The column below by R B Bhattacharjee (in The Edge Malaysia) drew upon the comments of Woo Wing Thye on the relevance to Malaysia of Professor James Mirrlees's lecture on the Global Financial Crisis at the inauguration of the Penang Institute, 9 December 2011. This column has some misquotes, e.g. it should be that (a) current account surpluses (in balance of payments), not deficits, mean capital account deficits, which indicate capital flight; and (b) "conclusion of the US-China negotiations that led to the accession of China into the World Trade Organization" and not "events that led to the collapse of the World Trade Organisation talks"

The Edge Malaysia (week of Dec 19-Dec 25, 2011)
Saturday, December 17, 2011

The case for a new policy framework - by R B Bhattacharjee, The Edge Malaysia (week of Dec 19-Dec 25, 2011)

Re-produced from his "My Say" column by The Edge associate editor R B Bhattacharjee which was published in the Edge Malaysia, week of Dec 19 - Dec 25, 2011:-

A key lesson of the eurozone crises that is relevant to Malaysia related to the problem of mismanagement of government budgets and the ability to hide this bad practice. The Greek budget deficit, for example, was twice the amount that was reported in official records, for which the country was duly punished by the market.

A second issue is moral hazard, in the form of incentives that promote misbehaviour, such as the generous bailout of businesses. In particular, it is the idea that a financial institution could be "too big to fail" since if it were allowed to go under, it could bring about the collapse of the system because of the interlinkages with other banks.

These were among the points made by Professor Woo Wing Thye, the incoming executive director of the Penang Institute, in his discussion of the Penang in Asia lecture that was delivered by Nobel Laureate Professor Sir James A Mirrlees at the launch of the state-funded think tank earlier this month.

In a brutally frank synopsis of Malaysia's economic malaise, Woo outlined several factors that need to be addressed to steer the country away from a downward trajectory. His message is a sobering one that bears being paid careful attention to.

Woo's opinion carries the weight of a highly distinguished academic career and formidable advisory portfolio. They include concurrent professorial posts at four universities in the US and China, leadership of international economic task forces and projects and advisory positions on government and international panels, including the International Advisory Panel to former Prime Minister Tun Abdullah Ahmad Badawi and the chairmanship of the International Economic Advisory Panel of Penang. He was born and had his early education in Penang.

In relation to the encumbrance of institutions that are "too big to fail", Woo noted that the experience in the US was to strive to remedy this problem. When President Barack Obama had talked about "the change we are waiting for", what he had aimed for, according to his adviser Paul Volcker, was to remove the relevance of the "too big to fail" factor. Basically, by having many more financial institutions, if any one were to fail, it would not matter.

With reference to Malaysia, Woo pointed out that this hazard exists in the key role that Petronas plays in the country's finances. The world's experience with state oil companies is that they would fail in the middle of a boom, he said. Indonesia's Pertamina failed in 1974 in the middle of the Opec boom and PetroMexico collapsed in the midst of the second Opec shock.

"These state oil companies were overextended and not very transparent", Woo said. "They were basically the cash registers of their governments.

"It is a good thing to have more transparency because the balance sheet of Petronas links directly to the government budget. If Petronas is in trouble, the government budget is in trouble," Woo observed.

The great emphasis is on getting the public to accept the goods and services tax, he opined, signals that Petronas may be in weaker shape than we think.

To mitigate the moral hazard, Volcker's response was to make sure that there were not institutions that were "too big to fail" because the banks in the US were too concentrated and had the lobbying power to resist the US Congress's efforts to institute meaningful regulatory reforms and open up the market.

Malaysia's response to the 1998 financial crisis was to reduce the number of financial institutions from 58 to 10 - that is to concentrate them. Tellingly, Woo's comment that "big banks are very useful because they can become a very convenient source of campaign finance" struck a chord with the audience.

The concentration of financial institutions had another insidious effect. "When we grouped these banks into much smaller numbers, it was basically close to a confiscation of private property," said Woo. "I think this contributed to the collapse of private investment in Malaysia after 2001 and is responsible for us being stuck in the middle-income trap."

The reason that the government could concentrate financial power in a few hands is that it is overly strong, resulting in the centralisation of decision-making powers, he said. This is seen in other areas too, such as in transport policy. "For example," said Woo, "which route the bus takes in Penang and where the bus stops are put is decided in Putrajaya."

This is the result of an outdated policy framework that is still being continued, although domestic conditions have changed, he said. For example, Malaysia no longer has cheap labour but has become highly dependent on imported labour for many economic activities.

"The biggest reason we are belly up is that the world has changed," said Woo. "The strong government has put in place policies that systematically drove away domestic capital. This is why Malaysia hasn't run a current account surplus in years, which, in other words, means capital flight."

He noted that a recent report by the Washington-based think tank Global Financial Integrity ranked Malaysia No. 5 in terms of capital outflow. Not only that, there has been a serious occurrence of brain drain.

Although the economy had grown 9% a year previously despite the flight of capital and talent, this was no longer possible because, according to Woo, "the world changed in May 2000". He was referring to the events that led to the collapse of the World Trade Organisation talks and China's entry into the body.

"All the FDI that was brought in to replace the capital that had fled disappeared," said Woo. "That was why our growth rate has gone from 9% to 4% since then. The capital flight and brain drain have systematically undermined the move towards a knowledge-based economy."

Citing the World Bank report entitled "Malaysia Economic Monitors: Smart Cities" that was released last month, Woo pointed to the discussion of the poor state of university education in the country in comparison with our regional peers. He highlighted the case of Universiti Malaya, which was ranked No. 207 in the QS World University Rankings 2010.

"It is a sorry tale of how we have run ourselves into intellectual isolation," said Woo.

"What Malaysia has to do is correct this wrong policy framework. A strong state was the right thing at the founding of the federation but over time, given the changes within the country and outside, we need a new policy climate."

Bitter medicine, indeed, but can we afford to ignore it?

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article above was taken from:
http://dukuhead69.blogspot.com/2011/12/case-for-new-policy-framework-by-r-b.html

article was posted on 29 December 2011 at:
http://www.theedgemalaysia.com/commentary/198536-the-case-for-a-new-policy-framework.html