Malaysia

Economy, politics and Australian relations

Stewart Nixon

Project oversight by: Peter Drysdale and Shiro Armstrong

A report prepared by the Asian Bureau of Economic Research (ABER) at the Australian National University
Contact:

Stewart Nixon, PhD Scholar and Researcher, Asian Bureau of Economic Research, Crawford School of Public Policy, WEH Stanner Building, 132 Lennox Crossing, ACT 0200. Stewart.Nixon@anu.edu.au.

Acknowledgements:

We are grateful for the ongoing support provided by the Department of Foreign Affairs and Trade (Australia) and other Australian Government partners to the Asian Bureau of Economic Research, without which this report would not have been possible.

We are also grateful for the helpful peer review comments and suggestions from our friends and colleagues at the University of Malaya, National University of Malaysia, Sunway University, Malaysian Institute of Economic Research, Institute of International and Strategic Studies, The World Bank, United Nations, EU-Malaysia Chamber of Commerce and Industry, CIMB, Ministry of Finance (Malaysia), Ministry of Economic Affairs (Malaysia), Bank Negara Malaysia, and the Australian High Commission in Kuala Lumpur.

Thanks also go to Arun Murali for his contributions to editing and formatting.

Foreword

2018 was historic for Malaysia — it experienced its first democratically elected change in government since becoming an independent nation in 1957. The unanticipated return of Malaysia’s longest-serving prime minister in alliance with the man he once imprisoned on dubious grounds was optimistically welcomed by Malaysians and sparked a great deal of interest globally. As an enduring regional friend and Commonwealth partner, Australia is among the countries eagerly engaging with the Pakatan Harapan (PH) government as it seeks to implement a new vision for governance, the economy, international engagement and beyond. This paper takes stock of the new administration’s first year and outlines some of the key challenges it faces, with a detailed focus on fiscal reform, infrastructure development, governance revitalisation and international engagement prospects — including a dedicated chapter on Malaysia-Australia relations and opportunities to enhance cooperation. It combines this with historical context and data to make it both relevant and accessible to readers with varying degrees of familiarity with Malaysia.
Executive Summary

- The Malaysian economy registered strong growth of 5.9 per cent in 2017, but has eased to below 5 per cent in the past 18 months as political uncertainty and fiscal consolidation dampened expectations. Inflation has fallen dramatically as the government prioritises reduced cost of living pressures and lowering public debt, while unemployment remains low and monetary policy is used sparingly. Sound macroeconomic fundamentals and robust domestic consumption are helping to combat global headwinds — emerging economy crises and trade wars — despite Malaysia being among the most exposed countries as a highly integrated global value chain participant.

- The government has taken a slow and deliberate approach to crafting its economic agenda. It kept investors waiting on announcements following the Council of Economic Persons’ confidential reporting to the Prime Minister. The Mid-term Review of the Eleventh Malaysia Plan and the 2019 Budget expounded on PH’s vision of reduced living costs, public expenditure rationalisation, inclusiveness and regional development among the economic focal points. Such pursuits are worthwhile but dependent on redistributing scarce government funds into areas that will do little for productivity. Meanwhile education, innovation, infrastructure, privatisation and competition are among the policy areas requiring significant reform, but for which the government's approach (beyond continuing existing measures) remains underdeveloped and unclear. In the absence of a robust medium-term structural reform agenda and a clear vision for encouraging economic growth, the government is vulnerable to a downturn in economic indicators. These risks are compounded by critical impediments to future sustainability including an unhealthy aversion to tax, transfers and debt-financed investment.

- PH’s early focus on governance reforms was well received by commentators and ordinary Malaysians, whose confidence in government will take some effort to restore. Prime Minister Mahathir Mohamad has made it clear to his ministers that elected officials are expected to act in the people’s interests. The pursuit of former prime minister Najib Razak and associates on corruption charges, the separation of powers for key agencies, erosions into the Prime Minister’s Department empire and promises to end the most egregious political appointments were among the promising early reforms. But greater challenges will test the capability and resolve of the new leadership, including unravelling the complex web of political patronage, revitalising democratic institutions and restoring confidence in government. Slow reform progress and rising ethnic politicking is eroding the considerable initial optimism in the ability of the charismatic Mahathir and his fresh-faced but capable ministers to revitalise Malaysia after years of policy and political stagnation.

- Developments in the cultural sphere are intrinsically linked to Malaysia’s economic and political prospects. Past affirmative action policies having left a legacy of extensive government ownership of industry, associated corruption, low levels of entrepreneurship and a floundering education system. There have been mixed signals from the government on the cultural front as it is hesitant to reward its supporters after promising to end divisive racial politics. Mahathir’s instinctive desire to look after the Bumiputra and his coalition’s more diverse membership and supporter base appear increasingly conflicted. The new government enjoys almost universal support among ethnic Chinese, significant majority support among ethnic Indians, but only 20-30 per cent of the ethnic Malay vote. Government statements have alternated between increasing support for the Bumiputra and emphasising the need to embrace Malaysia’s multicultural and multireligious society. The Mid-term review provided affirmation that divisive Bumiputra policies would continue alongside multicultural inclusiveness measures.
Malaysia and Australia form natural partners across a broad suite of international engagement as leading regional advocates of prosperous open economies, a rules-based order, peace and stability, multicultural values and cooperation among global powers. They already boast robust trade relations, deepening investment ties, close security cooperation and a history of people connectivity. Yet a wealth of opportunities exist where greater coordination and experience sharing would deliver benefits to both parties, elevating the bilateral relationship to greater heights. Australia's experiences provide valuable insights for Malaysia as it embarks on substantial reform efforts.
Introduction

Often overlooked against the extraordinary growth miracle of East Asia and the affairs of larger regional players, Malaysia too provides a positive story of rapid development underpinned by decades of stability, openness to trade and investment and sound economic management. It has become a moderately large, upper-middle income economy and an important geopolitical player in the heart of Southeast Asia. It provides leadership to ASEAN and advocacy in broader regional consensus-building, an exemplar for moderate Islam and prosperity, a peaceful image for multicultural society and strong evidence in support of liberalisation and global integration.

Malaysia’s major goods and services reflect a diverse combination of its natural resource advantages, export and FDI driven manufacturing and booming domestic financial and consumption markets. In 2018 it produced 37 billion electronic transistors, 54 billion rubber gloves, 19.5 million tonnes of palm oil and almost a trillion US dollars of banking assets. Its exports are significantly more concentrated in electronics, petroleum and chemical related products. Services industries have had limited success expanding internationally. But Malaysia is geographically and developmentally well positioned to command a greater share of global services trade should it pursue policies to address prevailing weaknesses.

Malaysia’s economy has performed well lately, recording robust growth, sustained low unemployment, revitalised exports and declining inflation. Macroeconomic management and monetary policy have been exercised judiciously for the most part, providing investors with a relatively high degree of confidence compared to regional peers. Yet the government that presided over this strong economic performance failed to invest the spoils wisely. Voter anger swelled as rising costs of living stood in stark contrast to the corrupt excesses of former government elites. This proved enough to unseat the government of 61 years in the May 2018 elections.

A key contributor to election success was the return of sentimental favourite and charismatic former Prime Minister Dr Mahathir Mohamad in a curious alliance with former friend-cum-foe Anwar Ibrahim. His coalition of opposition stalwarts proved preferable to the tarnished Najib-led government. Mahathir is revered as a wise elder statesmen whose past economic and governance missteps appear to have been excused. His second coming provides a chance at redemption for a heroic patriot who — at least outwardly — accepts earlier failings. Observers with long memories remain sceptical despite early reforms unwinding several of his past mistakes, while the optimism of the public and remaining commentators provided a strong but rapidly evaporating mandate as Malaysia’s saviour.

Governance reforms have taken centre stage since the new government took office, sending a clear message to Malaysians that elected officials are expected to act in the people’s interests. Initial efforts have set a positive platform and vigorous anti-corruption activities and institutional strengthening provide essential prerequisites for further reforms. The government’s revised Eleventh Malaysia Plan priorities signal ambitious reform intentions that would substantially improve governance quality. Implementation of these and further complex reforms will be challenging. The government faces a gauntlet of vested interests, institutional deterioration, a divided electorate and high expectations that will provide a true test of its ability.

Economic reforms have taken a backseat as the government takes a deliberate approach to formulating its medium-term agenda. Election commitments to scrap the Goods and Services Tax (GST) and restore petrol subsidies have been delivered, while reducing the public debt burden and cost of living pressures
have become the leading economic narratives. Large scale infrastructure investments and social welfare payments have been the early casualties of fiscal consolidation, with further expenditure rationalisation on the cards. Taxes and transfers, education, innovation, infrastructure, privatisation and competition are among the policy areas that would benefit from bolder reform efforts than signalled under the Mid-Term Review and delivered under the government’s first Budget. Addressing these will go a long way to safeguarding Malaysia from hits to economic outcomes that are increasingly possible in the prevailing global environment.

Malaysia and Australia are enduring friends with common allies and analogous worldviews. Together they are leading advocates of a peaceful and prosperous region, trade and investment deepening and a consensus-built, rules-based international order. While already engaging constructively across a range of economic, security and broader policy dimensions, there is scope to further enliven bilateral relations across a diverse range of areas, from investment to fiscal policy, institutional reform to gender equality.

This paper provides a detailed overview of the Malaysian economy, polity and bilateral relations with a contemporaneous focus supplemented by historical background. It offers early insights into the Pakatan Harapan government and its initial and prospective policies, while also highlighting areas for additional policy focus over the medium-term.

The remainder of the paper is structured as follows. The first chapter examines the Malaysian economy; starting with an overview of key indicators and background on its structural composition and development. It follows with an outline and broad perspectives on selected key policy challenges before offering more detailed analysis of two critical priorities: fiscal and infrastructure policies. The second chapter explores politics and culture, beginning with a snapshot of political fundamentals and recent developments. It then delves deeper into a handful of policy challenges, including a special focus on the prospects for revitalised democracy and development and international engagement approaches. The final chapter takes a closer look at the Malaysia-Australia relationship — detailing the extent and variety of existing ties and suggesting areas for possible further engagement. The paper concludes with a brief summary.
1. The Malaysian economy

1.1 Economic fundamentals

Malaysia is a moderately large, upper-middle income economy located in the geographical heart of Southeast Asia. Decades of social stability, openness to trade and investment and predominantly sound economic management have seen it experience stronger and more consistent growth than the majority of its regional peers. Often overlooked against the unprecedented scale of development in East Asia and India, Malaysia is not far from being a G20 country in purchasing power parity (PPP) terms and is wealthier than several OECD member countries in PPP per capita terms (Figures 1 and 2). Using Australia as a reference point, Malaysia has converged significantly on both measures over the past 30 years.

![Figure 1: GDP PPP](image1)

![Figure 2: GDP per capita PPP](image2)

Source: Author using IMF data

Despite its relatively high exposure to global volatility, Malaysia’s real GDP growth continues apace, buoyed by robust private consumption and investment. Growth of 5.9 per cent in 2017 significantly exceeded expectations, and 4.7 per cent growth in 2018 is respectable in current global conditions. The latest international organisation forecasts predict similar growth of 4.6-4.8 per cent over the next two years. Private consumption has received a temporary boost from the new government’s immediate measures to reduce taxes on goods and services, cap petrol prices, reduce the cost of broadband and dismantle industry monopolies. But contractions in public expenditure and investment are expected as the government revisits major investments and consolidates debt. While not well illustrated under the
conventional growth accounting approach, a recent revival in exports is also contributing to the solid recent performance and optimistic expectations.\(^1\)

Inflation has rarely deviated from a well-contained path despite the pace of Malaysia’s development. However, a spike in headline inflation in 2017 underpinned by particularly rapid rises in the price of necessities propelled rising living costs to prominence in public debate. Inflation has fallen significantly under the new government to just 0.2 per cent year-on-year in April 2019, but it will trend upwards again as the one-off GST impact subsides. With private consumption growth consistently exceeding wage growth, particularly wages in the increasingly important services sector, mounting household debt looms as a future constraint on both inflation and growth.

Labour market conditions remain broadly favourable — combining low unemployment and rising labour force participation. The expanding labour force is constraining the wage growth that would ordinarily accompany robust employment growth, reflecting Malaysia’s benefitting from a demographic dividend (albeit a temporary one based on current population projections). Large inflows of low-skilled foreign workers are often blamed for suppressing wages and deterring industrial upgrading, but robust empirical evidence of causality is lacking and intuitively unlikely and detracts from the more central debate about human capital development.

Malaysia’s central bank, Bank Negara Malaysia (BNM), has proven to be an effective operator in utilising macroprudential and monetary policies to keep the economy ticking since the Asian Financial Crisis. The official policy rate has remained at an accommodative 3-3.25 per cent in recent years, with the outlook biased downwards amid a challenging global growth environment. Financial sector performance is solid, with sound bank profitability and a low share of non-performing loans. High household debt presents a contained risk that is being monitored and managed through targeted restrictions, though the new government has eased lending rules for first home buyers. Housing policy is complicated by a polarised housing market featuring high reported prices, excess supply in high-end property (enabled by cash-rich developers sitting on unsold properties) and an undersupply of affordable housing. Capital flow management measures are one area in which BNM policies have drawn criticism from the IMF and investors. This includes the compulsory conversion of export proceeds into ringgits and limits on foreign currency investments extended to exporters in place since being introduced to address capital flight following the 2016 United States election. While the development of alternative approaches would be desirable, BNM is understandably reluctant to remove existing measures following a period of substantial short-term outflows post-election and amid an escalating US–trade war.

Years of reportedly prudent fiscal policy have been called into question following the change of government. The state of the budget and the administration of fiscal frameworks are facing serious criticism. While known debt and deficit levels are far from excessive, the extent and nature of contingent liabilities and off balance sheet transactions caused unease among investors and citizens alike. A forensic audit of the budget and surrounding processes remains an urgent priority to restore confidence.

The appointment of a Finance Minister — who is not the Prime Minister — and early declarations regarding the debt situation were positive steps towards developing transparent and rigorous fiscal processes that are essential for an economy approaching high income status. Addressing corrupt and

---

\(^1\) Under the conventional approach, the contribution of exports averaged around 12% of real GDP growth from 2010-14. On an import-adjusted basis, the contribution averaged almost 39% over the same period (Hassan et al 2018).
inefficient government procurement processes and streamlining the civil service also offer opportunities to improve fiscal sustainability.

Yet, populist tax and expenditure policies and an inability to communicate a fiscal narrative befitting a country of Malaysia’s development level present major short- and medium-term risks respectively. The critical fiscal policy challenges Malaysia faces are explored in greater depth in the below feature on ‘Fiscal Imperatives’.

Several other development indicators illustrate the dramatic transformation of the Malaysian economy. Urbanisation has occurred at a faster rate than in most comparator countries (and from a higher base), and at over 75 per cent is close to convergence with high-income countries (Figure 3). Internet penetration (Figure 4) and mobile phone usage have also experienced strong growth, though digitisation is an area where further investment is needed. Energy efficiency of GDP generation is an area of traditional relative strength, but progress has stagnated and fallen behind high-income countries and some regional competitors. The new government has expressed its intention to tackle climate change and environmental challenges, yet the reintroduction of fuel subsidies unwinds recent efforts to reduce Malaysia’s love affair with petroleum.

**Figure 3: Urbanisation rate**

![Urbanisation rate graph](image)

Source: UN (2018)
Table 1 provides a summary of key economic and social indicators.
Table 1: Selected economic and demographic indicators

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP (% change)</td>
<td>6.8</td>
<td>4.6</td>
<td>5.0</td>
<td>4.2</td>
<td>5.9</td>
<td>4.7</td>
<td>4.6-4.8</td>
</tr>
<tr>
<td>Real GDP per capita (PPP, 2011 $INT)</td>
<td>-</td>
<td>-</td>
<td>24,645</td>
<td>25,322</td>
<td>26,490</td>
<td>27,431</td>
<td>29,331</td>
</tr>
<tr>
<td>Private consumption growth (% change)</td>
<td>-</td>
<td>-</td>
<td>6</td>
<td>6</td>
<td>7</td>
<td>7.3</td>
<td>5.8-6.8</td>
</tr>
<tr>
<td>Public consumption (% change)</td>
<td>-</td>
<td>-</td>
<td>4.5</td>
<td>0.9</td>
<td>5.4</td>
<td>0.8</td>
<td>0.2-0.6</td>
</tr>
<tr>
<td>Private investment (% change)</td>
<td>-</td>
<td>-</td>
<td>6.3</td>
<td>4.3</td>
<td>9.3</td>
<td>4.4</td>
<td>5.5-6</td>
</tr>
<tr>
<td>Public fixed capital formation (% change)</td>
<td>-</td>
<td>-</td>
<td>-1.1</td>
<td>-0.5</td>
<td>0.1</td>
<td>-1.6</td>
<td>-2.5-1.1</td>
</tr>
<tr>
<td>Net exports (% change)</td>
<td>-</td>
<td>-</td>
<td>-0.3</td>
<td>0.1</td>
<td>-0.2</td>
<td>0.5</td>
<td>0.0-0.3</td>
</tr>
<tr>
<td>Agriculture value added (% GDP)</td>
<td>12.0</td>
<td>9.8</td>
<td>8.3</td>
<td>7.6</td>
<td>7.5</td>
<td>7.3</td>
<td>-</td>
</tr>
<tr>
<td>Industry value added (% GDP)</td>
<td>43.6</td>
<td>40.2</td>
<td>36.8</td>
<td>36.7</td>
<td>36.4</td>
<td>35.9</td>
<td>-</td>
</tr>
<tr>
<td>Services value added (% GDP)</td>
<td>44.3</td>
<td>50.0</td>
<td>54.7</td>
<td>55.4</td>
<td>55.6</td>
<td>56.7</td>
<td>-</td>
</tr>
<tr>
<td>GDP per unit of energy use (constant 2011 PPP $ per kg of oil equivalent)</td>
<td>7.91</td>
<td>8.0</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>CO2 emissions (metric tons per capita)</td>
<td>5.1</td>
<td>7.7</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Inflation (CPI)</td>
<td>2.8</td>
<td>2.5</td>
<td>2.1</td>
<td>2.1</td>
<td>3.8</td>
<td>1.0</td>
<td>2.2-2.5</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>3.8</td>
<td>3.2</td>
<td>3.2</td>
<td>3.5</td>
<td>3.4</td>
<td>3.3</td>
<td>3.3</td>
</tr>
<tr>
<td>Labour force participation rate, total (% of total population ages 15+) (modelled ILO estimate)</td>
<td>61.71</td>
<td>61.3</td>
<td>64.1</td>
<td>64.3</td>
<td>64.4</td>
<td>64.6</td>
<td>-</td>
</tr>
<tr>
<td>Trade (% GDP)</td>
<td>183.4</td>
<td>154.4</td>
<td>133.5</td>
<td>128.8</td>
<td>135.9</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>FDI net inflows (% GDP)</td>
<td>4.6</td>
<td>3.2</td>
<td>3.3</td>
<td>4.5</td>
<td>3.0</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>International migrant stock (% of population)</td>
<td>3.92</td>
<td>6.73</td>
<td>8.6</td>
<td>-</td>
<td>8.5</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Federal government overall balance (% of GDP)</td>
<td>-</td>
<td>-</td>
<td>-3.2</td>
<td>-3.1</td>
<td>-3</td>
<td>-3.7</td>
<td>-3.3-4</td>
</tr>
<tr>
<td>Revenue (% of GDP)</td>
<td>-</td>
<td>-</td>
<td>18.9</td>
<td>17.3</td>
<td>16.3</td>
<td>16.6</td>
<td>15-17.2</td>
</tr>
<tr>
<td>Expenditure (% of GDP)</td>
<td>-</td>
<td>-</td>
<td>22.1</td>
<td>20.4</td>
<td>19.3</td>
<td>20.3</td>
<td>18-18.2</td>
</tr>
<tr>
<td>General government debt</td>
<td>-</td>
<td>-</td>
<td>57.9</td>
<td>56.6</td>
<td>55.2</td>
<td>56.3</td>
<td>56.5-56.5</td>
</tr>
<tr>
<td>Age dependency ratio (% of working-age population)</td>
<td>61.8</td>
<td>48.0</td>
<td>44.6</td>
<td>44.3</td>
<td>44.1</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Population growth</td>
<td>2.4</td>
<td>1.8</td>
<td>1.6</td>
<td>1.5</td>
<td>1.4</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Urban population (% of total)</td>
<td>58.5</td>
<td>71.7</td>
<td>74.2</td>
<td>74.8</td>
<td>75.4</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Central bank policy rate</td>
<td>-</td>
<td>2.89</td>
<td>3.25</td>
<td>3.0</td>
<td>3.0</td>
<td>3.25</td>
<td>-</td>
</tr>
<tr>
<td>Household debt (% of GDP)</td>
<td>-</td>
<td>-</td>
<td>88.4</td>
<td>87.8</td>
<td>83.8</td>
<td>83</td>
<td>-</td>
</tr>
<tr>
<td>Bank capital to assets ratio (%)</td>
<td>-</td>
<td>-</td>
<td>10.5</td>
<td>11.0</td>
<td>11.2</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Bank nonperforming loans to total gross loans (%)</td>
<td>-</td>
<td>2.9</td>
<td>1.6</td>
<td>1.6</td>
<td>1.5</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Real Effective Exchange Rate index (2010=100)</td>
<td>-</td>
<td>98.4</td>
<td>89.6</td>
<td>86.5</td>
<td>85.1</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Market capitalisation of listed domestic companies (% of GDP)</td>
<td>158</td>
<td>136.7</td>
<td>129.1</td>
<td>121.2</td>
<td>144.8</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>S&amp;P Global Equity Indices (% change)</td>
<td>-</td>
<td>5.8</td>
<td>-20.6</td>
<td>-6.8</td>
<td>25.3</td>
<td>-12.7</td>
<td>-</td>
</tr>
<tr>
<td>Individuals using the Internet (% of population)</td>
<td>16.8</td>
<td>59.4</td>
<td>71.1</td>
<td>78.8</td>
<td>80.1</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Mobile cellular subscriptions (per 100 people)</td>
<td>24.19</td>
<td>127.9</td>
<td>143.6</td>
<td>139.4</td>
<td>133.9</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

1.2 Key industries and global integration

At independence in 1957, Malaysia was an agriculture and resource dominated economy headlined by natural rubber and tin ore. Malaysia harnessed its natural resources during its first two decades by further expanding into palm oil, oil and gas (PETRONAS was formed in 1974 and given exclusive rights to develop Malaysia’s oil resources). Commodity price shocks prompted diversification into manufacturing via import substitution then, more successfully, attracting foreign investment and export-led growth. The share of agriculture in value added has contracted from 44 to less than 8 per cent since 1960 as first manufacturing and then services have commanded greater shares of economic activity (Figure 6).

