

Najib's promised reforms: Doubts remain
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Doubts remain on promised pro-market economic reforms in Malaysia with Prime Minister Najib Razak hesitant to risk a voter backlash ahead of a general election which could be held as early as next year.

Since taking office in April 2009, Najib has delivered measures such as granting new bank licences and rolling back parts of a controversial racial affirmative action policy.

NONEHe has also pledged to cut crippling subsidies, trim the fiscal deficit and accelerate investment while aiming for average 6 percent annual economic growth under a five-year economic development plan unveiled on June 10.

Analysts say Najib is wary of upsetting poorer Malays, a critical votebank who could likely be hit initially by the government's pledged subsidy cuts. This means that many of the major reforms will probably only be implemented after he secures a strong win in the next general election.

Following is a summary of key Malaysia risks to watch in the coming months:

Political conflict

Political tensions spiked after the 2008 general election when unprecedented opposition gains transformed the political landscape. The BN coalition's 52-year grip on the country was dented when it ceded control of five states and lost its two-thirds parliamentary majority to an opposition led by former deputy prime minister Anwar Ibrahim.

The political uncertainty has weighed on foreign investment with net portfolio and direct investment outflows reaching \$61 billion in 2008 and 2009 according to official data.

While money has flowed into the bond market recently, according to central bank statistics, little has flowed into equities.

What to watch:

* Anwar's sodomy trial, which ends in late August. Anwar says the case is a political conspiracy, and a contentious verdict would anger his supporters. Any marked increase in political tensions could see more foreign money pulled from stocks, bonds and the ringgit. But with limited foreign portfolio investment still in the country, the impact will be muted.

* Elections in Sarawak, expected by the end of this year. The state's chief minister has directed the ruling coalition to ready itself for state-wide polls, and analysts say nationwide elections could follow soon after. BN's shock defeat in a May by-election in Sarawak raised doubts over its support levels in the state.

* The annual meeting of Najib's Umno party in October.

* Internal elections in Anwar's PKR in November, which will choose his successor in the event that he is convicted in his sodomy trial and jailed.

Economic reform

The government's commitment to economic reform is being put to the test with the 10th Malaysia Plan, which aims to trim subsidies, boost investment and reduce Malaysia's ballooning fiscal deficit, which hit a 20-year high of 7 percent of gross domestic product in 2009, to a targeted 5.3 percent this year.

Malaysia's export-dependent economy has been losing its low-cost manufacturing competitiveness to regional neighbours such as Vietnam and needs to move up the value chain.

Among recently announced foreign direct investments are \$1.2 billion in May from disk-drive maker Western Digital and \$1 billion in June from Exxon Mobil. But Malaysia's attractiveness as a regional investment destination has been eroding in the past few years due to faster-reforming neighbours.

Key to longer term investor confidence will be whether the government has the courage to significantly unwind crippling subsidies despite a potential voter backlash.

Najib is expected to soon announce more details of his New Economic Model (NEM), which will reform elements of a four-decade-old affirmative action policy favouring the majority ethnic Malays in order to boost the economy's competitiveness.

The race-based policy gave a wide array of economic benefits to ethnic Malays who make up 55 percent of the population.

Investors complain that abuse of the policy spawned a patronage-ridden economy and made the country less attractive to foreign investors than neighbouring states.

Najib has rolled back elements of the policy, and axed the rule that companies must offer stakes to Malays. But his plans face growing opposition from conservative Malay rights groups.

What to watch:

- * The phased rollout of the NEM and how far Najib will accommodate conservative Malay pressure groups. The policy's broad outline was announced in June and more details, including the timing of the new measures, will be announced in August.

- * Moves to reduce crippling fuel and food subsidies, with a decision expected in the next several months. Past fuel price hikes have drawn an intense public backlash which Najib appears wary of attracting. Malaysia was supposed to cut its fuel subsidy bill from May this year as part of the 2010 budget to tackle its fiscal deficit, but the measure was withdrawn.

- * The 2011 budget which Najib, who is also finance minister, is scheduled to table in Parliament on Oct 15. This could include a revision to GDP growth forecasts. If the budget contains populist handouts it will be a further sign elections are close.

- * The introduction of a Goods and Services Tax (GST), postponed in February. The government has said that it remains committed to introducing the tax with an initial rate of four percent.

Race and religion

Race and religion have always been explosive issues in Malaysian politics. Najib took power pledging a more inclusive approach to ethnic Chinese and Indian minorities, but some in his Umno party are beginning to cast this approach aside in a bid to woo conservative Malays.

The caning of three women under strict Islamic laws in February for having illicit sex signaled the government's increasing adoption of a stronger Islamic agenda, and this has worried some investors.

A heated row over the use of the word 'Allah' by Christians, which sparked attacks on religious establishments, is also threatening to prolong minority unhappiness with the government.

What to watch:

- * Efforts to resolve religious disputes. The government has set up an interfaith committee to promote religious harmony and is trying to reach an out-of-court settlement with the Borneo Evangelical Church, which went to court over the 'Allah' dispute.

- * If the government tries to woo Muslim voters with more conservative policies based on Islam, investors may be spooked.

- * A severe worsening of tensions could raise the spectre of sectarian unrest, but this is not regarded as likely for now.

Corruption

Malaysia used to be regarded as one of the region's more reliable countries, but worsening corruption and a perceived lack of judicial independence have damaged investment.

What to watch:

- * Government efforts to deal with the Port Klang Free Zone (PKFZ) scandal that exposed links between politics and business. False government guarantees given when the bonds were sold have triggered concerns among holders of \$1 billion of bonds that they might not be repaid.

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