commentators on Malaysia answer in the affirmative on the basis that fiscal consolidation is appropriate (see eg. Hussein, 2013). Generally, the 2016 budget was well received by the Sovereign credit agencies and the government's short term forecasts for eliminating the budget deficit by 2020 are considered realistic (Damodaran, 2015). In this respect, public debt is unlikely to negatively impact on short-term growth prospects.

7. Conclusion

Malaysia is a middle income country that, on the back of a long record of sustained growth, aspires to be a high income country by 2020. In this paper we have reviewed recent economic indicators for Malaysia and outlined the prospects for future growth. Our main conclusion is that the prospects for continued economic growth in the short-term are reasonably good, although there are risks, primarily in the form of weaker oil prices and low investor confidence in the fallout of the 1MDB controversies. The real question mark is over Malaysia's growth prospects in the longer term. Much hinges on whether Malaysia can move up the value-added chain into higher value added manufacturing; hence, escaping the middle income trap. This will depend, in important ways, on whether Malaysia can increase the returns it gets on investment in education, which, in turn, will depend on how successful the Education and Higher Education Blueprints turn out to be.

In addition, one of the important obstacles hampering the Malaysia economy today is a "confidence deficit". The confidence of investors and the Malaysian people more generally can be addressed with strong political will. On the one hand, the government has to show greater tolerance toward democracy, fighting corruption and implement conservative monetary and fiscal policies to restore investor confidence. On the other hand, to restore the confidence of the Malaysian people, and reduce ethnic and religion tension, the government needs to focus more on improving the welfare of all Malaysians, regardless of race and religion. It has to oppose extremism, instead of sometimes pandering to extremist views. Moreover, the priority in the Eleventh Malaysian Plan to assist the poor and low income groups need to be implemented more hastily, with concrete measures that can really benefit the poor at the grassroots level. Finally, the economic benefits and opportunities provided by external opportunities, such as the ASEAN Economic Community (AEC) and China's "one belt one road" plan need to be grasped if Malaysia is to realize its 2020 vision.

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