![Figure 6: GDP share by economic activity](image)

Source: World Bank

A relative openness to trade and foreign investment has been integral to Malaysia’s development success story. Export earnings and foreign capital helped fund commodity diversification and the development of industrial production. This is best illustrated in the period following the 1985 commodity price shock, when Malaysia abandoned public-debt fuelled industrialisation and doubled down on FDI and trade liberalisation (see Figure 7). Malaysia also became a net importer of labour during this period as business needs exceeded domestic labour supply. Joining the WTO in 1995 and currency depreciation following the Asian Financial Crisis prompted an export boom in the early 2000s, generating large trade surpluses and transforming Malaysia into a net capital exporter. Both exports and imports as a share of GDP have declined over the past decade (prior to rebounding in 2017) as domestic demand commanded an increasing share of economic activity.
Malaysia’s major goods and services reflect a diverse combination of its natural resource advantages, export and FDI driven manufacturing and booming domestic financial and consumption markets. The below infographic provides a snapshot of annual production, ranging from 19.5 million tonnes of palm oil and 36.9 billion electronic transistors to almost a trillion dollars of banking assets (Figure 8).

Exports, by comparison, are more concentrated in certain manufactures and resources. Machinery and transport equipment and mineral fuels are the dominant categories, together with other manufactured goods — a pattern that has persisted over the past couple of decades as overall export volumes have expanded significantly (Figure 9). Export growth rebounded strongly after the global financial crisis before plateauing between 2012 and 2016 amid weak global growth. The past two years saw a substantial expansion in exports led by electrical and electronic products — Malaysia’s leading export sector, commanding a 38.2 per cent share in 2018 (Figure 11). Petroleum products (7.7 per cent), chemicals and chemical products (5.8 per cent), metal manufactures (4.5 per cent) and machinery (4.1 per cent) round out the top five. Imports by broad category follow a similar pattern to exports, reflecting Malaysia’s integration into regional and global value chains (Figure 10). Key differences in the top 10 imported goods include transport equipment, iron and steel products, and processed food (Figure 11). Its major trade partners are comparatively spread but regionally focused, led by China and Singapore (Figure 11).

The escalating trade war between the United States and China presents both opportunities and threats for a highly trade-exposed Malaysian economy that managed to sustain robust positive but slowing export growth in 2018. Tariffs on competing products such as soybean oil and synthetic gloves should increase the competitiveness of palm oil and rubber glove exports to Chinese and United States markets, but manufacturing sectors involved in global value chains with final assembly in China and consumption in the United States are likely to suffer from reduced downstream demand. Various analyses of the trade war highlight Malaysia’s relatively high exposure as measured by global value chain participation (6th most vulnerable with 60 per cent of exports involved; Pictet Asset management 2018), value-added embedded in Chinese exports (2nd highest at 6 per cent of GDP; Reuters 2018) and estimated impact on GDP (0.6 per cent hit in 2018; DBS 2018). It is in Malaysia’s best interests to work with likeminded countries to prevent the erection of further trade barriers and reinvigorate regional liberalisation efforts.

Source: Adapted from World Bank data
Provides...
343 billion ringgit worth of wholesale and retail trade, food, beverage and accommodation services per quarter
2.7 trillion ringgit in banking assets, of which a quarter are in Islamic banking

Manufactures...
- 36.9 billion electronic transistors
- 29.8 billion integrated circuits
- 22 billion semiconductors
- 54.2 billion pairs of rubber gloves
- 3.7 billion tin cans
- 32 million m$^3$ of concrete
- 4.4 million air-conditioners

Provides...
- 603,000 tn of rubber
- 19.5 million tn of palm oil
- 7.8 million barrels of oil per day
- 77 billion cubic feet of natural gas per day

Note: 2018 data in all cases.
Figure 9: Export growth and product composition

Source: Matrade

Figure 10: Import growth and product composition

Source: Matrade
Figure 11: Export share 2018

- Beverages and tobacco: 44%
- Miscellaneous transactions and commodities: 1%
- Crude materials, inedible: 3%
- Food: 8%
- Animal and vegetable oils and fats: 16%

Figure 11: Import share 2018

- Chemicals: 43%
- Manufactured goods: 11%
- Miscellaneous manufactured articles: 14%
- Mineral fuels, lubricants, etc.: 12%
- Machinery & transport equipment: 7%

<table>
<thead>
<tr>
<th>Of which top 10 exports…</th>
<th>and imports…</th>
</tr>
</thead>
<tbody>
<tr>
<td>Electrical &amp; Electronic products</td>
<td>38.2%</td>
</tr>
<tr>
<td>Petroleum products</td>
<td>7.7%</td>
</tr>
<tr>
<td>Chemicals &amp; Chemical products</td>
<td>5.8%</td>
</tr>
<tr>
<td>Manufactures of Metal</td>
<td>4.5%</td>
</tr>
<tr>
<td>Machinery, Equipment &amp; Parts</td>
<td>4.1%</td>
</tr>
<tr>
<td>LNG</td>
<td>4.0%</td>
</tr>
<tr>
<td>Palm oil</td>
<td>3.9%</td>
</tr>
<tr>
<td>Crude Petroleum</td>
<td>3.7%</td>
</tr>
<tr>
<td>Optical &amp; Scientific Equipment</td>
<td>3.6%</td>
</tr>
<tr>
<td>Rubber Products</td>
<td>2.6%</td>
</tr>
<tr>
<td>Other</td>
<td>22.0%</td>
</tr>
</tbody>
</table>

Top 10 export destinations and import sources

| Singapore | 13.9% | China | 19.9% |
| China | 13.9% | Singapore | 11.7% |
| United States | 9.1% | United States | 7.4% |
| Hong Kong | 7.5% | Japan | 7.2% |
| Japan | 6.9% | Chinese Taipei | 7.2% |
| Thailand | 5.7% | Thailand | 5.5% |
| India | 3.6% | Indonesia | 4.0% |
| Viet Nam | 3.4% | South Korea | 4.0% |
| South Korea | 3.4% | India | 3.0% |
| Australia | 3.3% | Germany | 3.0% |
| Other | 29.2% | Other | 25.9% |

Source: Matrade
As figure 7 shows, Malaysia has a long history of foreign investment dating back to pre-independence. While nationalisation during much of the first two decades of independent Malaysia saw a temporary reversal, foreign investment was soon encouraged again to drive manufacturing development. FDI inflows rose dramatically during the late 1980s and early 1990s, and have continued to grow at a substantial pace throughout the past decade albeit at a slowing but still significant 5-10 per cent per annum (Figure 12). 2018 saw solid growth despite political uncertainty, though the overall net investment position has become increasingly negative due to outwards investment growth. The sectoral composition has gradually shifted with the services sector experiencing the fastest growth, overtaking manufacturing as the main recipient sector (Figure 13). Of the 631 billion ringgit worth of FDI in Malaysia at the end of 2018, around 48 per cent was in services and 42 per cent in manufacturing.

Source: MysIDC (2018)
The source economies for FDI have also undergone a substantial shift in recent years, with Asian economies commanding a greater share (Figure 14). The top five Asian economy investors (Singapore, Japan, Hong Kong, China and South Korea) provided around 48 per cent of the FDI stock in 2018, up from around 33 per cent in 2008. This substantial shift in stock suggests an even more dramatic change in flows. In turn the shares from the United States and the European Union have declined in relative terms, though in nominal terms the latter’s FDI stock has more than doubled over the period.

![Figure 14: Share of FDI by source economy](image)

Source: MysIDC (2018)

Despite large foreign outflows from the Malaysian stock exchange since Election 2018, the medium-term prospects for direct investment appear upbeat with solid economic fundamentals and a new government committed to eradicating corruption and encouraging investment. Nonetheless there are risks as the new government revisits major infrastructure projects associated with mismanagement and alleged corruption under the former government and public investment contracting short-term in the constrained fiscal environment.

Careful management of government-to-government relations (with China and Singapore in particular) is essential to attracting further investment from key regional partners, especially with Malaysia increasingly embracing the Belt and Road Initiative and Chinese investment more broadly after a rocky start. Policies aimed at curbing the number of foreign workers may also have unintended and undesirable effects on investment in export-oriented sectors in which foreign investors and migrants are overly represented.

Foreign persons also make substantial contributions to the Malaysian economy, and have done so to varying degrees throughout its history. Malaysia’s ethnic diversity stems from a history of migration that has been economically and culturally beneficial, but not without controversy.

A relative openness to foreign workers, both by design and ineffective migration policies, has resulted in a labour market with a significant dependence on labour imports. Official (legal) foreign worker stocks have hovered around the 2 million mark in recent years (Figure 15), though recent estimates suggest the actual number (including illegals) could be almost three times that (Lee & Khor 2018). Foreign workers are sourced almost exclusively from less developed countries within Asia to work in labour-intensive, unskilled occupations across various sectors — from plantations and manufacturing to domestic services.
Migration policy, both skilled and unskilled immigration and skilled emigration, is among the most contentious policy issues at present but robust empirical evidence on economic impacts is scarce and not definitive.

The new government originally appeared determined to reduce the number of unskilled and illegal immigrants while encouraging permanent migration of skilled migrants (including expatriate Malaysians), but it recently flagged consideration of sourcing unskilled plantation workers from Africa. Regardless of whether it pursues cuts, its preferred approach of further empowering the business monopoly is misguided and unlikely to succeed.

Malaysia is a popular destination for international tourists, ranking 12th in the world following a period of substantial growth from 1998-2008 (Figure 16). Tourism exports earned Malaysia over 82 billion ringgit in 2017, or around 6 per cent of nominal GDP. Arrivals have stagnated in recent years as its competitiveness has trended downwards, suggesting Malaysia is struggling to reap the benefits of an increasingly large and mobile Asian middle class. A comparison with Thailand in Figure 16 is particularly illustrative. With extensive cultural links to China, India and much of Southeast Asia, there appears to be considerable potential to increase tourism returns. Recent budget measures to increase levies on travellers are counterproductive.

---

Figure 15: Foreign workers by sector

Figure 16: Foreign workers by source country

Source: Ministry of Home Affairs

---

2 Recent high-level analysis by Khazanah Research Institute (2018) argues foreign workers are not direct competitors for local workers and likely create upstream jobs.
Malaysia is aspiring to become a hub for international tertiary education, aiming to attract 250,000 international students by 2025 (under the Malaysia Education Blueprint 2015-2025 (Higher Education)). This represented a realistic target given growth up until 2016, before student numbers declined in 2017. The overall standard of higher education still requires significant development to compete with leading global destinations, which hampers potential growth. Its degree of global competitiveness is highlighted by the absence of developed countries among major source countries (Figure 17). Malaysia is more successful at attracting students from developing Asia, Middle East and Africa.

Source: UNESCO (2018)
Malaysia owes much of its prosperity to its relative openness to international trade, investment and migration. Continued efforts to further its global integration and engage with likeminded countries in promoting liberalisation will be important to Malaysia achieving developed nation status (discussed further in the policy feature on international engagement for best practice).

1.3 Overview of selected economic policy challenges

The change of government provided an unprecedented opportunity to reinvigorate and reshape the economic policy agenda. Solid growth in recent years has come despite a reluctance to undertake the significant structural reforms necessary to launch Malaysia into the upper echelons of the global economy. The new government has prioritised institutional reforms that could support a bold economic agenda, but its reform outlook remains uninspiring. Fiscal consolidation, social welfare and healthcare are among the stated priorities of the government, as these formed the key economic pillars of PH’s election platform.

These target immediate concerns and form an important first wave of reforms to restore public and investor confidence in Malaysia’s commitment to inclusive and fiscally sustainable growth. Equally important are reforms to enhance productivity and boost competitiveness to sustain growth over the medium term, requiring essential policy improvements in areas such as education, competition, innovation and labour markets. It is imperative that this second, more challenging wave is not sidelined by a populist agenda centred on putting money back into voters’ pockets without increasing their economic contribution.

Progress in PH’s first year has been despairingly slow, with little demonstrable economic reform undertaken. Confidence in the government’s economic management has plummeted from 65 to 40 per cent and is approaching Najib era dissatisfaction, with the PM’s approval rating similarly diving (Merdeka Center). While by no means attempting to be comprehensive, the following provides an overview of key reform areas (with the exceptions of fiscal and infrastructure policies, which are analysed in greater depth in subsequent policy features).

1.3.1 Education

Few areas of government policy attract more vociferous debate than education, which finds itself caught between competing objectives ranging from human capital to social and cultural development. Conjecture often surrounds features including ethnicity-oriented schools, relative attention to English and Bahasa Melayu, affirmative action policies affecting entrance into university education, and the national curriculum and recognition of competing systems.

Malaysian governments have invested considerable resources into improving education outcomes. While much success has been achieved in terms of inclusiveness, education quality standards have failed to meet expectations. Malaysia was consistently among the worst performers on the OECD’s benchmark Programme for International Student Assessment until 2012, while its most recent (2015) results were excluded from the OECD database due to concerns with possible data rigging. Poor performance is not confined to average students — employers (particularly foreign investors) complain that tertiary graduates lack the soft skills and attitude necessary to succeed in global business.

3 For a short summary: https://www.themalaysianinsight.com/s/10125
Most respected voices in the local education debate call for an acknowledgment of system failings and an honest and transparent assessment of reform options. Prominent among the concerns raised by education policy experts are that:

- the culture stymies intellectual discovery, rewards obedience and memorisation and takes a herd approach to students rather than adjusting to individual needs;
- teachers are overburdened with administrative tasks, detracting from course preparation time;
- it focuses mechanistically on employability rather than complementary hard and soft skills;
- it relies on centralised decision-making with limited local accountability or adaptation to needs and differing quality of teachers allocated across regions;
- it segregates students rather than advancing cultural exchange and appreciation of differences;
- it burdens tertiary students with loans on unrealistic and unfavourable terms; and
- university researchers face constraints in obtaining the data they need to analyse policies and are further limited from speaking their views freely.

Education reforms were not among the immediate priorities of the new government, except for the contentious issue of removing student loan debtors from a travel blacklist. This policy highlights the deficiencies of an education loan repayment system that is not linked to later income or integrated with income tax collections — a policy the PH manifesto committed to implementing and the 2019 Budget went some way to progressing. The government is also subsidising education costs for disadvantaged students, funding infrastructure upgrades, assigning better teachers and providing greater autonomy to Sabah and Sarawak schools, enhancing academic freedom and free speech for universities, and expanding the availability of vocational training programs. The new education minister has stated his main missions are to instil moral values among students, heigthen English language standards and expand technology use in the classroom.

The Mid-term Review of the Eleventh Malaysia Plan maintains human capital development among the government's core priorities, incorporating measures to address immediate skills mismatches and raise the quality of education. It also promises to review the Malaysia Education Blueprint 2013-2025 and the Malaysia Education Blueprint 2015-2025 (Higher Education) that, if continued unmodified, represent a tremendous investment of time and resources without tackling the aforementioned shortcomings. Yet substantive education reform plans remain unclear following the Budget despite reforms to improve system quality being critical to the future of Malaysia’s productive workforce and its international competitiveness across a range of sectors.

1.3.2 Living costs

The rising cost of living in Malaysia was a key battleground for the 2018 election, with key pillars of the PH platform being commitments to reverse unpopular (albeit economically prudent) policies that introduced a 6 per cent Goods and Services Tax (GST) and removed petroleum subsidies. Repealing the GST and capping petrol prices were among the first commitments implemented by the new government, demonstrating their popular appeal. Complaints about soaring living costs are endemic in the big cities and rural communities alike, leaving economists grappling with the apparent contradiction of a relatively low and declining headline inflation rate. It averaged 2.7 per cent between January 2015 and May 2018, was 1.8 per cent around the time of the election and fell to 0.8 per cent year-on-year the month after the
GST was repealed. Wage growth is also perceived as being insufficient despite it being well above inflation and productivity growth, adding to the perplexing nature of popular debate.4

Analysis by the World Bank suggests that the problem is twofold (World Bank 2018a). First, more salient consumables such as food, non-alcoholic beverages, housing, utilities and transport have experienced disproportionately high inflation in recent years. Expenditure on food commands around a 10 per cent higher share of consumption in poorer households compared to others, suggesting they have been hit particularly hard. Second, inflation has increased at a higher rate in urban areas than in rural, indicating an emerging poor urban class most acutely feeling the pinch of rising living costs.

Nonetheless, part of the story likely reflects a perceptions problem perpetuated by a history of anti-inflation political rhetoric. Some 24 years ago during his previous turn as prime minister, Mahathir waged a Zero Inflation Campaign at a time when inflation rates were marginally higher than long-term averages. Combined with inflation having been ably managed over time by BNM, consumers may have become more reactionary to temporary spikes. A crude comparison of relative growth in average wages and CPI since 2014 reveals Malaysians have fared significantly better than most comparator countries (Figure 18). While CPI has experienced more rapid growth in Malaysia than in many such comparators, concurrent wage growth has created a significant living standard premium. This does not contend with assertions that certain populations are struggling with rising living costs, merely that more targeted measures may deliver better outcomes for people, markets and revenue.

More targeted measures necessarily involve the income tax and transfer system rather than eliminating indirect taxes or introducing price distortions. The government’s promise to construct a new cost of living index may highlight but not help address concerns, with many commentators arguing more needs to be done.

4 Concerns that Malaysians are underpaid are not completely groundless, as neatly illustrated in a feature article in BNM’s latest annual report (BNM 2019b, pp35-47). However, this reflects a between-country comparison that cannot explain the spike in within-country negativity in recent years.
1.3.3 Social welfare

Like many of its regional neighbours, Malaysia maintains a long-held stigma against many forms of social welfare, or at least government provision of it. The hesitation stems from a perception that giving people handouts will discourage them from working — an attitude that continues to guide the policy direction of the new government.

Social welfare expenditure has not followed the typical pattern of rising alongside GDP per capita, and on best estimates compares unfavourably even among regional peers (OECD 2016). While precise and contemporaneous statistics for government social welfare expenditure are difficult to obtain, rough estimates based on the ‘Others’ sub-category under social operating expenditure by the Federal Government has social welfare at a maximum 3.5-4 per cent of total operating expenditure and 0.6-0.75 per cent of GDP from 2014-19 (MOF 2018). By comparison, OECD countries averaged public social welfare expenditure of around 21 per cent of GDP.

Improving social welfare involves more than just increasing the budget allocation. It means ensuring a well-managed and targeted system directs funds where they are most needed without providing the perverse incentives feared by critics. In this respect, the previous government’s cornerstone BR1M policy increased distributions to relatively poor households via a series of unconditional, one-off payments. The approach has attracted much criticism for exercising political objectives over welfare needs. BR1M had numerous features highlighting poor policy design, including imprecise targeting (households could come and go from the bottom 40 per cent and their eligibility would not change), not basing it on an assessment of need, not tying it to programmes that reduce dependence, not integrating it into the tax and transfer system and not providing support regularly enough to aid household decision-making.

The new government was quick to rebrand the programme ‘Cost of Living Aid’ and has since announced its discontinuation, with specific replacements under development. The PH manifesto envisions the implementation of a universal social safety net like those in developed countries. The Mid-term Review and 2019 Budget reference the implementation of an integrated and comprehensive social protection system, so this should be among the government’s first substantive economic reforms.

1.3.4 Competition

With the introduction of the Competition Act in 2010 and the creation of a dedicated regulator in the Malaysian Competition Commission (MyCC), Malaysia took important steps towards developing a robust competition environment for businesses. From a legal standpoint the system provides substantive powers over the sectors MyCC regulates. But these powers do not extend to several key sectors including energy, telecommunications and aviation. These are separately regulated by their own agencies. As a relatively young agency, MyCC is still building its capacity to enforce its powers and is constrained by limited resources.

While an openness to foreign investment brings efficiency enhancing competition, the dominant role of government-linked companies (GLCs) in the Malaysian economy has the opposite effect. GLCs represent around half of local stock market value (Menon 2018), and earlier international comparisons rank Malaysia alongside the likes of Saudi Arabia, Russia and China as the most SOE-concentrated economies.

---

5 Remaining social operating expenditure exclusive of education and training, health and housing.
6 MyCC had 57 staff members in 2017 (OECD 2018). By comparison Australia’s competition regulator had 772 during the 2016-17 financial year.
globally (Kowalski et al. 2013). The GLCs are controlled by a more select group of government-linked investment companies (GLICs). The most prominent GLIC being Minister of Finance Incorporated, which gives the Minister of Finance control over an enormous slab of the Malaysian economy (Gomez et al 2017).

The detrimental effects on competition and productivity are no doubt extensive (if not well studied), particularly given the number of political appointees running these corporations. The new government has promised to remove the political appointees and ensure GLICs and GLCs operate in accordance with international best practice. Yet, this does nothing to remove the distortions and crowding out of private investment that comes from their political privilege, market dominance and sector regulator positions. It also fails to recognise that the extensive connectivity between government and business creates an enabling environment for the corruption that the new government is determined to eradicate.

While the 2019 Budget speech declared that stakes in ‘non-strategic’ government businesses are to be reduced, concrete measures are yet to be seen. By contrast, Mahathir has spoken about the revival of ‘Malaysia Incorporated’ and returning GLICs to their original mission of affirmative action — a move that revives fears of a repeat of the 1980s privatisation attempts where gifting assets to hand-picked allies spectacularly failed to develop large bumiputera-run enterprises. Privatisation is an important objective, but it must be carefully managed using open, contestable processes that deliver wealth back to the people.

1.3.5 Technology, innovation and entrepreneurship

To truly achieve its goal of becoming a high-income nation, generating innovative businesses and entrepreneurial people that bring Malaysia closer to the technological frontier will play an essential role. This need has been recognised in recent years, sparking considerable efforts to expand programmes and develop infrastructure to enhance the digital economy. Foreign investment is a critical contributor, with over 320 billion ringgit in digital industry related investments attracted through the Malaysia Digital Economy Corporation (World Bank 2018a). The Digital Free Trade Zone launched in March 2017 has also attracted beneficial investment from prominent players including Chinese giant, Alibaba. Meanwhile industry-focused digital entrepreneurship training programmes, eRezeki and eUsahawan, are delivering hundreds of thousands of tech savvy graduates with the skills necessary to succeed in e-commerce. Internet adoption among households is relatively high in Malaysia (over 80 per cent) and is particularly strong in major urban centres, suggesting essential platforms are in place to grow the digital economy.

Though rapid progress is being made, several challenges remain. Burdened by a monopoly provider (GLC Telekom Malaysia), broadband prices are prohibitively high, speeds are slow and adoption is low. Infrastructure improvement has lagged comparable countries due to the lack of market-driven incentives to invest. Business internet adoption has also been slow, with e-payment availability and use well below typical levels for an upper-middle income economy. Malaysia’s poor performance on human capital indicators contributes to it ranking just 63rd on the ICT Development Index 2017 (ITU 2017). Levels of entrepreneurship are also a concern, particularly in areas such as product innovation, start-up skills and the availability of risk capital (it ranks 58th on the Global Entrepreneurship Index; GEDI 2018).

Fostering entrepreneurship through further digitisation was the productivity centrepiece of the 2019 Budget, committing additional funds to areas such as SME technology adoption and training and tackling high broadband prices. These are positive initiatives, but it is important to recognise the interrelationships between Malaysia’s policy challenges — limitations in one area of the economy create challenges in others. The development of the digital economy requires investment driven by competitive forces
coupled with educated households and firms capable of utilising them. It also requires efforts to maximise accessibility and affordability for people of all backgrounds and regions.

1.4 Policy feature: fiscal imperatives

On the back of an election platform that emphasised simultaneously reducing cost of living pressures and government debt, the government has created a perilous fiscal policy tightrope for itself. Balancing the implementation of populist policies that reduce an already narrow revenue base and raise expenditure expectations while maintaining fiscal consolidation targets will present a challenge for any government, let alone one with limited governing experience. Nonetheless new people bring new approaches, and hope that Malaysia can develop more transparent fiscal processes and a constructive narrative around debt and taxes. In the absence of such improvements, there are considerable risks to fiscal sustainability as expenditure rationalisation options become increasingly constrained.

Fiscal consolidation: continuing or commencing?

Under the previous government, Malaysia was committed to a gradual fiscal consolidation process to reduce deficits and achieve a balanced budget by 2020. Deficit reductions in the last few years were small, but large enough to see Federal Government debt peak and begin to decline. This prudent approach reflects the realities of budget management in a country concerned about the debt servicing implications of a credit rating downgrade, and hard won support from ratings agencies and international organisations alike (IMF 2018). The fiscal deficit had reached 3 per cent of GDP in 2017 and debt was down to 50.8 per cent (Figure 19); neither of which appears immediately concerning, though potentially reducing space to manoeuvre in the event of a shock. Having originally indicated that it would meet the 2.8 per cent of GDP deficit target for 2018, the new government instead delivered a 3.7 per cent of GDP deficit and committed to restoring a 3 per cent of GDP deficit by 2020. The commitment appears increasing fragile amid external pressures.

![Figure 19: Fiscal debt and deficit](image)


Soon after taking office, the new government changed the debt narrative by alleging mismanagement on the part of its predecessors. Debt was no longer consolidating but increasing excessively, with accusations that suspect accounting practices had been used to cover up a 1 trillion ringgit debt (Eng
The difference between the two figures reflects the classification of contingent liabilities and longer-term guarantees associated with public-private partnerships (PPPs). The new government has declared guaranteed debt commitments associated with government entities unable to service their debts, most notably the scandal-ridden 1MDB (see the guaranteed debt included in Figure 19). In addition, it classifies lease payments associated with PPPs as obligations structured in such a way as to circumvent Malaysia’s self-imposed debt ceiling. The exact nature of these commitments is unclear, though neither the World Bank nor IMF have expressed much concern about associated fiscal risks in the short term. Ratings agencies also appear to have declared this a reclassification, not a discovery of previously unaccounted for debt.

Beyond classification issues, the new government has committed to further belt tightening, and has been actively (and successfully) renegotiating major infrastructure projects to reduce debt levels and restore investor confidence. It appeared much more hawkish on fiscal discipline prior to revising the fiscal deficit target, with continuing deficits dampening expectations of debt reductions. This approach has both benefits and costs — the advantages of reduced debt servicing and government expenditure during a cyclical upswing weighed against the foregone investment opportunities that additional debt might enable. The trade-off will appear particularly acute if necessary infrastructure, education and technological investments are indefinitely delayed. An unexpected benefit of the debt ‘crisis’ has been the staggering level of community support for debt reduction efforts, with a dedicated crowdsourced ‘Hope Fund’ raising over 196 million ringgit to pay off debt.

Taxing times

Alongside debt reduction, abolishing the GST and reintroducing petrol subsidies (through a cap on the retail price) were the immediate priorities of the new Finance Minister. These flagship policies under the Government’s cost of living reduction agenda are a reversal of the former government’s efforts to diversify the tax base (reducing dependence on oil) and reduce leakage. Despite a relatively low rate of 6 per cent and an extensive list of exempt and zero-rated goods, the GST proved remarkably successful in raising higher than expected revenue and building a repository of taxpayer information. A victim of its own success and the increasingly unpopular government that introduced it, the GST became a symbol of rising living costs instead of improved fiscal sustainability. There is a certain irony in repealing a measure designed to deliver a more stable revenue base alongside efforts to reduce debt.

Abolishing the GST and restoring petrol subsidies goes against the recommendations of international organisations and respected experts, creating a large hole in the revenue base that risks medium-term fiscal sustainability (the GST represented almost 20 per cent of government revenue since being introduced, compared to the Sales and Service Tax (SST) which averaged around 7.5 per cent after 2010). A mere two months before the election, the IMF recommended the GST be raised (IMF 2018), with earlier reports highlighting Malaysia as having one of the lowest GST rates among its regional peers and beyond (OECD 2016). Replacing an effective GST with the narrower SST not only impacts revenue, but disproportionately affects export industries and increases avoidance risks. The significant vertical integration among supply chains creates opportunities to misrepresent costs and reduce the tax burden, with the SST levied on wholesale and not retail prices.

Raising significant revenue from consumption taxes will be politically untenable in the short term given the toxicity of the GST narrative, which highlights the importance of efforts to correct the nature of

---

7 Fuel and food subsidies were phased out from 2010, with the largest reductions during commodity price collapses in 2014-15. The 6% GST was introduced in April 2015, replacing a narrower Sales and Services Tax (SST).
As is clear from Figure 20, the narrative around tax has proved a long-term struggle. Like other resource-rich countries, Malaysia historically relied on oil-related revenue and has found it difficult to transition to a more diversified mix of income, company, consumption and other taxes. Tax revenue fell to 13.3 per cent of GDP in 2017, a level last seen in 2010 when non-tax revenue (mainly Petronas dividends; Figure 21) was last used to prop up the budget. The Budget projects a further fall to 11.5 per cent of GDP in 2019, with the shortfall only partly compensated by a dramatic hike in Petronas dividends. While not a unique problem within the region, Malaysia’s revenue base is less than 40 per cent of the OECD average and declining. The decline contradicts the expected relationship between rising income levels and an increased tax revenue share of GDP, leaving the government without the funds needed for the investment and redistribution policies typical of most developed countries. Arresting the decline and correcting the narrative around taxing and spending is perhaps the single largest economic challenge facing Malaysia.

Correcting the narrative requires a shift in the social contract between government and taxpayers. A prerequisite is building confidence that the government is acting in the best interests of the people, acting efficiently, transparently and without corruption. That revenue raised will be employed judiciously to further development and inclusiveness. Explicitly linking taxes to expenditure, such as by providing taxpayers with a graphical representation of where their taxes go, has worked well in other countries. The new Finance Minister appears acutely aware of this, stating the need for government to restore confidence among taxpayers by highlighting the positive initiatives funded by their taxes. Efforts to eradicate corruption, dramatically improve the efficiency of procurement processes and enhance transparency all bode well in this regard. There is also a great deal of optimism stemming from the appointment Lim Guan Eng as dedicated Finance Minister (the position was previously held by the former Prime Minister) who is widely regarded as a capable operator.

---

Nonetheless Eng has his work cut out trying to resuscitate the tax base. His first Budget picked easy revenue targets including property gains, sugary beverages, casinos, imports and online services while plugging the fiscal gap through extraordinary dividend raids on GLCs. With consumption taxes highly politicised, this important and underutilised area will be difficult to reform in the short-term (though intriguingly the Mid-term review highlights intentions to diversify indirect taxes). Income taxes are extraordinarily low, both in terms of rates and only capturing around 15 per cent of working age Malaysians (Figure 22). High income earners should pay more, middle income earners need to be brought into the system and low income earners could then be the beneficiaries of a targeted transfer system. Achieving such reforms will need to fight against a widespread belief that incomes are too low to levy taxes, and opponents arguing inconsistency with cost of living relief.

But it is quite conceivable that a lack of redistribution in the tax and transfer system is contributing to cost of living pressures for poorer households, fuelling the consumption that drives up prices while leaving them on inadequate incomes. This is an area for further analysis by tax system experts.
Perfecting processes

Beyond the bottom line, the government has a tremendous opportunity to strengthen the institutions and processes supporting fiscal frameworks. The Prime Minister and Finance Minister have both emphasised transparency, good governance and greater efficiency. If maximally applied to fiscal frameworks they would greatly enhance sustainability and accountability, setting an important example for all government agencies. The clarification of government liabilities set a positive tone of transparency that could usefully be extended to all government finances, minimising opportunities for corruption and enabling stakeholders (including the public) to engage meaningfully on policy prioritisation.

Transparency across governance is the number one reform priority among local policy experts and an area where easy wins can be obtained at little cost. In terms of fiscal policy, it means the release of fully costed, medium-term fiscal projections for all government expenditure — consistent with medium-term fiscal frameworks that have reportedly been operating since 2015. It means the adoption of accrual accounting practices alongside traditional cash processes to limit opportunities for shifting expenditure off the books. It means appropriately utilising windfall gains from commodity price rises, not creating off-balance sheet funds that serve no purpose other than to avoid overshooting the deficit target (as appeared to be accepted practice under the former government).

An additional measure that would boost transparency and promote democratic processes would be to create an independent agency responsible for costing election commitments and ongoing policies from any political party. Modelled on Australia’s Parliamentary Budget Office, it would enable voters to understand the financial implications of election promises for all parties; creating a level playing field come election time. It would deter parties from making excessive and unaffordable commitments that have not been subject to rigorous costing. Following GE14, it is unclear whether the Ministry of Finance costed the PH manifesto commitments in full (even following the election outcome — certainly not before) and this has affected the implementation and reprioritisation of commitments.

Public procurement processes are another area where adopting international best practice would help reduce corruption and deliver significant cost savings. Concerned with cost blowouts and unfavourable contract terms agreed under the previous government, the new government has been quick to review major infrastructure agreements, postponing projects until renegotiation could deliver substantive cost reductions. The reaction has been overwhelmingly positive domestically, with the results equal parts impressive and concerning. The scale of the savings achieved highlights fundamental flaws in procurement and project management processes that require systematic improvements beyond individual re-examination. Competitive and open public tender processes should become the norm, with additional safeguards in place for agreements negotiated between governments. Additional checks and balances are also necessary to ensure the people responsible for tender processes are prevented from abusing their positions of power.

The government has committed to both the Open Budget Initiative and the Open Contracting Partnership as measures to increase transparency in fiscal policy and government procurement. Its first Budget was strong on furthering these and other commitments to improving fiscal governance, offering much hope for beneficial reform.
Breaking up the family

It is difficult to understate the reach of Minister of Finance Incorporated (Malaysia’s largest GLIC, over which the Minister of Finance has ultimate legal authority) throughout the economy, and in turn the degree of interrelatedness between the public and private sectors. MoF Inc. owns the other six GLICs, and between them they own hundreds of GLCs (455 as of 2013) representing half of the local stock market. Dominance across several key sectors has implications for fiscal management in Malaysia, reducing both risk and efficiency.

GLCs hold an overwhelmingly strong position within the financial sector, including the two largest players, Maybank and CIMB, and other large competitors such as RHB, Bank Islam and Affin Bank. If the government needs credit, it can reduce debt default and exchange rate risks by sourcing the majority domestically. However, this creates complacency in fiscal discipline and inefficiency in the financial sector. It also distorts credit markets to the detriment of private sector business, which may ultimately affect the fiscal balance through lower growth in revenue collections.

The dominance of GLCs in the property development and construction sector would also be expected to impact the budget. Their privileged access to government tenders crowds out more efficient and technologically advanced private sector providers to the detriment of the bottom line. The pervasiveness of personnel links between GLCs, government and bureaucrats more generally creates ample opportunities for corruption at the taxpayers’ expense, though the new government is slowly attempting to tackle the political patronage problem. Whether it is willing to remove the opportunities for corruption rather than just potentially conflicted people remains to be seen.

Another concerning aspect is the role of government as ultimate guarantor of bad debts. With such extensive economy-wide links, the government’s exposure is large and likely underestimated by conventional budgetary accounting. The 1MDB and similar scandals highlight the potential costs, both financial and reputational, for the government. Less often mentioned in the commentary on 1MDB is the nature of the fund itself — another arm of the Ministry of Finance but one that could effectively print its own money. Unlike most sovereign wealth funds that receive endowments from government and invest them prudently under strict investment rules, 1MDB was allowed to raise extraordinary amounts of debt under government guarantees with limited supervision. Its investment activities and financial health were concealed from the public and involved a frightening list of alleged conspirators abusing positions of trust. The corrupt practices and bemusing investments that occurred provide a historically costly lesson highlighting fundamental flaws in the institutional model that should be eliminated across all government investments, present and future.

As a final point on the family, the government also has an unhealthy addiction to dividends from related entities, particularly Petronas. Petronas was often relied upon by the former government to stave off larger budget deficits and the new government has doubled down on this practice, allowing inefficiencies to creep into budgeting and potentially impacting Petronas’ business. BNM also pays annual dividends to the government, creating potential conflicts with its functional independence. There is little advantage, from either an economic or governance perspective, in maintaining the status quo with respect to dividends (and ownership in the case of Petronas), though it will take bold reform to disembark the gravy train.

---

9 At least prior to the election. There has been some recent shifts to the new Ministry of Economic Affairs and other agencies, but this has not been undertaken in a sufficiently transparent manner to enable an update.
The final word

The new government has prudently committed to fiscal consolidation, albeit at a slower pace than its predecessors. Fiscal targets remain achievable in the short-term as robust oil prices and major project postponements provide temporary boosts to the bottom line, but medium-term fiscal sustainability is on less secure ground. Improvements to governance and institutions offer potential gains, driving expenditure efficiency and higher investor confidence. They also provide a means of increasing public faith in the tax system, setting the platform for reforms to reinforce the revenue base. For Malaysia to become a truly developed economy, it must reshape the fiscal narrative to provide the space needed to undertake investments that enhance productivity and inclusiveness.

1.5 Policy feature: enabling infrastructure

Infrastructure is a critical economic enabler, connecting people, markets and a full range of government services. Without essential infrastructure to facilitate it, trade and investment would stagnate. Without simple and affordable means to access schools and hospitals, development and living standards would suffer. Time stuck in traffic or undertaking long daily commutes is productivity lost to the economy.

Infrastructure development has featured prominently in public debate both prior to and since the election. The former government poured billions of ringgit into the development of roads, high-speed rail (HSR), light rail, airports, ports and pipelines and had signed several landmark deals with foreign investors to increase investment exponentially. The sudden ramping up of Chinese investment following Najib’s November 2016 visit to China unsettled many Malaysians, marking an important turning point in the infrastructure debate from positive nation-building to unpatriotic, corrupt and profligate spending.

The new government expressed concerns with Chinese investment growth during the election campaign, and has been quick tosuspend and renegotiate many major projects since taking office (not just those of Chinese investors), pending an improved fiscal balance and the negotiation of better terms. It has since warmed considerably to Chinese investment, while becoming increasingly antagonistic towards the United States (discussed further in the policy feature ‘international engagement for best practice’).

The debate around where the infrastructure comes from and how much it will cost is an important one, but it should be accompanied by a considered assessment of needs and benefits. Whether some of the largest infrastructure projects in Malaysia’s modern history deliver sufficient benefits to justify the costs is a legitimate question that is rightly being reassessed following revelations of corruption in contractual dealings. As noted in the above sections on competition and fiscal imperatives, there is significant scope to make government tender processes more transparent and competitive, freeing up additional funds for investment in infrastructure or elsewhere.

This section focuses on Malaysia’s infrastructure needs, its logistics performance, urban bottlenecks and public transport effectiveness. It then considers emerging, non-traditional funding sources in Islamic financial products and Chinese investment – including Malaysia’s engagement with the Belt and Road Initiative (BRI).
Infrastructure needs and gaps

Obtaining an accurate picture of infrastructure quantity and quality is constrained by data limitations that are not unique to Malaysia, which in turn creates difficulties for projecting future needs. Nonetheless, a reasonable snapshot can be presented from available data to highlight strengths and weaknesses.

Following an initial period of public expenditure driven investment during the 1970s and 1980s, infrastructure development has increased significantly in the past two decades in three distinct phases (Figures 23 and 24). In the early to mid-1990s, infrastructure investment boomed through a wave of privatisation and private spending (including via PPPs), though many of these investments were later nationalised following the Asian Financial Crisis. Massive increases in infrastructure spending under the 8th to 10th Malaysia plans (2001-2015) were increasingly government financed, while towards the end of that period and in the past few years a new wave of private — and almost exclusively foreign — investment has emerged. If actualised, the major investment projects agreed under the previous government would take private investment in future years off the scale in Figure 24.

Key achievements from this investment include that electricity and water connectivity covers approximately 98 per cent and 95 per cent of the population respectively, with only remote areas of the country not fully serviced. The road length in 2016 (at almost 237,000km) was more than three times that in 2004, though significant gaps remain, particularly in Sabah and Sarawak. Rail networks have developed at a slower pace (with Kuala Lumpur the main beneficiary), though this would change dramatically if the Kuala Lumpur to Singapore HSR and the East Coast Rail Link projects are completed. Road, rail and physical infrastructure quality more generally are rated among the best in Asia, but perceptions have
mostly been trending downwards in recent years (WEF 2018). In a constrained fiscal environment, maintenance expenditure has not kept pace with requirements, suggesting Malaysia risks depleting the value of its existing stock. In July 2018, the Works Minister cited the cost of road maintenance at 2 billion ringgit annually (well in excess of the 600-800 million spent), with 30 per cent of federal roads in poor condition.\(^{10}\)

The Global Infrastructure Hub provides data on investment trends from 2007-15 and projections of infrastructure needs out to 2040 (Figure 25). It suggested that extrapolated trend growth would be sufficient for most infrastructure sectors, with roads, ports and ‘Sustainable Development Goals (SDG)’ expenditure (required to reach 100 per cent coverage for electricity, water and sanitation) the areas where gaps exist. Note, however, that these estimates reflect a comparison with best performing peers rather than a systematic assessment of investment gaps by sector. As an example, the absence of an investment gap in rail indicates that Malaysia’s peers have not invested in large scale rail development, not that the investment itself would be unbeneficial. A root and branch assessment of Malaysia’s projected infrastructure needs has either not been undertaken or is not available for public debate. This could usefully be rectified to support longer term planning and garner public support for needed investment. The Mid-term Review refers to an impending launch of a national transport policy that could be extended to infrastructure more broadly.

![Figure 25: Infrastructure trends and gap projections](image)

**Figure 25: Infrastructure trends and gap projections**

Sources: Global Infrastructure Hub (2018).

**Diminishing performance affects competitiveness**

One product of infrastructure adequacy for which readily available benchmarking is possible is logistics performance. The World Bank’s Logistic Performance Index rates countries against six criteria (including infrastructure) and its impact on trade logistics, in effect measuring selected non-tariff barriers to trade (World Bank 2018b). Figure 26 depicts Malaysia’s performance relative to the frontier economy in the sample years (either Germany or Singapore), with the distance from zero reflecting the degree of inefficiency (in percentage terms).

\(^{10}\) The Star [https://www.thestar.com.my/news/nation/2018/07/04/no-decision-to-review-pan-borneo-highway/]
Alongside customs processes, infrastructure stands out as an area of weakness relative to frontier economies, with the gap widening significantly in the past five years (due to both a deterioration in Malaysia’s absolute rating and an expansion of the frontier). This forms part of an overall slide in logistics competitiveness, with international shipments the only category where Malaysia is closer to frontier economies in 2018 against 2012.

There is some corroborating evidence for this in annual freight data, albeit with the disclaimer that such data reflects an aggregation of domestic and international movements. Air transport freight volume per kilometre declined by almost 10 per cent in 5 of the last 8 years, including almost 43 per cent in 2016 (when it reverted to below 1995 levels; Figure 27). Rail freight enjoyed consistent growth before declining significantly from 2015-17, while port container freight volumes have fared slightly better. While economic factors (such as trade patterns) might partly explain the direction of the shifts, the magnitudes appear to suggest some diversion of freight traffic away from Malaysia. This is an area requiring further examination under a broader infrastructure needs assessment, however the indications suggest relative infrastructure quality and maintenance levels are not well reflected in the Global Infrastructure Hub projections.

Keeping people moving

Keeping people moving quickly and safely between economic centres and residences is just as crucial as the movement of goods. Nowhere is the challenge of doing so more acutely felt than in Kuala Lumpur, a city whose economic vibrancy faces the constraints of urban infill and sprawl. With traffic congestion an ever-increasing burden, there has been significant investment in recent years to construct additional rail corridors in a bid to get commuters off the roads. Despite this, rail passenger numbers have fallen well short of growth targets, with many lines operating well below capacity (Financial Times 2018).

Meanwhile, car ownership continues to increase strongly, with almost 29 million registered motor vehicles on Malaysian roads at the end of 2017 (Figure 28). Across the country, it is clear that growth in roads and cars has outpaced other forms of transport, with other public transport options experiencing slow or negative growth in recent years.

Kuala Lumpur’s transport shortcomings are multifaceted according to recent indicators (Figure 29). It compares unfavourably with cities in the region across a range of indicators, from public transport system affordability and accessibility to availability and usage. The problem may not be in absolute terms but a relative one — if the financial costs of driving are not substantially higher and the convenience level still not prohibitively dampened by traffic congestion, then convincing commuters to switch to public transport is challenging. Effective policies must consider raising the relative cost of driving if public transport systems are to generate the desired returns.

Figure 28: Transport indicators, growth 2010-17

On balance, the new government’s policies are likely to exacerbate existing problems. Its pledge to expand the public bus fleet will be dwarfed by increased incentives to drive — including the reintroduced petrol subsidies and promised abolition of toll roads — and the postponement of rail projects. A more considered medium-long term approach that balances reduced living costs (both out of pocket and opportunity costs) and infrastructure benefits is needed to avoid further expansion of crippling bottlenecks.

Deep infrastructure financing markets headlined by Islamic finance

Compared to its regional peers, Malaysia has been relatively successful in developing deep and well-functioning financial markets to fund major infrastructure projects. Locally financed greenfield project bonds are effectively structured to manage the additional risks these investments entail, providing capital market depth beyond the brownfield (Euromoney 2017). Malaysia is yet to secure project funds from the Asian Infrastructure Investment Bank as a result of its relatively unconstrained financing.

Contributing to this success and a key component of Malaysia’s overall financing model is Islamic finance. Islamic finance is structured to be consistent with Shariah principles, including prohibitions on interest, speculative transactions (gambling), haram activities and uncertain or unfair transactions. Islamic finance represents about 61 per cent of the overall capital market and a similar proportion of both stock market capitalisation and bond issuance (Securities Commission 2019). Total sukuk (Islamic bonds) outstanding reached 880 billion ringgit by March 2019, with new issuance having experienced annual growth of 30 per cent in 2017 and 18.5 per cent in 2018.

Substantial Islamic finance growth over the past decade has contributed to infrastructure finance availability, via both lending and bond issuance. While infrastructure is not specifically categorised in sector split data, the growing volume and share of loans from Islamic banks into the electricity, water and gas (EWG), transport, storage and communication (TSC) and construction sectors provides a sense of

\[\text{Note that a large proportion of construction sector projects would not strictly be classified as infrastructure, though disaggregation is not possible using available data.}\]
its growing importance (Figure 30). Corporate bond issuance over the same period (2007-18), including *sukuk*, totalled 115 billion ringgit in EWG, 78 billion in TSC and 75 billion ringgit in construction. Figure 31 provides an overall sectoral decomposition of Islamic finance by sector, highlighting the infrastructure sectors.

**Figure 30: Islamic banking loans by sector**

<table>
<thead>
<tr>
<th>Year</th>
<th>EWG - Islamic</th>
<th>Construction - Islamic</th>
<th>TSC - Islamic</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2008</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2009</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2010</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2011</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2012</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2013</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2014</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2015</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2016</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2017</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2018</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Source: Bank Negara Monthly Statistics*

**Figure 31: Islamic financing by sector**

- Electricity, gas and water supply
- Transport, storage and communications
- Wholesale & retail trade, and hotels & restaurants
- Construction
- Finance, insurance and business activities
- Mining and quarrying
- Primary agriculture
- Education, health and others
- Manufacturing (including agro-based)
- Real estate

*Source: Bank Negara Monthly Statistics*

Malaysia is the global leader and pioneer in *sukuk* issuance, having led the way with several notable infrastructure bonds. Prominent examples include Projek Lebuhraya Usahasama Bhd (an expressway partly funded by a 30 billion ringgit *sukuk* in 2012), Malaysia Airports (an innovative perpetual airport maintenance bond worth 1 billion ringgit in 2015) and Tadau Energy’s Sustainable Investment *Sukuk* (the first green energy vehicle of its kind for solar energy investment, undertaken by a Chinese-owned company). *Sukuk* structures are well suited to long-term infrastructure financing and issuances are regularly oversubscribed, attracting both Islamic and other investors. Continuing to deepen infrastructure bond markets through Islamic instruments will play a major role in financing future projects, and offers important insights for other countries considering infrastructure funding vehicles.
The alternative infrastructure road

One final pertinent development in respect of Malaysian infrastructure has been the increasing role of Chinese investment. Malaysia has been a relatively slow mover in this respect, with Chinese investment only gaining momentum in recent years (as Figure 32 shows, it has lagged well behind Singapore, Australia, Indonesia and even Laos in the period up until end 2017). Strategic hesitancy towards China, underpinned by disputed seas and domestic ethnicity-based politics, was discarded during the latter part of Najib’s prime ministership. It became a full scale embrace with the signing of 14 agreements worth 144 billion ringgit in November 2016 (The Star 2016). Among the major projects involving Chinese investors are major property developments (the US$100 billion Forest City property development near Johor), the flagship East Coast Rail Link (estimated at up to US$20 billion but recently renegotiated to US$10.7 billion), gas and petroleum pipelines in Peninsula Malaysia and Sabah, port development in Malacca and Kuantan and digital technology parks (the Digital Free Trade zone).

The sudden scaling up of Chinese investment alarmed many Malaysians, consistent with the experience of other countries that caught the investment wave. When combined with allegations of corruption against an increasingly unpopular former government, Chinese investment became a prominent issue in General Election 14. The new government continued its firm line on the projects, terminating the pipeline deals and postponing the East Coast Rail Link prior to successful renegotiation in April 2019. The revised rail deal represented a compromise reflecting the difficult fiscal environment, contractual obligations and better terms for Malaysians. Following a period of uncertainty post-election for these projects and Chinese investment generally, China led a surge in FDI into Malaysia in the second half of 2018. A fourfold annual increase in approved investment contributed to a 48 per cent jump in economy-wide FDI. Discussion around headline projects masks a quiet doubling in the overall number, with each project investing around 500 million ringgit on average. The successfully renegotiated ECRL agreement provided an important win-win for the new government’s foreign policy approach and China’s effectiveness in managing flashpoints on the Belt and Road. Malaysia represents a key pillar in the Maritime Silk Road and, as a relatively developed country within the region, provides an important example to other countries considering their own BRI engagement. Malaysia’s BRI participation and relations with China appear

![Figure 32: Chinese outward investment stock and BRI flows](chart)

Source: CEIC database
increasingly constructive, and are likely to tighten further under the pragmatic leadership of two elder statesmen, subject to the effective management of popular concerns.

2. The Malaysian polity and culture

2.1 Political fundamentals

Malaysia’s political structure, as a constitutional monarchy and federation, is very familiar to Australians. It is divided into 13 states — 11 on Peninsula Malaysia plus Sabah and Sarawak on Borneo Island — and three federal territories, with state governments and local authorities allocated various responsibilities under the constitution. The governance architecture was predominantly inherited from the British, whose colonisation along with the preceding period of Dutch occupation in large part shaped the institutional structure of what became Malaysia on 31 August 1957.

The head of state is the King of Malaysia, who is elected every five years from among the nine sultans heading the Malay states (the Peninsula states excluding Penang and Malacca). However, governance is almost exclusively the responsibility of a federal government whose members come from a familiar two-house parliament (the Dewan Rakyat or House of Representatives, and the Dewan Negara or Senate). Elections to the Dewan Rakyat occur every five years (maximum) via direct democratic voting in 222 single-member electorates, while the 70 Dewan Negara members are appointed every three years by a mixture of the state governments (26) and the King (44).

The government executive is headed by a prime minister who appoints a cabinet from parliamentary members. While the constitution bestows many powers on the parliament, it is the executive that effectively dictates political decision-making. The government is supported by a large civil service that has benefitted politically from its sheer size as a voting bloc. It has proved largely immune to the sorts of rationalisations and cost-cutting exercises experienced in other countries and impacting other parts of the Malaysian economy in recent years.

While on paper Malaysia’s political system incorporates the core features of the Westminster system, it operates more like a highly centralised, one-party state. The core coalition of parties that negotiated independence from the British held government (with a smattering of additional coalition partners) for 61 years until May 2018. The original alliance between the United Malays National Organisation (UMNO), the Malaysian Chinese Association (MCA) and the Malaysian Indian Congress represented the major ethnic groups in Malaysia (both then and now), but representation within the alliance became increasingly skewed towards UMNO and ethnic Malays as citizens from the other groups increasingly turned to other parties for representation. Ethnicity is a heavily politicised and polarising issue, particularly so during the past decade as UMNO’s policies narrowed in favour of its core ethnic Malay constituency.

Electorate redistributions also became a tool of political patronage rather than a means of ensuring Malaysians of all persuasions were being appropriately represented. Meanwhile the capacity of state and local governments to govern according to regional interests has been heavily circumscribed under near-absolute fiscal centralisation. Centralisation of power within the Federal Government itself has also created opportunities for corruption and a general erosion of governance standards that will require considerable repair efforts under the new government. It is within this context that the following recent developments and political challenges are considered.
2.2 Recent developments and prospects

The election of 9 May 2018 provided a historic first change of government for Malaysia as an independent nation. Pakatan Harapan (Alliance of Hope; PH) formed government with a majority of 113 seats (121 including its additional governing partner), unseating the former Barisan Nasional (BN) government.\(^\text{12}\) PH comprises four alliance parties: Malaysian United Indigenous Party (BERSATU — headed by Prime Minister Mahathir), the People’s Justice Party (PKR — headed by Anwar Ibrahim), the Democratic Action Party (DAP — headed by Finance Minister Lim Guan Eng) and the National Trust Party (AMANAH — headed by Defence Minister Mohamad Sabu). BERSATU is a Malay nationalist and socially conservative party that holds 26 parliamentary seats (it won 13 at the election) including the prime minister, while the remaining parties which represent different aspects of progressive politics hold the vast majority of seats (PKR 50; DAP 42; AMANAH 11). The Sabah Heritage Party (WARISAN — with nine seats) is also represented in the cabinet though not formally a PH member, as is an NGO called the Hindu Rights Action Force.

All in all, it makes for a complex marriage of diverse interests united by a common desire to dethrone the former government. Now having assumed the hot seat, PH has been confronted with the challenges of converting an alliance of convenience into effective government.

A first change of government in 61 years brings with it a dearth of governing experience. Only the returning Mahathir and his home affairs minister (who was sacked from Najib’s cabinet) have Federal Government experience, with selected others having previously held state or local government positions. What the new cabinet lacks in experience it stands to gain from a freshness of approach, its greater diversity (of backgrounds and skills) and a more meritorious selection process. Certain parties (BERSATU and AMANAH) and Peninsula Malaysia are overrepresented in the ministry, creating some risks to the sustainability of present arrangements (exacerbated by BERSATU’s acceptance of UMNO defectors). Nonetheless the new cabinet was initially met with widespread optimism among local commentators hoping for a reversal of the divisive politics and policy stagnation under the previous regime.

Considerable debate about the government’s prospects surrounds the revived relationship between Mahathir and Anwar, whose personal history contains more explosive storylines than the average local drama series. Anwar was imprisoned on contentious charges as Mahathir’s successor-in-waiting back in 1999, and then subsequently imprisoned again in 2015 by the previous government under similarly politically-motivated charges. He then became allied with Mahathir again ahead of the recent election. Anwar was pardoned and released from prison soon after PH formed government, and the pair are supposedly working under another succession agreement which will see Anwar assume the prime ministership within two years (though speculation around timing is rife in the absence of a clear succession plan). Anwar has since been re-elected PKR party president and returned to parliament via a by-election, with his current role within government somewhat of a mystery.

Many western commentators have long memories and little sympathy for the returning PM, giving him little credit for his contribution to electoral success and coveting a swift transition to Anwar (Slater 2018). By contrast, local commentators recognise the essential role Mahathir’s personal popularity and electoral cut-through played in getting the opposition into power, and maintain guarded optimism around his policy priorities. They see the Anwar of 2019 as an unknown entity who can no more be judged for his

\(^{12}\) The government’s representation has swelled since, particularly through defections from BN to BERSATU. It held 128 seats (138 including additional governing partners) at the time of writing.
past deeds than the Mahathir who has been quick to dismantle some of the misguided governance changes he introduced when last in office. Debate is polarised around the prospects for their respective leaderships, as uncertain as each scenario remains.

There appears to have been less consideration given to the delicate but beneficial counterbalance that these leaders and their parties represent. Mahathir and his allies provide a voice for ethnic Malays and moderate Islam that is essential to maintaining support among Malaysia’s largest demographic, while Mahathir also resonates as a respected and revered elder statesmen with the political credentials to drive bold reforms (though his personal support is not limitless and is waning with reform inactivity). Anwar and the parties that have battled in opposition for many years provide impetus for a more audacious political and cultural vision for Malaysia. Anwar himself brings a combination of economic strengths and religious conservatism that excites and worries interlocutors in equal doses. The Government’s prospects rest on how effectively the contrasting visions of eclectic allies translate into constructive policies that improve governance and boost the economy to the betterment of all Malaysians.

The early signs constitute the mixed bag expected of a new government under a complex coalition. The prioritisation of reforms to restore confidence in institutions and improve governance standards, driven by a mantra of anti-corruption and responsibility to serve the people, has been well received as a necessary and sensible approach. The consultative approach to policy priorities undertaken by the Council of Eminent Persons provided a dispassionate and considered process (albeit a secretive one, with the final report remaining unpublished) for gathering expert opinions while buying some breathing space for new ministers to learn their portfolios. It would have been tempting for the new government to launch a series of half-baked policies, and while there has been the occasional policy decision seemingly made without a full assessment of associated impacts, for the most part the government kept its powder dry and ministers are singing from the same song sheet.

Yet, as PH’s anticipated reform vision remains scarcely implemented after more than a year in office, people have become restless and doubts are flourishing. The transition from opposition to government requires a philosophical readjustment that has proved difficult for the new ministry, with many new ministers struggling to shed the negative, combative mindset of opposition politics and get on with instituting positive policy change. Policy wins - such as the unanimously supported lowering of the voting age to 18 - have been rare. The government faces challenges in navigating a hostile Senate and quelling rising Malay rights activism, together with a need for fiscal constraint that has limited implementation of PH manifesto policies that would be warmly welcomed by the people.

It is in this context that the subsequent sections discuss some central political and cultural challenges faced by the PH government.

2.3 Political challenges

2.3.1 Governance

There has been no shortage of hyperbole since (and before) the election on the governance challenges facing Malaysia, with the government itself leading the chorus against its predecessor’s legacy. Corruption scandals and budgetary impropriety have dominated headlines in the past couple of years, and decades of one-party rule have eroded confidence that those governing are acting in the interests of the rakyat and not themselves. But getting caught up in the rhetoric enables a potentially excessive approach to ‘cleansing’ that puts the ability of a new government to deliver the policies and essential services it
promised at risk. A more measured approach is needed to assess the effectiveness and scrupulousness of institutions and officials (government ministers and public servants) and facilitate targeted improvements.

Malaysia’s performance has been varied across the World Bank’s Governance Indicators, with voice and accountability and political stability areas of relative weakness (it ranks at or below the median country for these sub-indicators), and government effectiveness and regulatory quality comparative strengths (Figure 33). In the 21 years for which data is available there has been deterioration across most categories and each of the past three prime ministerships. Developments in the final stages of the Najib era suggest further deterioration in certain categories, including control of corruption (with the 1MDB and other corruption allegations deepening), rule of law (Sedition Act strengthening and heightened enforcement) and voice and accountability (gerrymandering attempts to manipulate the election outcome). The poor score for the political stability indicator perhaps betrays an area in which recent developments shine a positive light — the peaceful transfer of power post-election is a positive sign of political maturity.

Weakness in voice and accountability goes to the heart of citizen participation in democracy, free speech, freedom of association and a free media. The former government resorted to increasingly extreme measures to maintain power in the weeks before calling the election, including gerrymandering and the passing of ‘fake news’ laws to silence and detain dissenters. It added to a long history of election manipulation and persecution of opponents that has undermined Malaysia’s democratic institutions and stifled the learned debate vital to accountable governance.

The largest media outlets in the country are controlled by a mix of GLICs and political parties (MCA and UMNO), which necessarily influences the reporting of public debate (The Edge 2017). Direct government influence also extends to major public universities whose vice chancellors and faculty deans have long been appointed by the Education Minister, resulting in flow-through effects on academic freedom. While many of these structural features remain following the change of government, there has been a noticeable increase in tolerance of dissenting views and media outlets have shown a surprising degree of support for the new government despite their conflicted ownership. Whether this reflects a
permanent improvement to the public sphere or a temporary accommodation during the new
government’s honeymoon period remains to be seen, but it provides a compelling example of the
potential benefits that reforms could bring.

Rule of law is another area that experienced substantial diminution in recent years but stands to gain
under the new government. PH has promised to restore rule of law by repealing the authoritarian laws
imposed in recent years (including those relating to security, terrorism, communications and the penal
code) and end their selective use for political ends. The government was also quick to improve the
independence of key judicial and watchdog entities (among them the Malaysian Anti-Corruption
Commission, Election Commission, Human Rights Commission of Malaysia and the National Audit
Department) and dismantle the behemoth Prime Minister’s Department in an important display of its
commitment to improved governance. It had also planned to correct a longstanding and widely criticised
failure to sign a range of United Nations human rights conventions but backed down under public
protest. Key judicial appointments have been welcomed for bringing ethnic and regional diversity to the
posts, with both the Attorney-General and Chief Justice deviating from the conservative tradition of
ethnic Malays from Peninsula Malaysia. Such improvements to the legal framework and key personnel
together with the return of Kepimpinan Melalui Teladan (Leadership by Example) are positive signs of a new
era in which the political elite are no longer considered above the law.

Government effectiveness is a much trickier area, one in which the capability of elected officials
and public servants together form key components. Effectiveness rose dramatically in the latter part of
Mahathir’s first term as prime minister but has steadily declined since according to the World Bank
indicators, while remaining Malaysia’s best performing governance feature. In recent years there has been
considerable debate surrounding the size, capability and politicisation of the civil service. With respect to
size, Malaysia’s 1.6 million civil servants represent a much larger footprint than in most comparable
countries, though direct comparisons are muddied by the inclusion of the armed forces, police, public
teachers and health workers in the overall figure. The actual figure net of these groups is not separately
disclosed but has been suggested as being in the region of 500,000. If true, this would place Malaysia
within the range of comparable countries on a percentage of population basis. Considerable duplication
of function within the bureaucracy and the absence of any recent systematic rationalisation exercise
suggests opportunities exist to reduce numbers, and this has already begun under the new government
with the retrenchment of 70,000 positions that were deemed political in nature. Expenditure on
emoluments and civil servant retirement charges represents almost half of total government operating
expenditure (by comparison these costs represent around 4.5 per cent of Australian Government
expenditure). This makes it a fiscally significant but political charged area should consolidation be
pursued.

Public service capability is much harder to assess objectively, though few countries have engaged in more
comprehensive attempts than Malaysia in the past decade. It enthusiastically caught the Key Performance
Indicator (KPI) wave starting in 2005, with the flagship Government Transformation Programme (GTP;
2009) instilling KPIs as essential metrics for ministers, ministries and senior officials. The effectiveness of
the GTP in improving service delivery appears impressive on paper, with performance targets in the
National Key Result Areas (crime, corruption, education, poverty, rural development, urban public
transport, and cost of living) met with few exceptions. The creation of delivery unit PEMANDU to
specifically monitor and report on performance targets has been lauded as an example of effective
government transformation. There have doubtless been pockets of improvement resulting from an
efficiency-oriented culture, however the reliability of GTP results has been called into question. Among
the concerns levied are the easy attainability of the targets, their focus on inputs not outcomes,
manipulation of data by responsible ministries (few targets are based on external or international
indicators, and a police whistle-blower once alleged that crime statistics were systematically manipulated to meet KPIs) and the selective reporting — or burying — of missed targets (Siddiquee 2014). Perhaps most important are results that starkly contrast public perceptions and experiences, particularly regarding crime and corruption.

Beyond metrics, anecdotal evidence abounds about poor service delivery and the diminution of civil service standards. The former government (albeit continuing a process initially started under Mahathir’s first term) preferred centralisation and additional layering when trying to tackle problems, creating duplication and confused responsibilities. Centralisation favoured generalists over policy experts and encouraged rent-seeking among senior officials who were rewarded for political loyalty, eroding the independence of the civil service and creating an environment susceptible to corruption (Cheong 2017). The politicisation of the civil service has not only diverted some officials from their core focus of serving the people, but instituted a top-down culture that has reduced policy innovation and formulation from topic area experts. The bureaucracy’s ranks are not lacking in intelligent and capable officers who are highly educated and experienced, but effective utilisation of their talents is questionable. The new government’s purge of politicised and corrupt senior officials and reinstatement of former officers victimised for speaking out against corruption under the former government sent a message that integrity is highly valued. Instilling an ethical culture and reinvigorating the policymaking credentials of the broader service will be much more challenging, requiring deep and determined reforms. Wide-ranging reforms along tried and tested lines we’re foreshadowed in the Mid-term Review, with the Public Service Department charged with leading improvement efforts. Whether the flagged measures and the Public Service Department are capable of delivering system-wide changes remains to be seen.

Governance reforms are rightly central to the new government’s policy priorities and there is considerable optimism that the Prime Minister has the political capital and patience to deliver improvements and restore confidence. Recent reports suggest the relationship between civil servants and ministers is improving with time and trust. There are no quick fixes when it comes to governance culture, so the government should be afforded time to determine its approach and institute reforms that will garner widespread acceptance within the civil service and beyond.

2.3.2 Corruption

The reputation of Malaysian governance has been dealt a significant blow in recent years by allegations of corruption involving government investment funds and former Prime Minister Najib. The most prominent such scandal involving 1MDB was first broken by the Wall Street Journal in July 2015, which alleged that Najib’s personal bank accounts received US$700 million in siphoned payments. Despite mounting international pressure via United States, Switzerland and Singapore led probes of alleged misappropriation totalling US$10 billion, the former government effectively suppressed investigation efforts and brushed off accusations, persecuting those within the bureaucracy who dared to claim wrongdoing. Prior to PH’s widely unanticipated election victory, there was no expectation of an independent investigation or legal action being taken against alleged perpetrators. There was a real sense that Najib and his associates were above the law and corruption was no longer being tackled but enabled by his administration.

Najib’s electoral defeat sent a strong message that voters were less forgiving of a government perceived to be stealing from taxpayers amid rising cost of living pressures. The true extent of alleged corruption and elite excess has begun to come to light in the months since Najib lost the power to protect himself, most sensationally in the 27 June 2018 raids of premises linked to Najib that seized cash and luxury goods
worth 1.1 billion ringgit. Criminal proceedings against Najib have since commenced, with legal processes expected to drag on for months.

In the wake of this ongoing saga, the new government has the unenviable task of tackling corruption and restoring faith in public institutions. It has expressed a firm zero tolerance message publicly and within government circles, staking its reputation on its success in stamping out corrupt behaviour. Beyond the high profile activities that have dominated headlines, an important question is just how big a task the new government faces. That is, how widespread is corruption within the public sector and broader economy.

Corruption is notoriously difficult to measure directly, with the people and entities being monitored often themselves responsible for the data on which assessment depends. The corrupt are obviously unlikely to declare themselves, so corruption assessment relies on a combination of third-party surveys, backward looking accounts of revealed corruption and an assessment of the institutional and cultural environment as a potential enabler. In addition to the World Bank control of corruption indicator presented above, the most commonly cited measure is Transparency International’s Corruption Perceptions Index. Perceptions have worsened marginally since the index was first published in 1995, including a pronounced dip since 2014 (Figure 34). Malaysia’s score has not improved despite efforts under the GTP and perennial poor performers like Indonesia are converging fast. Its ranking of 61st sees it well below acceptable levels for a country of its development level, placing it equal with Cuba and below a host of developing African and Eastern European countries.

Reports of corruption in business are also on the rise according to the latest PwC Global Economic Crime and Fraud Survey Report (PwC 2018). Some 41 per cent of businesses reported suffering economic crime during the past two years, up from 28 per cent in 2016 and 24 per cent in 2014. Misconduct, asset misappropriation and bribery are the most common offences, with opportunity believed to be the main motivator and senior management the largest offenders. It is not surprising then that financial and political corruption topped the list of concerns for Malaysians in May 2018, though confidence that the country is heading in the right direction surged post-election and remains elevated (IPSOS 2019).

Transparency International estimates the cost of corruption to the Malaysian economy at about 4 per cent of GDP per year since 2013, amounting to over 212 billion ringgit in total (Saied 2018). It specifically
mentions inflating the cost of government-negotiated contracts as an area of concern, though even at its original inflated 55 billion ringgit price tag, the East Coast Rail Link could have been afforded four times over with the proceeds of corruption. Indeed, all the talk about stamping out corruption through leading by example might encourage some degree of voluntary compliance, and netting big fish like Najib with harsh penalties might provide some deterrent but does little to reduce the pervasive opportunities for corruption available under a government-dominated economy. New restrictions on political funding and the acceptance of gifts provide more concrete improvements, while the creation of the Governance, Integrity and Anti-Corruption Centre to implement initial efforts and formulate a National Anti-Corruption plan offer hope. So too does the transformation of the Malaysian Anti-Corruption Commission into a fully independent body with enhanced powers. But ultimately, the most effective means of reducing corruption is taking away the opportunities that come from direct government (and GLC) intervention in and dominance of markets, excessively powerful bureaucrats, and broader barriers to effective competition. It remains to be seen whether such measures will be incorporated into anti-corruption efforts.

2.3.3 Ethnicity and culture

It is impossible to talk about politics (or economics) in Malaysia without considering ethnicity and culture. Malaysia is a young, multiracial nation whose history and identity are inherently linked to politics — an inseparability that has wide-ranging implications for people and development. In reopening parliament after the last election, the King’s speech pleaded for an end to bickering on racially sensitive issues and to ‘negative elements’ threatening peace and stability. Mahathir wants the youth to think of themselves as ‘pure Malaysians’ regardless of race or religion, offering hope that the leadership change will produce a more inclusive narrative.

The promotion of unity and harmony among the races has long been a fraught policy area, with a heavily divided multiracial society inherited from its colonial past. British rule relegated the Malays to the bottom of the social hierarchy and propagated negative stereotypes that, to some extent, persist more than 60 years later (including in the wording of the government’s Mid-term Review report). The British imported Chinese and Indian migrants en masse to provide the hardworking labour deemed unavailable among the local population, while ruling with a clear delineation of ethnic classes. Feudalistic governance was similarly inherited on independence, with the UMNO-led alliance expecting loyalty from the people as their new ruler and protector. As Malay Studies scholar Azhar Ibrahim notes: “Such cultural authoritarianism and expectations of conformity and reverence means curbing the growth of positive individualism, a sense of freedom, and respect for a democratic ethos, or the clamour for justice. These are among the important elements that are necessary for any development process to take place.” (Ibrahim 2017, p105).

The continued success of former migrant (particularly Chinese) entrepreneurship in the decade following independence culminated in the race riots of 1969 and the beginning of policies to advance the lot of the Bumiputera. Indeed, the Bumiputera classification itself is a complicated amalgamation of Malays, Muslims and other indigenous peoples that, like Malaysia itself, is more of a construction than a natural grouping (King 2017). There have been numerous attempts in the decades since to influence identity development among the Malays, usually in pursuit of political ends. The most prominent and lasting of which is Mahathir’s ‘New Malay’ conception which argued Malays needed to be more hard-working, confident, and embracing of knowledge and new technologies — the undercurrent of which being that Malays were somehow deficient in all of these. The perpetuated stereotype of the politicised ‘New Malay’ contrasts the more optimistic conception by scholars — modern Malays who are progressive and
adaptable without compromising traditional (pre-colonisation) cultural and religious values (Ibrahim 2017).

Affirmative action policies began under the New Economic Policy in 1971, with state-led development targeting a redistribution of wealth away from foreign and non-Malays to the Bumiputera. The goal was to increase the Bumiputera share of wealth from around 2.4 per cent in 1970 to 30 per cent by 1990 (noting their population share was around 53 per cent in 1970; most recent estimates have this having increased to over 69 per cent compared to around 23 per cent Chinese and 7 per cent Indian) through a suite of policies granting preferential treatment. Civil service leadership was made exclusively Malay (with the overall civil service workforce becoming highly skewed over time), quotas ensured privileged access to higher education, discounts on property gave a leg up in the housing market, companies were nationalised and later run by Mahathir-selected Malays, government investment funds were created specifically as pro-Bumiputera vehicles and government procurement was directed to Bumiputera companies (albeit many were simply on-sold to Chinese companies). Despite largely meeting their targets (at least in terms of poverty reduction; entrepreneurship targets ended in spectacular failure with forced re-nationalisation during financial crises), affirmative action policies continue in various manifestations to this day with perverse effects on Malaysian society and economy.

Affirmative action by nature makes ethnic division salient both in society and politics. Efforts to foster a unified national identity are undercut by differential treatment and political framing of issues with racial overtones. While affirmative action policies may have been appropriate and necessary 50 years ago to correct the colonial legacy and promote equality, they have overstayed their welcome and only serve to perpetuate political divides at odds with community trends. In fact, despite the unconducive political environment, people of different ethnicities interact amiably and with a heightened appreciation for cultural differences than exists in countries with stricter assimilation policies. Social cohesion has been achieved through mutual understanding, surface interactions and non-interference, but few Malaysians report close friendships outside of their own ethnic group (Aun 2017). The trade-off from affirmative action policies and allowing freedom for all cultures to flourish through non-interference appears to be segregation that while not unstable, perpetuates ethnic division.

Opinion remains divided along ethnic lines regarding the necessity of continued affirmative action, but not to the degree one might expect. Malaysians of Chinese and Indian ethnicity are expectedly against policies that disadvantage them, however the benefiting Malays are split down the middle in supporting or opposing their continuation (Aun 2017). Support for affirmative action is waning in the urban centres where interactions among groups are more common, with personal experiences of policy discrimination against former schoolmates or neighbours creating more inclusive attitudes among Malays — particularly the higher educated. Nonetheless pro-Malay policies remain popularly entrenched among rural voters, with ethnicity again being incited as a rallying point by UMNO (aligning with PAS) in opposition.

Income inequality by ethnicity has been trending downwards for several decades and while convergence has not quite been achieved, remaining differences are far from destabilising (Khazanah Research Institute 2016a). Inequality by ethnicity is relatively low compared with countries like the United States, where ‘Asian’ households earn almost 25 per cent more than ‘White’ Americans and more than double African-Americans (United States Census Bureau). Residual differences may be affected by the higher upward mobility rates among Malaysian-Chinese households, who continue to thrive despite (or in fact because of) the additional competition for tertiary education resulting from unfavourable quotas (Khazanah Research Institute 2016b). Nonetheless the overwhelming opinion of inequality experts is that the inequality within groups and between urban and rural areas is far more pressing than between races. The Council of Economic Persons seemingly agreed, with its concluding press release referring to a
Bumiputera Agenda that does not contradict inclusivity and wellbeing of all Malaysians. Unfortunately for supporters of a more inclusive agenda, the Mid-term Review and elements of the 2019 Budget affirm the government’s commitment to its continuation and extension.

Should the new government pursue a more inclusive approach to ethnic politics, it would be the second attempt in the past decade. Najib’s prime ministership began with an emphasis on social transformation, with the New Economic Model promising to phase out preferential treatment. However, the 2013 election result prompted an abrupt about-face as BN instead sought to reinforce its popularity among a narrowing, Malay-centric supporter base. PH arguably has the opposite problem in pursuing a reorientation of affirmative action. It commands almost exclusive ownership of the ethnic Chinese vote, a sizeable majority of the ethnic Indian vote, but a minority of support among the Malays. Its supporters will expect progress towards a more equal multiracial society (reinforced by the backing of international commentators), but it must tread carefully to engender support among Malays courted by increasingly divisive opposition forces. Beyond affirmative action policies, the withdrawal of race relations from the political sphere would be a lofty goal but one that neither side of politics seems likely to pursue.

The new government has a tremendous opportunity and daunting task to reshape identity politics and forge a truly inclusive and singular nation. Building a narrative around shared ideals and appreciation of differences will be challenging, but not a great leap from the current situation and achievable without significant disruption to peoples’ lives. Ensuring today’s youth grow up thinking of themselves as Malaysians with equal opportunities to participate in future governance, society and economy — reversing an exodus of talent compelled to seek opportunities abroad. In many respects, Malaysia’s democracy and development prospects depend on it.

2.3.4 Decentralisation

In contrast to the vast majority of countries that have experienced decentralisation since the 1980s, Malaysia has experienced a gradual centralisation process from an already top-heavy starting point. With no change of Federal Government in its first 61 years and sub-national dominance for a large chunk of that period, consolidation and concentration at the federal level served political and personal ends for ruling party members. The erosion of the ruling party’s hold on sub-national governments in the past decade prompted further efforts to diminish the power of ‘rogue’ regions. Indeed Malaysia presents a conundrum regionally as being among the most formally decentralised (in terms of legal statues largely inherited from colonial times) but the most centralised in practice (Otswald 2017).

The Federal Constitution of Malaysia (1957) provides the basis for the various tiers of government and their responsibilities, with the initial delineation a product of the times. The need for rapid economic development, the threat of the Malayan Emergency, ethnic divisions and the geographical fluidity of the fledgling nation all contributed to the concentration of power in the centre. States have been left with just localised functions relating to land, agriculture, forestry and local government services and have minimal avenues to raise funds. The decades since have seen a variety of measures further strengthen federal government power, including the use of party appointments to ensure loyalty, the dilution of state representation in the Dewan Negara, privatisation then later nationalisation of state assets, the creation of federal territories, the appropriation of functions (such as waste management), the formation of federal supervisory bodies and the expanding empire of the Prime Minister’s Department (Otswald 2017; Hutchinson 2015). Centralisation became even more thinly-veiled and cynical towards states that became

---

13 By comparison, the Australian Constitution was led by powerful states who retained significant responsibilities and fiscal autonomy (not all of it lasted however).
opposition party led, with first Kelantan and Sabah in the 1990s and wealthier states including Selangor and Penang from 2008 being cut off from fiscal allocations and having development expenditure cancelled.

The present state of affairs sees the Federal Government command over 88 per cent of both revenue and expenditure, with the 13 states and 154 local authorities left to split the remainder (with a ratio of between 2-3:1; Ministry of Finance 2018). While international comparisons are difficult in the absence of necessary data, other federations like Australia and the United States are closer to a 50:50 expenditure split. While the democratic election of state governments allows some localisation of governance choice, local government officials have been appointed by their seniors since local elections were abandoned in 1965. Such overwhelming control highlights the dependency of local areas on the central authorities, with significant regional disparities resulting from neglect or deliberate, politically-motivated distortions.

Decentralisation is not a panacea for improved governance, but it offers several potential benefits that are urgently needed in the Malaysian context. It delegates authority to a wider range of government and civil society actors, lessening opportunities for abuse of power. Local citizens and their representatives are empowered to influence decisions that more directly affect their lives and respond to localised needs and preferences more dynamically and consultatively. Accountability benefits from greater citizen engagement and economic efficiency is driven by more accurate matching of expenditure with needs.

One of the PH manifesto’s core promises is to return oil royalties to producing states and restore historical governance autonomy to Sabah and Sarawak, though delivery of such reforms is encountering serious fiscal and political obstacles. The government has begun to decentralise by dismantling the Prime Minister’s Department and restoring power to specific ministries. It has also promised to reallocate development expenditure and award federal grants on a more equitable and less politicised basis.

Systematic and comprehensive decentralisation (political, fiscal, administrative and market-oriented) that empowers citizens and improves efficiency and governance will require bolder reforms. Whether the prime minister who initiated many of the biggest centralisation policies in Malaysia’s short history can orchestrate an equally substantive reversal remains to be seen, with policy announcements thus far reinforcing paternalistic control of local government above genuine decentralisation and empowerment.

### 2.4 Policy Feature: Reinvigorated Democracy as a Reform Catalyst

Having experienced its first democratically elected power transition since independence in 1957, there was considerable optimism that Malaysia has entered a promising new era of institutional, economic and societal reform. The peaceful transition from and dramatic downfall of a corrupt regime, the return of the outspoken (older and perhaps wiser) patriotic former PM and the redemption of a long-time reform advocate all contributed to an upbeat atmosphere among citizens and democracy advocates alike. Changes can certainly be expected under any new regime, but is a revolution or far less dramatic rearrangement on the cards? Can an unexpected injection of democracy precipitate wholesale reforms?

There is no simple answer to these questions, but history suggests there are certainly no guarantees when it comes to leadership change. The transition from agitating opposition with an idealistic vision to an effective government is especially challenging — there is nowhere to hide once the honeymoon period ends and the previous regime’s legacy continues to linger. Blaming the predecessors will only
wash for so long before the people start to doubt whether the new government can do any better, with clear signs of progress towards fulfilling promises a necessity.

Malaysia is fortunate in many respects, with several characteristics of the transition, new government and environment providing cause for optimism. These include:

- **the orderly and peaceful transition** — there was surprisingly little instability for an unprecedented transition of power, with only isolated protests and no need for military force. Destruction of assets was avoided, and institutions preserved for the new government to reshape as it sees fit;

- **fair and democratic election** — the government won a free election with a sizeable majority, despite the gerrymandering efforts of the previous government to undermine its chances. The people chose this government over the alternatives, providing it with a clear mandate to govern. The former government was also free to take its place in opposition to hold the new government to account;

- **a clear and comprehensive agenda** — when government changes are either disorderly (via a coup or military intervention) or expected of a deeply unpopular government, the new government has little incentive to declare its own policy platform in advance. In this case however, a clear and comprehensive policy manifesto articulated the then opposition’s vision should it assume office, giving the new government confidence its policies are understood by the electorate and not cobbled together on the fly. If anything, the manifesto was so comprehensive that it created promises that haven’t be kept and reduced flexibility on policy development;

- **the promise of governance reform to improve democracy** — not only does the new government have a clear agenda but a key component is a promise to improve governance. Many new governments are reluctant to tamper with the political environment that got them into power and simply adopt the poor institutions of the previous regime. Yet with governance changes central to the first year of the new government, this is clearly not the case for Malaysia;

- **coalition and counterbalancing** — the risk of policy missteps is reduced by the government comprising several coalition parties, bringing a degree of consensus decision-making. There is certainly a risk and mounting evidence that government will be weighed down by such an arrangement, so effective procedures for resolving disputes will be critical to ongoing success;

- **Mahathir’s personal popularity and governance experience** — a transition of power 60 years in the making understandably introduces a new government lacking in governance experience and earned credibility. It is both unusual and beneficial therefore that this one is headed by an experienced operator who remains popular among demographics that other coalition members struggle to resonate with. He brought a calmness and discipline to the new government while it learned the ropes and a respected elder figure to help sell difficult reforms. He is seemingly unconcerned about retaining his job long-term, which means he can prioritise reforms over his own political livelihood. Nonetheless there are increasing signs that his popularity is waning and an orderly transition needs to be set into motion;

- **a diverse and representative team** — the government has obtained office on a platform of inclusive politics with a team that is more representative of the Malaysian population than the previous administration. A more representative government has the potential to garner broad-based support, even if its existing voter base is demographically and regionally skewed. The team is also better credentialed and more meritoriously determined than was previously the case, and will bring new ideas and fresh approaches to old policy problems;

- **the economic environment is relatively strong** — it is a rarity for a government to be removed from office when the economy is performing above trend, but that is exactly what happened. The new government inherited an economy with robust growth, declining inflation and low unemployment; providing the perfect platform to first focus on governance reforms. The fiscal situation does not
provide a great deal of expenditure flexibility to deliver on promises but it does provide a clear rationale to abolish former government policies.

The additional hope behind reinvigorated democracy is that ordinary citizens feel empowered to hold the new government to account. A clear demonstration that participation can affect change could encourage greater involvement by the people and a more inclusive governance orientation. But it risks creating further disillusionment if promised changes are not delivered.

Improvements to governance practices and institutions already underway offer a sample of the potential improvements possible should reforms be progressed. Reducing corruption and cronyism and instilling efficient government procurement processes will not only restore confidence in government, it will provide additional resources for more productive pursuits. Depoliticising and returning civil servants to their core missions of delivering evidence-based policy advice and effective programmes and services also offers significant benefits. The early governance returns were positive, but the slowing pace and ambition of reform efforts is concerning with many important reform areas yet to see improvements.

While not predetermined, there is a considerable body of recent evidence linking enhanced democracy and improved governance with higher growth and faster development (e.g. Acemoglu et al 2014; Han et al 2014). Evidence is scant in the Malaysian context, but even across the 20-year period for which the World Bank Governance Indicators have been produced Malaysia’s aggregated ratings display a moderate positive correlation (0.56) with GNI per capita growth. Whether an improved outlook for democracy and governance in Malaysia can precipitate the sorts of economic and societal reforms discussed earlier in this report remains to be seen, but the conditions are favourable and the new government deserves every opportunity to demonstrate its capability to deliver on its mission.

2.5 Policy feature: international engagement for best practice

Malaysia’s economic prosperity and societal dynamism are in large part a product of its high level of integration into the global economy. It has played an active role in regional community building over many decades, taking a pragmatic approach to foreign policy through positive engagement in multilateral forums and constructive bilateral relations. Underpinned by ideals of peace, prosperity, nationalism and non-interference, Malaysia exerts influence through consensus-building and balancing its interests with major powers.

The return of PM Mahathir to his familiar role as Malaysia’s leading global statesman was not expected to cause a major foreign policy reorientation, but short-term frictions were expected as the outspoken leader brought back his signature brand of uncompromising rhetoric. A strong sense of nationalism is central to his approach, with budget repair and policy nostalgia major drivers of his early bilateral dealings. Regionalism is high on the agenda, consistent with Mahathir’s previous prioritisation of local-led groupings over United States and Euro-centric forums. Meanwhile his approach to China has captured most attention, softening significantly from his outspoken approach in opposition.

International engagement also offers an important avenue for benchmarking Malaysia’s experiences against comparable others, objectively highlighting areas of relative strength and weakness. Referencing international best practice can provide the impetus necessary for difficult domestic reforms and provide
credibility to globally-oriented policies adapted to specific country circumstances. Good governance, competitive markets and effective taxation provide salient examples.

This section explores Malaysia’s international engagement approach and expectations of the PH government.

2.5.1 Foreign policy stance

Historical underpinnings

Since successfully negotiating independence from the British in 1957, Malaysia’s foreign policy has had two distinct phases. Instability within the region during its first decade of independence necessitated a retention of Commonwealth defence ties to combat the Malayan Emergency and Indonesian Confrontation. Policy was consequently guided by Commonwealth alignment with anti-communist orientation, including the formation of Malaysia proper in 1963 with the additions of Sabah, Sarawak and briefly Singapore.

The withdrawal of British troops following the Suez Crisis in 1967 followed by the race riots of 1969 prompted a major shift in foreign policy. Malaysia would not abandon British ties altogether (it signed the Five Powers Defence Arrangements with Britain, Australia, New Zealand and Singapore in 1971 to continue cooperation) but its diminishing role necessitated a more active and self-sufficient approach to regional relations. Earlier efforts to promote regional collaboration provided the platform for the advancement of the Association of Southeast Asian Nations (ASEAN), established in 1967 after Indonesia eventually recognised Malaysia’s sovereignty. ASEAN would become the central pillar of a Malaysian foreign policy promoting peace and neutrality within the region — a forum designed to build consensus and foster mutually-beneficial development without interfering in domestic affairs.

The ASEAN-centred neutrality approach paralleled Malaysia’s rejection of the US-led South East Asia Treaty Organization — an initiative centred on fighting the spread of communism. Malaysia instead led efforts to maintain equidistance between major powers and avoid being drawn into Cold War hostilities, including the declaration of ASEAN as a Zone of Peace, Freedom and Neutrality in 1971 (Milner 2014). Separately, it joined the Non-Aligned Movement and was consequently the first among the original five ASEAN nations to restore diplomatic relations with China and recognise the communist governments of Indochina following the Vietnam War. This ultimately paved the way for the expansion of ASEAN membership to 10.

Mahathir’s first prime ministership saw the neutrality concept reinforced with strong nationalistic sentiment and the advancement of an East Asian identity. His ‘Look East’ policy sought to enhance relations between ASEAN, Japan, China and South Korea to the exclusion of interfering western nations, towards whom he maintained a cooperative but hawkish stance. Mahathir was often a vocal critic of the United States, but was pragmatic in strengthening economic relations with the world’s largest economy. East Asian regionalism efforts bore fruit with the creation of the ASEAN+3 grouping in 1997, though this and the later formed East Asia Summit added to rather than supplanted other parts of the regional architecture.

Flagship policies under the first Mahathir era covered the full spectrum from protectionism to liberalisation and international cooperation. Early on he took an anti-Commonwealth stance headlined by the Buy British Last Policy (1981), placing severe restrictions on British imports with approvals
operating out of his own office. He also rejected advances for closer engagement with the United States, preferring outspoken advocacy for developing countries as a leading proponent of commercial diplomacy for development (particularly in support of African countries). His signature Look East Policy and neighbourhood regionalism efforts mixed cooperative (towards regional partners) and combative (towards outsiders) motives, but ultimately helped champion a degree of self-sufficiency within the region that has contributed to more selective and beneficial engagement with global partners.

The Mahathir prime ministership also featured a more economics-led foreign policy approach, with the enhancement of trade and investment ties at its centre. Unilateral liberalisation efforts were coupled with free trade agreements (FTAs) both regionally (through ASEAN) and bilaterally, with the first FTA involving Malaysia (ASEAN-China FTA) entering into force during July 2003. A total of 13 FTAs (seven bilateral and six regional) have since entered into force, while two more (including the CPTPP) have been signed and await ratification. This makes Malaysia one of the most active regional negotiators.

Alongside efforts to harness regional cooperation, Malaysia has also taken a lead role in developing collaboration among Islamic states. It became a founding member of the Organisation of Islamic Cooperation (OIC) in 1969 with Malaysia’s first prime minister Tunku Abdul Rahman its first Secretary-General. Now boasting membership of 57 states, the OIC promotes solidarity among Muslim states in the promotion of peace and security, economic, social and cultural development, and advances in education and scientific technology. As one of the more economically advanced and politically stable members of the OIC whose membership largely comprises Middle Eastern and African countries, Malaysia provides a positive example of the compatibility between trade and investment-led development and moderate Islamic values. Islamic solidarity also influences Malaysia’s position in international affairs, most prominently its support of Palestine and not recognising Israel.

**Current and future policy direction**

Malaysia’s Ministry of Foreign Affairs declares its foreign policy to be ‘independent, principled and pragmatic…founded on the values of peace, humanity, justice and equality. The overarching thrust…has been to safeguard Malaysia’s sovereignty and national interests as well as to contribute meaningfully towards a just and equitable community of nations through the conduct of effective diplomacy’ (Ministry of Foreign Affairs 2019). Its foreign policy also highlights:

- ASEAN as its cornerstone supported by bilateral and multilateral engagement;
- the centrality of promoting trade and investment, peace and stability;
- its commitment to global peace through engagement with the United Nations;
- its technical cooperation and experience sharing with developing countries through initiatives including the Malaysian Technical Cooperation Programme (MTCP) and the Langkawi International Dialogue; and
- its engagement with a diverse range of multilateral forums including the OIC, Non-Aligned Movement and APEC, promoting south-south, Muslim country and regional cooperation.

This policy has been consistently applied for several decades with only minor deviations of emphasis to suit the leader and prevailing environment. It has been supported by a vast network of diplomatic missions — the most extensive of any country outside of the G20 (including individual European Union members; Lowy Institute 2018).
Early pronouncements by key ministers suggested more of the same under the new government (The Edge 2018). Priority issues for global cooperation include economic growth and social development, environmental sustainability, combatting transnational crime and anti-terrorism. A more conciliatory stance with the United Nations on human rights is also in prospect, with the new government ideologically supportive of ratifying the remaining conventions (though it has failed to deliver ratification in the face of public pressure) and symbolically using the UN as the stage to officially launch its foreign policy (the PM’s speech to the UN was later tabled in parliament as Malaysia’s official foreign policy). The PM’s speech highlights the role and importance of the UN.

Mahathir’s return has already sparked the revival of several pet policies from his previous tenure. Early visits to Japan and China suggest a rekindling of the Look East Policy, though in practice this would involve very different reorientations for the two countries (and South Korea). The Langkawi International Dialogue (1995) was also mooted for a comeback, having been abandoned in 2011, though the prohibitive costs of organising appear to have deterred this. The Dialogue’s spirit of fostering partnership between nations, governments and non-government actors with a focus on the challenges facing developing countries remain a feature of Malaysian foreign policy.

After much external speculation and internal government review, Malaysia has affirmed its continuing commitment to the CPTPP. Mahathir’s somewhat anti-globalisation leanings had led many experts to believe it would withdraw from the agreement, however it appears the withdrawal of the United States and the more intrusive commitments that left with it have prevented such a move (Mun 2018). Yet, its broader approach to globalisation remains to be seen, while prospects for its engagement with selected partners are discussed in the next section.

2.5.2 Prospects for regional and bilateral relations

Consistent with its overarching foreign policy stance, Malaysia can be expected to continue mostly constructive relationships with key partners. It remains acutely aware that continued prosperity relies upon cordial relations with more powerful nations and openness to trade and investment, but stands to be more assertive in projecting domestic interests into international decision-making. The return of Mahathir to the helm is unlikely to benefit all equally, with a reorientation in favour of some partners at the expense of others.

China

China is Malaysia’s largest trade partner and an increasingly important geopolitical and strategic player in the region. That continued strengthening of ties would be mutually beneficial was outlined in earlier discussions on trade and infrastructure in particular, with both parties seemingly committed to fostering an increasingly important friendship.

Strengthening the relationship in the immediate aftermath of GE14 has required the skilful navigation of stormy waters. The rapid acceleration of Chinese investment and associations between Najib’s excesses and transactions involving Chinese firms have been partially credited with BN’s election demise, with the new government a vocal critic of the pace of relationship deepening while in opposition. A cordial first visit by Mahathir to China was overshadowed by the cancellation or postponement of major projects, with fears for bilateral relations. Mahathir further risked backlash by subsequently denying
residency visas for investors in the Forest City development despite the enormous development having attracted two-thirds of its buyers from mainland China.

But it would be naive to attribute these actions as China-motivated rather than pro-Malaysia and anti-Najib. The PM is unrelenting in his pursuit of what is best for his country and unwavering in his belief that Chinese investments must deliver more for Malaysians. Pragmatism ultimately prevailed with the recently revived East Coast Rail Link deal demonstrating both countries’ commitment to mutually-beneficial regional development. Malaysia recognises the necessity of accepting Chinese investment, though untethered growth creates risks politically unpalatable perceptions of foreign subjugation and a marginalisation of ethnic Malay interests. The fourfold increase in approved Chinese FDI in the second half of 2018 suggests a quiet deepening of relations outside of the headlines.

Beyond the investment flashpoints, the South China Sea also looms as a re-emerging area of contention. As China continues its manoeuvres to reclaim territory and dominate the contested waters, Mahathir holds the firm belief that the South China Sea should be open for all nations and not dominated by an individual power (Mun 2018). China can no longer rely on Najib’s acquiescence and will need to navigate potential opposition from Malaysia, with recent softening of the Malaysian position suggesting it has made inroads. Resisting the temptation to diverge from the historical course would also be in China’s interests, with both countries having benefitted tremendously from a peaceful and stable regional order enabling trade and investment acceleration.

Focusing too closely on the current hotspots however would be to miss the forest for the trees. Malaysia–China relations have withstood challenges over many decades and are set on the sturdy foundations of peace, non-interference and mutually beneficial development. Factors such as history, geography and Malaysia’s demography will continue to have a stabilising influence on relations (Parameswaran 2018). But unlike other countries that benefit from the networking effects of large Chinese diaspora, ethnic politics put a handbrake on the pace of deepening the Malaysia-China relationship.

In many respects effective balancing and perceived neutrality with other major powers will be critical to building relations with China at a rate close to its potential. Concurrent growth in partnerships with Japan, India and the United States among others will temper fears of growing Chinese influence. Consistent with this, signs of disquiet are emerging with a perceived about-face towards deepening China relations alongside alienation from the US. Equally important will be converting national interest rhetoric into practice to convince everyday Malaysians of the benefits of a broader relationship. A revitalised Look East Policy (one that could reportedly also incorporate India and Central Asian countries) and the BRI framework each offer opportunities to grow the relationship if handled judiciously.

United States

Malaysia has a robust relationship with the United States underpinned by solid economic foundations, shared democratic principles and regional security cooperation. Trade and investment ties have been strong for decades, with United States investors having made a leading contribution to the development of export-oriented industries (particularly electronics) and Malaysia’s involvement in global value chains.

While economic relations provide strength and stability to the relationship, political changes have brought fluctuating fortunes. Deepening relations post-independence became strained under PM
Mahathir’s first time in charge, as he was not shy in lambasting the ‘bullying behaviour’ of the United States in attempting to shape global rules and institutions. Relations revived somewhat in the intervening period, culminating in the relationship being elevated to Comprehensive Partnership status in 2014, but soured somewhat as the FBI investigated corruption allegations against Najib. The unwinding of Obama’s Pivot to Asia under Trump has also stymied growth in political relations.

The historic election result that unseated BN should have been a boon for enhanced relations, with Malaysia bucking a longstanding regional trend of increasingly undemocratic governments. The United States Secretary of State on his first visit to Malaysia since the election emphasised shared democratic values as the cornerstone of a strengthening relationship, optimistically espousing his and the President’s hopes for heightened cooperation. Yet there are numerous reasons to be pessimistic about short-term relationship prospects.

In many respects, Mahathir and Trump are heading in opposing directions on several fronts. Front and centre is the escalating US–China trade war, with Malaysia among the countries most exposed to collateral damage. Trump also appears determined to erode global institutions at the same time Mahathir has warmed to their virtues in supporting tough domestic reforms. Mahathir’s decision to remain part of the CPTPP came complete with barbs at the United States for having domineered parties into including unfavourable terms, which were part of the original TPP deal Trump abandoned because it did not deliver on US interests.

The Trump administration’s approach to the sensitive issue of Israel–Palestine contestation has elevated a relationship sore point to one of questionable tenability. Pro-Palestine Malaysia does not recognise Israeli sovereignty and has been outspoken against atrocities affecting Palestinian Muslims — something that is unlikely to change under prevailing public sentiment and a Mahathir government (the PM’s speech to the UN emphasised this issue). Trump’s recognition of the contested territory of Jerusalem as Israel’s capital and expected funding cuts for aid agencies operating in Palestine have not been well received in Malaysia, with Mahathir himself (while in opposition) labelling Trump an ‘international bully’ and ‘villain’ for the former (Today 2017). Furthering relations under this backdrop will be extremely difficult politically.

So, while both sides may benefit from closer economic ties there is no longer the prospect of a trade agreement to spur growth. While the United States may have a pivotal role to play in regional power balancing — something that would fit neatly with Mahathir’s neutrality approach — it is intent on withdrawing. And while reinvigorated democracy in Malaysia has the potential to advance United States interests in both Southeast Asia and the Muslim world, Trump’s Palestine policies have made him unpopular among Malaysia’s majority Muslim population. It is no wonder Mahathir sees Trump as difficult to deal with and is taking a cautious approach to bilateral relations, with prospects for relationship advancement stuck in reverse.

Japan

The outlook for Malaysia–Japan relations is among the brightest for bilateral partnerships under the new government. That Japan was Mahathir’s first overseas destination as restored PM was a fitting reflection of his deep admiration for a country that was central to his original Look East Policy of the early 1980s. Prime Minister Shinzo Abe appears even keener than Mahathir is to revive his own policy, noting the
wide-ranging cooperation facilitated under the original Look East Policy in areas such as technology, education and industrial development.

Japan stands to benefit from a rebalancing of relations away from China and to a lesser degree the United States. It is already a top three trade and investment partner despite growth stuttering under the latter stages of the Najib government. Najib’s Look East Policy 2.0 underwhelmed in its attempts to build relations through a focus on digital and technical cooperation, with accelerating Chinese relations largely sidelining Japan (Mun 2018). Japanese companies were Singapore’s and China’s main competitors in bidding to develop major rail projects, with recent developments suggesting that they and bilateral relations may have dodged a fiscal bullet.

Additionally, Japan’s leadership and commitment to regional cooperation efforts should complement the Mahathir approach. Through its support for ASEAN, ADB, APEC and related forums, Japan is well positioned to be an increasingly valued partner in the advancement of regional relations. Mahathir has already signalled his desire to strengthen relations with Japan, all that remains is how and to what extent this will be operationalised under Look East Policy 3.0.

India

India may also feature prominently in Malaysia’s foreign policy plans, underpinned by shared development goals, ethnic ties and its positioning as a natural power balancing partner. Economic interconnectivity grew significantly over the past decade, but bilateral trade and investment continues to fall well short of potential despite a series of cooperation agreements. India’s Act East Policy includes a leading role for Malaysia, whose development experience following that of East Asia provides important lessons about removing barriers to global commerce. Meanwhile a revitalised Look East Policy would benefit from the incorporation of India in the interests of regional neutrality.

Prime Minister Narendra Modi’s visit to Malaysia weeks after the election signalled a commitment to deepening relations. The two countries share similar interests and a history of cooperating in various international forums, particularly in relation to the Non-Aligned Movement and India–ASEAN engagement. Mahathir’s return offers an opportunity to redouble efforts, increasing the centrality of ASEAN to regional development and engaging India as an additional counterbalance to China.

As with China, Malaysia’s ethnic and cultural ties to India provide opportunities and threats to advancing relations. Malaysian Indians have not been immune to the politicisation of ethnic relations, though as a smaller and less economically successful minority the intensity is less. Both sides of Malaysian politics saw increased Indian credentials as important to garnering votes at the last election, with the new government’s promises to improve opportunities for ethnic Indian communities providing a potential boost to bilateral relations. Being a closer friend of India is accordingly more politically palatable with voters than with China, giving rise to opportunities to harness ethnic ties to further cooperation.

Threats arise in the religious sphere, with religious politics an ever-present detraction from relations. The Modi government has been associated with a brand of Hindu nationalism that comes at the expense of Muslim minorities, angering Muslim Malays. Meanwhile Malaysia provides refuge to some controversial Muslim figures whose views have made them enemies of the Indian state. Careful navigation of such flashpoints is essential to continuing the development of bilateral relations.
Not always the most harmonious of neighbours, Malaysia and Singapore have made great strides in bilateral relations over the past decade under the more conciliatory approach of their respective leaders. Long simmering issues were set aside in the interests of enhancing trade and investment ties (Singapore is Malaysia’s largest foreign investor and export destination), with rapid development in neighbouring Johor state and the planned KL–Singapore HSR project prominent examples of improved relations. Add to that cooperation on defence and security matters, around 30,000 flights each year connecting the capital cities and 400,000 people crossing the causeway each day, there is no shortage of interactions between the historically linked nations.

However, the return of Mahathir to the top job has inevitably spooked commentators who remember the difficulties that prevailed throughout his previous tenure, particularly the latter stages. Mahathir has continued to be outspoken in recent times (both prior to and since the election), particularly in respect of long-term water supply agreements and major infrastructure projects that he considers unfavourable to Malaysian interests. Construction of the KL–Singapore HSR project has since been postponed until June 2020 while Malaysia addresses budget sustainability concerns, though the timing more neatly coincides with the anticipated handover of the prime ministership to Anwar. Nonetheless postponement does not resolve concerns regarding the merits of the deal, it only buys additional time to consider them further.

Posturing around rail, ports, airports and water aside, it is largely business as usual between increasingly interconnected neighbours. Malaysian ministers have been shoring up economic relations on the sidelines of Singapore’s ASEAN chairmanship year, while hundreds of thousands of Malaysians live and/or work in Singapore. The new government’s more ethnically diverse Cabinet and its strong support among Malaysian Chinese should counterbalance the PM’s hawkishness and provide solid foundations for continued relationship growth. Navigating the fine balance between cooperation and competition between neighbours is never straightforward, but a reversal of recent trends appears unlikely under the new government.

ASEAN

Malaysia has assumed a leading role in ASEAN since its inception, advancing regional dialogue as a means to provide stability and facilitate shared development. Its most recent chairmanship in 2015 produced the declarations of an ASEAN Community and towards ASEAN 2025, marking major milestones for regional integration efforts and setting the platform for continued cooperation. ASEAN has come a long way from a narrow political and security dialogue, having advanced free trade, capital and skilled labour mobility, standards harmonisation and a collective approach to broader regional and global issues.

ASEAN has been the cornerstone of Malaysia’s foreign policy for more than 50 years and there is no expectation of that changing under the new government. Mahathir is a strong proponent of regional solidarity and prioritises engagement with ASEAN countries above broader relations. His return provides a powerful and revered voice to regional diplomacy, while the support of a united ASEAN would bring essential reinforcement for Malaysia’s power balancing efforts.

It is in respect of power balancing that the greatest change can be expected. Mahathir’s approach to the South China Sea could bring competing ASEAN member interests vis-à-vis China back into play. His
fondness for Japan could also present it with a larger role in cooperating with ASEAN, providing additional security as trade tensions between China and the US escalate. His staunch defence of national interests could be adopted in the regional context, encouraging ASEAN to more forcefully negotiate its interests with other regional players. None of these injections represent a significant diversion from the status quo but offer a potential short-term vitality boost to ASEAN’s contribution to the global order.

2.5.3 Engagement for the promotion of best practice

Malaysia has long been an eager and active participant in a wide range of international forums and frequently draws upon the expertise of international organisations in developing policy approaches. An openness to learning from the experience and independent assessment of others has benefited its development where more insular countries have fallen behind. Accompanied by a discerning approach that allows for adaptation to local circumstances, it has generally utilised international engagement to positive policy ends.

One example of this is Malaysia’s ready adoption of various indices and key performance indicators as benchmarking tools. It has used the pursuit of improved rankings on the WEF’s Global Competitiveness Index as a catalyst for business environment reforms, even employing teams dedicated to improving its ranking. It has also developed and tracked performance against its own well-being index derived and adapted from similar measures available internationally. As noted earlier in this report, the Government Transformation Programme is underpinned by ministerial performance targets including international benchmarks such as the Corruption Perceptions Index.

But like all countries, it is prone to selectivity when adopting international policy best practice where it would suit domestic policy needs but conflicts with political objectives. The extent of such selectivity has increased considerably in recent years as reform under the former government stagnated and externally-generated policy recommendations fell on deaf ears. The failure of the former government to communicate the importance of difficult but necessary policy reforms such as introducing the GST and removing petrol subsidies was perhaps deflected onto the international organisations that recommended them. Ill-conceived and ineffective policies like BR1M and 1MDB, extensive government domination of private markets and increasingly opaque procurement practices in turn reflect it having stopped listening to experts and voters in equal measure. The election result came at a time of heightened insularity that the new government would be advised to correct.

The new government appears attuned to these concerns and has begun to strengthen its engagement with international institutions. Early activity in the areas of human rights and foreign policy engagement with the UN represent a promising reversal of past obstinacy and a sign of Malaysia’s commitment to a global rules and institutions-based order at a time when notable powers are breaking ranks. Unlike other strongly nationalistic regimes however, Malaysia recognises that being a global team player can benefit domestic policy without compromising country specific priorities.

The 60th and final promise in the PH manifesto gave an indication of the government’s likely approach to solidifying its international engagement. It listed several important areas in which the government will seek to engage globally in pursuit of best practice policy and governance, including:

- joining the Open Government Partnership to develop action plans that increase government accountability and inclusiveness;
• managing GLCs and GLICs in accordance with international best practice approaches (referencing the OECD);
• Open Contracting Partnership, Open Budget Initiative and similar standards;
• seeking a leadership role in the OIC and ASEAN sub-bodies; and
• seeking to have officials appointed to the ASEAN and Commonwealth secretariats.

Additional areas where international best practice could prove particularly useful in reform development include:

• *Tax and transfers policy* — domestic-focussed debate has proven ineffective in developing a more advanced and inclusive system befitting Malaysia’s development level. A narrative built on international benchmarking and confidence around government fiscal management could help sell difficult reforms;

• *Competition policy* — the current system favours large GLCs at the expense of more dynamic smaller firms. Market concentration and insufficient safeguards have facilitated inefficiency and corruption within both markets and government. Engagement should not only focus on the best way to manage GLCs and GLICs but whether government ownership remains the best model.

• *Education* — simply completing the next PISA round without manipulating the results would be an improvement in this area, but further opportunities abound. In a highly politicised policy area, dispassionate advice from international experts could prove particularly useful. A collaborative exercise combining local cultural understanding and independent international policy expertise seems the most likely to produce suitable reforms adapted to Malaysia’s specific needs.

• *Data* — delivering on open data principles would enable a wealth of additional analysis and debate on effective policymaking. Government and officials must learn not to fear the results of such analysis but embrace an environment of greater understanding.
3. Malaysia–Australia relations

Malaysia and Australia share a long and enduring friendship that predates their formation as independent nation states. Linked by a common colonial past that spurred early trade exchanges, established cooperative security arrangements and bestowed similar institutional structures, they have developed a collaborative and mutually beneficial relationship that continues to grow apace. As leading regional advocates of prosperous open economies, a rules-based order, peace and stability, multicultural values and cooperation among global powers, the two countries form natural partners across a broad suite of international engagement. Direct bilateral initiatives also exhibit tremendous breadth covering economic ties, education exchanges, security cooperation, combatting international crime and more recently gender equality.

The following sections provide a historical overview of a lasting relationship that, like any close friendship, has had its ups and downs but remained steadfast. It details the depth of trade, investment and people connections that continue to provide the essential underpinnings to positive political ties. It then concludes with an analysis of prospects for continued and enhanced cooperation under the new leadership of both countries.

3.1 An interconnected history

Brought together by British colonisation, Malaysia’s and Australia’s modern histories have been closely linked and have followed strikingly similar trajectories. Malay pearl divers (also miners and plantation workers) were contributing to Australian agriculture as early as the first half of the 19th century, albeit in modest numbers that reached 932 by Federation in 1901 (DFAT 2015). Trade relations similarly predate Federation, as exemplified by Sabah–Australia relations in the late 19th century. The colonial government in Sabah recognised Australia’s growing population as a market for commodities like sugar, coffee, rubber and hemp, while Northern Australia in return similarly produced sugar and coffee but also tea and cotton. Fittingly given more recent times, Sabah and Australia shared an urgent need for imported labour that prompted early examples of cooperative arrangements (Idris, Bala and Morshidi 2013).

Tin and rubber trade were also central to the early economic relationship, being cornerstone goods of Malaya’s British-influenced commodity industries and essential inputs to Australia’s post-Federation development. Initial examples of Australian investment in Malaya surround the tin industry, with investments in Malayan mines during the 1890s and the founding of Austral Malay Tin Limited in 1911 (which would later become major building supply company CSR limited; DFAT 2015).

As the world descended into the chaos of the Second World War, Australian troops fought alongside future Malaysians in the defence and liberation of Japanese occupied territories. Australia continued to provide military support for Malaysia against communist aggressors during the Malayan Emergency and beyond, while assisting diplomatically as a leading advocate in Malaysia’s pursuit of independence from Britain. The Australian High Commission was opened in Kuala Lumpur in 1955, two years prior to Malaysian independence, and trade relations began to grow strongly under Malaysia’s first (and notably pro-Western) Prime Minister.

But signs of division began to emerge with Australia’s condemnation of Malaysia’s race riots (1969); the beginning of a series of political disagreements that would see aspects of the relationship strained for almost 35 years. First peripherally but increasingly central to the flashpoints was the emergence of Mahathir who, as Education Minister then Trade and Industry Minister, oversaw anti-Australia student
protests and escalating bilateral trade disputes (Funston 2013). Mahathir’s unapologetically anti-Western rhetoric became a feature of his prime ministership, with its first decade including several further instances of bilateral political strain. The 1985 executions of two Australians for drug possession proceeded despite the attempted intervention of Prime Minister Hawke. Australian politicians and government-funded media also found Malaysia unreceptive to its commentary on issues such as deforestation and internal security, highlighted by the ABC’s *Embassy* program prompting an official downgrading of diplomatic ties in October 1990 (Zamani, Idris and Idris 2017).

Where Hawke sought appeasement, his successor in Paul Keating fought fire with fire. Keating famously referred to Mahathir as a ‘recalcitrant’ in 1993 for not attending an APEC Leaders’ meeting and propagating a conflicting vision of East Asian regionalism. Political relations remained frosty in Prime Minister John Howard’s early years, with Mahathir’s sacking and imprisonment of Anwar Ibrahim in 1998 openly rebuked by Australian politicians. The affronted Mahathir was equally critical of Australia’s handling of its own domestic affairs (particularly the treatment of Indigenous Australians), and sought to exclude Australia from interfering in regional affairs. Mahathir later suggested much of the animosity was just political posturing to a domestic audience rather than reflecting any fundamental dislike of Australia or its former leaders.

Relations improved markedly under the Badawi prime ministership, with a 2005 visit to Australia ending a 20-year hiatus for Malaysian leaders. The visit saw the establishment of an Australia-Malaysia Institute 14, designed to enhance mutual understanding and advance engagement through bilateral visits, education exchanges and related scholarship. That year also saw the formation of the East Asia Summit regional grouping, marking a positive departure from the more exclusive approach that hampered bilateral relations. Malaysia also became an ever more constructive contributor to the APEC process it once competed against, with Australian and Malaysian positions increasingly complementary.

Bilateral ties continued to progress strongly under a regional lens, highlighted by the landmark ASEAN-Australia-New Zealand Free Trade Agreement (AANZFTA) which entered into force in January 2010. It was a significant agreement representing among the most comprehensive negotiated by all participants, covering not just goods but services, investment, competition, intellectual property and a host of other areas. Building on the foundation of AANZFTA, Australia and Malaysia signed a bilateral agreement that entered into force three years later, providing near complete tariff-free trade relations. The countries would become strategic partners in 2015 and signatories of the CPTPP, evidencing a continued convergence of interests around a shared vision of regional peace and prosperity.

Alongside strengthening economic ties, bilateral cooperation was extended to asylum seeker and refugee management with the somewhat infamous ‘Malaysian Solution’ signed under the Najib and Gillard governments. The agreement saw Malaysia accept illegal asylum seekers from Australia in return for UN certified refugees, providing a controversial attempted solution to dangerous asylum attempts. Not all recent people movements have been so cooperative, with then Australian Senator Nick Xenophon detained and deported from Malaysia in the lead up to the 2013 election, purportedly due to the ‘security risk’ posed by his outspoken comments on human rights issues and alleged election fraud (BBC 2013). Even more recently Malaysia and Australia’s long and beneficial migration ties have come under scrutiny over allegations of visa fraud and overstaying, suggesting further cooperation may be on the cards (Bucci 2018).

---

14 The institute lasted about eight years before being transitioned into the Australia-ASEAN Council.
PH’s electoral victory was warmly welcomed by the Australian Government, which has been enthusiastic to forge deeper engagement with the new government. Former Foreign Minister Julie Bishop visited Kuala Lumpur in August, and spoke effusively of a continuing commitment to strengthen the friendship between the two countries (Bishop 2018). Despite Mahathir’s history of hawkishness towards Australia and Anwar’s recent comments that Australia was complicit in supporting Malaysia’s corrupt former regime, both appear to reciprocate a desire for positive relations.

Before considering the opportunities for bilateral cooperation, the following sections provide details on the flows of trade, investment and people that underpin the interconnectivity between the two nations.

3.2 Trade

Trade relations between Australia and Malaysia have experienced substantial growth in both the volume and variety of goods and services. Australian exports to Malaysia totalled $10 billion in 2018 (note all dollar references in this chapter refer to AUD), increasing 17 per cent on the previous year and almost 850 per cent in the past 3 decades. Growth in Malaysian exports into Australia has been even more impressive, totalling $14 billion in 2018, up 17 per cent on 2017 and almost 16 times 1988 levels (Figure 35). Malaysia is Australia’s 11th largest export destination and 10th largest import source, illustrating the higher mutual importance of the two open economies relative to their overall shares of global activity.

![Figure 35: Bilateral trade Australia-Malaysia](image)

Trade growth eased significantly prior to the 2018 jump, with much of the levelling off reflecting weak global trade flows rather than specific bilateral concerns. This is apparent in the relatively consistent share of bilateral flows as a share of ASEAN trade, which has hovered between 18-21 per cent throughout the period (Figure 35). Malaysia is a key partner for Australia in ASEAN and the broader region, sharing similar commitments to trade openness and political and economic values.

The composition of bilateral goods and services trade displays the natural complementarity between the two countries. Australian exports to Malaysia are predominantly comprised of services, resources and agriculture, whereas petroleum and manufactures dominate Malaysian exports to Australia (Figures 36 and 37). Australian services exports (particularly travel and tertiary education) have grown significantly in nominal terms in the past decade but their share has declined relative to resources exports. Exports of
food (mainly meat, dairy, wheat and sugar), coal and metals (copper, nickel, aluminium and zinc) help feed and fuel Malaysia’s fast developing economy. Meanwhile Malaysia’s exports to Australia have become increasingly concentrated in areas of traditional strength during the past ten years, consistent with its broader export trends that have seen growing services sectors domestically not translating into international expansion (together with diminishing competitiveness in externally oriented services like travel). Petroleum and electronics alone command a majority share of total exports to Australia, supplemented by a diverse range of manufacturing and resource products including machinery, furniture, rubber, plastics, fertilisers and copper.

![Figure 36: Australian exports to Malaysia - composition](image)

![Figure 37: Malaysian exports to Australia - composition](image)

The degree and form of complementarity in respect of trade composition is illustrated most starkly in Figure 38, with Australia and Malaysia occupying different broad sector categories. Notwithstanding the maintenance of certain natural advantages (in particular resources for example), a progressive reorientation towards services would be expected for both countries. That Malaysia has experienced the reverse over the past ten years should be troubling to policymakers, as Australia should serve as a natural springboard for firms with global aspirations. With similar political and legal institutions, economic openness and a fair degree of language complementarity, Australia should be a preferred destination for globally competitive Malaysian service industries.
Continuing to build bilateral trade relations requires vigilance to keep opportunities and complementarities front of mind. Both countries offer robust, mid-sized consumer markets and interconnectivity into regional and global production networks, with minimal barriers to entry. Malaysian exporters have benefited from tariff-free entry into Australia on all goods since the Malaysia–Australia Free Trade Agreement (MAFTA) entered into force on 1 January 2013, while Australian exporters face zero tariffs on 99 per cent of goods entering Malaysia. The agreement and commencement of the CPTPP will further benefit mutual efforts to encourage regional trade liberalisation, while a conclusion to Regional Comprehensive Economic Partnership (RCEP) negotiations would provide a timely additional boost to bilateral and regional trade connectivity.

In an increasingly insular global trade environment being dictated by the fervent recidivism of Trump’s United States, it is more important than ever that likeminded partners including Malaysia and Australia work closely to stem the tide. As non-threatening advocates of peace, cooperation, prosperity and mutually-beneficial liberalisation, they stand among the best placed to lead regional (and global) coalitions to combat the trade war. There is no better response to a trade war than continued liberalisation by philosophically opposed countries, particularly multilateral approaches including a swift conclusion to RCEP and the reinforcement of international institutions like the WTO (Productivity Commission 2017).

### 3.3 Investment

The bilateral investment relationship has also experienced significant growth in recent years, most notably in the years since AANZFTA came into force (2010). The stock of Malaysian foreign investment in Australia has grown almost tenfold since 2001, with about 70 per cent of that increase having occurred since 2010 (Figure 39). The stock of FDI has grown by a similar magnitude, and at 63 per cent of total investment commands a much larger share than for most comparable countries (for example, Singapore 32 per cent, United States 21 per cent). In proportionate terms, Malaysian FDI has increased its overall share in recent years to around 1.4 per cent of total FDI in Australia, but its share of total investment is lower (0.6 per cent) and declining slightly. Data separating investment by sector and country is not available, but approved proposed FDI data by sector is available from various Foreign Investment Review Board annual reports. These suggest that Malaysian FDI into Australia has been dominated by the real estate (51 per cent) and services (38 per cent) sectors (Figure 40).
Australian investment in Malaysia is well below that of the reverse, both in nominal and proportion terms (Figure 39). Total investment has remained hovering around the $10 billion mark in recent years with Australia’s share of total investment into Malaysia easing to just 0.4 per cent. Growth in the stock of FDI too has stagnated and fallen to around a 1 per cent share. That both total and direct investment stocks are below half those of Malaysian investment in Australia suggests the need for continued vigilance in increasing both the awareness and execution of opportunities for Australian investors in the Malaysian market.

While both countries rely upon foreign investment and maintain welcoming environments, they each retain restrictions that potentially constrain investment opportunities. Despite commendable liberalisation efforts, both compare unfavourably with comparator countries on the OECD’s FDI Restrictiveness Index (Figure 41), albeit for quite different reasons. Malaysia maintains ownership limitations in a range of primary and services sectors and comparatively few barriers in manufacturing. Investment flows have demonstrated a corresponding bias towards manufacturing, creating globally competitive export-oriented
industries. These sectors are not unaffected by restrictions in other sectors, with limitations in enabling services (financial services, telecommunications, retail and distribution) likely to be impeding value-added upgrading and growth. That many of the restricted sectors are dominated by GLCs further hampers FDI attraction and stifles the competitive pressures that spur innovation and productivity.

Australia maintains few absolute restrictions on FDI but reserves the right to block or impose conditions on certain investments deemed contrary to the national interest. While few investments are prevented under national interest screening, processing applications can significantly delay sensitive proposals. Whether the system deters (via delays and additional costs) or facilitates (via the increased certainty approval provides) investment is difficult to ascertain, with the OECD counting the system as a regulatory barrier irrespective of investment outcomes.

With similar interests in attracting investment without compromising national interest objectives (particularly the ability to regulate in the public interest where this conflicts with investor interests), Malaysia and Australia should continue to cooperate on measures to enhance their investment environments. Improving investment facilitation mechanisms is one such area where mutual learnings (together with regional and global partners) could bear fruit, particularly to counter perceptions in both countries that nationalistic sentiment is increasingly drowning out the voice of foreign investors. A coordinated approach to BRI engagement by these like-minded economies and security partners could also help shape it into a genuinely multilateral initiative guided by sound governance and mutually beneficial development aspirations.

### 3.4 People movements

As important to bilateral relations as trade and investment, temporary and permanent movements of people contribute positively to deeper integration. The flow of Malaysians permanently settling in Australia in particular has a long and significant history that continues to this day. Around 165,000 persons of Malaysian origin call Australia home (Figure 42), having doubled in the past 20 years. The cancellation of large infrastructure projects in Malaysia is motivated by elements of nationalism as much as fiscal prudence, while Australia’s foreign investment regime is becoming increasingly security oriented.

---

15 The cancellation of large infrastructure projects in Malaysia is motivated by elements of nationalism as much as fiscal prudence, while Australia’s foreign investment regime is becoming increasingly security oriented.
number of Australians in Malaysia has grown faster still, but at around 5,500 represents a small fraction of
the reverse flows (as would be expected given relative development levels). The proportionate trends are
perhaps more revealing, with the share of Malaysians in Australia's immigration stock increasing gradually
over time (to about 2.3 per cent today), while Australians comprise a decreasing share of Malaysian
permanent settlers (at around 0.2 per cent; reflecting high levels of immigration from developing
countries within Asia) despite nominal increases.

Historical Australian settlement data allows for a closer look at Malaysian immigration patterns since
independence in 1957 (Figure 43). Numbers were suppressed in the two decades to 1978 as Australia
prioritised European migrants under the highly controversial White Australia Policy, with the permanent
settlement of students brought in under the Colombo Plan providing an exception. Malaysian inflows
increased significantly from the late 1970s to the early 1990s under more favourable Australian policies
and affirmative action in Malaysia (which contributed to a high proportion of ethnic Chinese outflows).
Its share in Australia's migration intake peaked at 5.3 per cent between 1988-90 before falling
disproportionately as overall immigration was curbed in the early 1990s. Malaysian migration rebounded
strongly under the increased intakes of the early Howard years, particularly through the conversion of
high student numbers into skilled permanent migrants. Overall numbers have drifted downwards in
recent years (to around 3,200 year) through a combination of Australian policy tightening and Malaysia
experiencing rapid economic development and introducing return migration incentives. Categorical data
from the last twenty years shows consistent but gradual growth in family migration coupled with
fluctuating skilled migration flows, with the latter typically vulnerable to fluctuations in overall migration
caps.
Temporary people movements command an increasingly large fraction of overall migration, consistent with broader changes to Australia’s migration policy. Temporary visa holders from Malaysia exceeded 48,000 by end 2018, fifteen times the annual permanent intake (Figure 44). The majority of these reflect a combination of visitors (non-tourist), students and bridging visas (a symptom of increasing wait times for permanent residency). The share of Malaysians among temporary visa holders has not changed markedly in recent years, with the notable exception of the bridging category. It is not immediately clear why Malaysia’s share of bridging visas has more than quadrupled since 2014, whether reflecting a coincidental spike in applications or a disproportionate slowdown in processing. If bridging visas are excluded, the quantity of temporary visa holders has experienced an annual decline for the first time in recent memory, suggesting new applications may have peaked in the face of longer wait times.

Looking more closely at the subcategory of education visas, two distinct trends are evident over the past 10 years (Figure 45). Both the total number of new visas granted and Malaysia’s share in the tertiary education sector have experienced a steep decline. Its share has fallen to 2.8 per cent from a high of 6.7 per cent, with around 3,000 fewer students granted visas each year. Countering that has been a tripling of the number and share of Malaysian VET students, albeit from a lower base. These trends are intriguing...
and difficult to explain in the context of Malaysia’s education development needs and Australia’s international student enrolment growth. Somewhat dated Department of Education (2014) research suggests VET has not become a stepping stone to further higher education for Malaysian students (only 5.5 per cent of higher education students get there via VET), nor is it a major pathway for existing higher education students (9.2 per cent of which end up in VET). Whether it is being driven by labour market prospects in either country, education costs or entry requirements is an area for further research.

![Figure 45: Education visas](image)

Finally, tourist arrivals provide another area of significant activity between the two countries. Australia has benefited from growth in Malaysian tourist arrivals over the past decade, almost tripling to a peak of over 340,000 in 2017 (Figure 46). Figure 36 made it clear how significant an export industry tourism has become for Australia, with Malaysians now providing over 6 per cent of total tourist arrivals. Australian tourist arrivals to Malaysia grew significantly in the first part of the past decade, fluctuated slightly before nosediving between 2014 and 2017. In 2010-11, three times the number of Australians visited Malaysia compared to the reverse, yet by 2017-18 two-way flows had almost converged. Malaysia has lost ground while regional rivals Indonesia, Thailand, Japan and China have experienced significant growth in Australian tourists. Addressing Malaysia’s declining competitiveness among Australians is another area where bilateral cooperation could serve mutually beneficial ends.
3.5 Cooperation and shared priorities

As countries with significant commonalities in their characteristics and interests, opportunities to further enhance existing cooperation are broad and varied. Recent developments within each country and in the international arena increase the prospects and necessity for strengthening ties, with cosmetic difficulties under the previous Mahathir prime ministership a naïve guide to contemporary relations. Specific policy areas where greater coordination and experience sharing would assist in pursuing common interests are discussed in this section.

Trade — trade relations are among the most robust elements of the bilateral relationship, with few remaining tariffs and joint participation in a range of multilateral liberalisation efforts. As relatively open, mid-sized economies, both heavily depend on the continuation of an increasingly interconnected international trading system based on widely accepted and reinforced rules and norms. This system is under attack from a Trump administration determined to bully trade partners into bilateral concessions that undermine decades of hard-fought gains. Countries responding individually and directly with the United States plays into its hands, allowing the US to dictate unfavourable and lopsided terms. Likeminded countries banding together and resisting the imposition of retaliatory trade restrictions, while continuing efforts to reduce barriers between themselves (particularly in groupings like RCEP), offers a more effective approach to combatting US trade headwinds.

Malaysia and Australia’s roles are potentially among the most critical, as important but non-threatening countries in the global order. As security partners to the United States (Australia formally and Malaysia through cooperation) and regional players of relative importance to China, their balancing actions set examples for other countries considering their responses. At present they pursue the same goal through contrasting means, with Australia careful in its outward condemnation of increasing protectionism.
favouring increased bilateral engagement behind closed doors. Mahathir by contrast has been characteristically sharp in his commentary and indifferent in his disposition towards United States engagement, prioritising domestic and regional engagement. Greater synchronisation between the approaches and a determination to conclude RCEP would benefit both countries.

**Investment** — several areas for increasing investment cooperation stand out from the earlier analysis. Malaysia and Australia are both among the WTO members advocating a multilateral framework for investment facilitation, recognising the potential benefits that comprehensive facilitation approaches deliver for domestic and foreign investors alike, and quality of governance more broadly. More immediate actions unilaterally and bilaterally alongside the WTO process would be beneficial, reversing contradictory trends in the investment environments of each country. Malaysia could use a clear signal that investment is welcome after the postponement, renegotiation or cancellation of prominent deals, while Australia needs to shed the perception that investor voices are overshadowed by security officials in investment approvals and broader policymaking processes. Direct mechanisms for facilitating bilateral investment could also be developed as additions to the MAFTA, to boost two-way investment flows.

Harnessing common interests in engaging China and the BRI offers another important investment initiative. Both countries need Chinese investment in infrastructure (and across a range of sectors) conditional on it being in their national interests but are confronted with parallel concerns in accommodating it. Malaysia’s problems relate to the affordability and cleanliness of major projects agreed under the former government and rising anxiety among the population that Chinese investment is increasing too rapidly. Australia too faces the latter issue while additionally managing asset sales involving heightened security implications. Each would benefit from less individual approaches to BRI engagement, promoting instead the multilateralisation of the initiative supported by agreed governance frameworks. Whether within or outside of the BRI, both would also benefit from encouraging the use of more diversified, consortia investment vehicles by Chinese investors and international partners.

**Migration policy and tourism** — to reiterate the findings of the above analysis, the sustained decline in Malaysian students undertaking higher education in Australia and the increasing prevalence of Malaysians on bridging visas are both concerning developments worth further investigation. Similarly, the substantial decline in Australian tourist arrivals in Malaysia in recent years is worth addressing through bilateral efforts.

As also noted in the introduction, recent flashpoints in the migration relationship point to the need for further cooperation. This includes addressing allegations that Malaysia has become a hub for migration policy abuses; concerns that threaten to prompt reactive policies detrimental to ordinary people movements. Indeed, Malaysia has the unwanted title of the largest source country for illegal migrants in Australia, having experienced substantial recent growth contradicting declines in other major illegal sources.

**Security/regional power balancing** — Australia and Malaysia are longstanding collaborators on security matters, parties to broader arrangements with Commonwealth partners and with an ongoing Australian Defence Force presence stationed at Butterworth. The countries cooperate closely on security matters including counter-terrorism and people smuggling, and have a shared interest in a peaceful, stable and prosperous region.

Managing escalating tensions among rivalrous powers while defending national interests is the shared aspiration of both countries. Malaysia is among the non-aligned nations actively balancing its interests among the competing powers without taking sides. Australia meanwhile has sought to balance its security
and political values alignment with the United States against its sizeable economic interdependence with China, generally avoiding situations in which it faces divisive choices (though such choices have become increasingly prevalent under Trump). But the two approaches are not mutually exclusive, with ample opportunities for coordination to advance a shared world view. A united ASEAN working alongside Australia and other agreeable regional players provides a strong deescalating voice.

**Education** — Malaysia’s education system is in need of significant reform and while Australia’s is far from perfect, it has some important features that could usefully be adopted in the Malaysian context. One is a commitment to transparency and competition among education providers, which harnesses the energies of parents to drive improvements at the school level. Australia’s more decentralised approach to school administration also empowers tailored approaches to local needs. Additionally, and perhaps most importantly, an inquisitive learning culture that encourages students to question teachings in a manner that respects teachers for their knowledge rather than strict authority. Discouraging rote memorisation and encouraging intellectual curiosity is a feature of advanced schooling systems globally and maximises the chances of developing the future innovators and leaders suited to the global marketplace. Australian educators are already assisting the Malaysian education ministry in the development of digital English learning modules in an important pilot project for future cooperation.

Student exchanges are also important to enhancing the quality of higher education, together with raising cultural understanding. Three Australian universities have Malaysian campuses (Monash, Swinburne and Curtin), providing an exchange platform for thousands of students. The New Colombo Plan also provides funding for Australian students to study or intern in Malaysia, supporting over 2,100 young Australians since 2015. Assisting students from both countries to have immersive overseas study experiences involving friendships and collaborations beyond their own country people is a positive exercise that could be further enhanced through mutual learning among universities. Building further exchanges at the postgraduate and research levels is also critical to boosting tertiary sector quality in both countries.

**Fiscal policy reforms** — Malaysian policymakers are facing a budget repair task that provides tremendous impetus to pursue critical reforms to fiscal frameworks. Restoring confidence requires more than just fiscal discipline; it necessitates a commitment to transparency and best practice in budget management that has long been promised but delivered underwhelming results. Fiscal policy is an area where Australian experience provides valuable examples for reform measures suited to Malaysian circumstances. Examples include transparent reporting, accrual accounting, medium-term fiscal frameworks and independent policy costing (via the Parliamentary Budget Office). Government procurement and tendering processes, decentralisation and efficient government administration are also areas where moving towards Australia’s system would address the governance concerns highlighted as priorities by Mahathir. Australia could also assist in developing a more sustainable narrative around tax and transfers in Malaysia, drawing on successful measures illustrating where taxpayers’ money is spent. Again, in this respect transparency and public engagement breeds confidence among citizens that government is acting in their interests.

**Institutional reforms** — despite having inherited similar institutions from the same colonial master, Australia’s and Malaysia’s systems have diverged significantly since. A comparison of prevailing differences could prove enlightening for both countries, though more immediately useful for a new Malaysian government embarking on institutional reforms. Areas such as election rules and electorate boundary changes, institutional independence, accountability to voters and the law, decentralisation (delegated responsibilities and their financing) and rule of law are all areas where neither country operates a perfect system and could learn from the relative merits of each other’s approaches and those of
comparable peers. This is certainly not an area for Australia to preach superiority, but to offer assistance with Malaysia’s efforts while reflecting on its own shortcomings and opportunities for similar reforms.

**Competition/privatisation** — while both countries embarked on privatisation campaigns and competition reforms in recent decades, outcomes have been starkly different. Australia has been fairly successful in its efforts, with recent privatisations involving critical assets that only a minority of countries have released from public ownership (such as electricity and water supply) that have not been without controversy. Malaysia’s affirmative action driven privatisations in the 1980s and 1990s were ultimately renationalised following the Asian or global financial crises, leaving Malaysia among the most government dependent economies (especially for its income level). With the government having committed to abolishing toll roads and to reform rather than sell GLCs, it would appear further renationalisation is more likely than privatisation in the near future.

Such a policy approach ultimately has ramifications across the whole economy, not just the government sector. GLCs are less efficient, innovative and competitive than market driven counterparts. They crowd out the development of private (particularly small) enterprises and as providers of essential business inputs (finance, telecommunications, infrastructure and utilities), have flow-through effects on their global competitiveness. Perhaps most pertinently in the context of public debate in Malaysia post-election, they breed corruption in all aspects of economic life. A combination of privatisation and competition policy reform (together with complementary reforms to regulation and governance) would be the single most effective mechanism to eliminate corruption. Australia’s experiences, both successful and otherwise, provide important references.

**Gender/diversity** — in August 2018, Malaysia and Australia announced the creation of a bilateral Gender Policy Dialogue tasked with advancing gender equality. Former Deputy Prime Minister of Australia Bishop described the initiative as: ‘[enabling] us to exchange perspectives and insights and experiences on the development of gender and women’s empowerment policies with the focus on the contribution that women can make to law reform, to business, to peace and security.’ It is hoped that this worthwhile initiative is truly bilateral in nature, as Australia too has a long way to go on gender equality and could learn from Malaysia’s efforts as much as Malaysia can from Australia. Recent events in Australian politics drive home this point. Embracing diversity more broadly in an area where comparing the differing approaches to and environments for multiculturalism could prove enlightening.

**Environment** — last but certainly not least, environmental protection and restoration ranks among the most pressing issues of present times, with Malaysia and Australia far from peripheral players. Both rank among the countries with the most threatened species and responsibility for biodiversity loss, both are significant energy producers contributing to damaging emissions and both face considerable risks from climate change. Most recently, Australia’s recycling waste crisis has headlined bilateral relations as Malaysia applies a return to sender policy on imported plastic waste. These are all areas where shared community interests need to triumph over vested commercial interests, with bilateral and multilateral cooperation efforts critical to developing innovative industries and protecting environmental assets.
Conclusion

Following the historic election outcome of May 2018, Malaysia has a tremendous opportunity to chart a new course for its governance, economy and society. The stability and maturity of the power transition together with decades of strong development outcomes provide a solid foundation for addressing the breadth of challenges inherited after many years of reform stagnation. Mahathir’s experience together with the fresh approach of capable new ministers offers optimism that difficult but positive changes are forthcoming.

An impressive commitment to governance reforms has taken centre stage since the new government took office, sending a clear message to Malaysians that elected officials are expected to act in the people’s interests. The pursuit of Najib and associates on corruption charges, the separation of powers for key agencies, erosions into the Prime Minister’s Department empire and promises to end the most egregious political appointments are among the promising developments. Ambitious reform intentions offer further hope that this government will deliver substantial improvements to governance quality. Greater challenges await however, as unravelling the complex web of political patronage, revitalising democratic institutions and restoring confidence in government will test the capability and resolve of the new leadership.

Having ousted the former government despite the economy performing well on most metrics, the new administration has had an extended honeymoon to formulate its economic agenda. An initial focus on reducing cost of living pressures and lowering public debt, headlined by the imprudent reversal of the GST and petrol subsidies, together with the cancellation of major investments and social payments, is testing the patience of commentators and citizens anticipating more substantive economic reform measures. A more sustainable approach to lowering living costs and improving government services requires measures to increase productivity and inclusiveness, which means addressing significant shortcomings in areas such as education, competition, innovation, taxes and transfers. With cost of living concerns not satisfactorily addressed and a clear growth and productivity reform agenda yet to be delivered, confidence is deteriorating and urgent action is needed.

As an enduring friend with plentiful common interests and relevant experiences, Australia provides an important partner in the pursuit of a peaceful and prosperous region. Malaysia and Australia already boast robust trade relations, deepening investment ties, close security cooperation and a history of people connectivity. Nonetheless a wealth of opportunities exist where greater coordination and experience sharing would deliver benefits to both parties and elevate the bilateral relationship to greater heights.
References

ACCC & AER, Annual Report 2016-17, viewed 20 August 2018,


Ahmad, R 2018, ‘Dr M to outline Malaysia foreign policy in UN’, The Star, 31 August,


BNM 2019a, Monthly Highlights and Statistics, viewed May 2019,

BNM 2019b, Annual Report 2018,


Channel NewsAsia 2018, ‘1MDB scandal: a timeline’, 22 May,

Cheong, LM 2017, ‘Filling in the gaps of public sector governance’, The Star, 1 March,


Ibrahim, A 2017, Historical imagination and cultural responses to colonialism and nationalism, Strategic Information and Research Development Centre, Petaling Jaya, Malaysia.


Khazanah Research Institute 2016b, Climbing the Ladder: Socioeconomic Mobility in Malaysia, Kuala Lumpur, Khazanah Research Institute.


Bilaterial relationship references


ABOUT THE ASIAN BUREAU OF ECONOMIC RESEARCH

The *Asian Bureau of Economic Research (ABER)* is based at the Crawford School of Public Policy at the Australian National University. It provides comprehensive, independent research and analysis on the issues affecting Asia and their implications for Australia. ABER collaborates with policy makers, academics and the private sectors across Asia to develop practical solutions to pressing policy challenges, increase living standards and make economies stronger, more resilient, more inclusive and more integrated. ABER brings together academics from over 40 institutions throughout Asia to promote the exchange of ideas and regional cooperation.

*Author and project leaders*

**Stewart Nixon**

PhD Scholar and Researcher

Asian Bureau of Economic Research

stewart.nixon@anu.edu.au

**Professor Peter Drysdale**

Professor of Economics and Head of the Asian Bureau of Economic Research

peter.drysdale@anu.edu.au

**Dr Shiro Armstrong**

Director of the Asian Bureau of Economic Research and Director of the Australia-Japan Research Centre; Fellow

shiro.armstrong@anu.edu.au