

Khazanah Megatrends 2009

**Lessons from Beyond
the Dismal Science**

Opening Keynote Address

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Members of Khazanah Board of Directors

Tan Sri Azman Mokhtar

Managing Director, Khazanah Nasional Berhad

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Distinguished speakers and guests,

Ladies & Gentlemen.

Lessons from Beyond the Dismal Science

1. It gives me great pleasure to kickoff the discussions at this year's Khazanah Megatrends Forum. I must commend Khazanah for having yet again successfully assembled a distinguished group of speakers from academia and public sector, as well as finance and corporate leaders.

2. It is especially timely for us to engage in a forum such as this, given the difficult time the world is going through. The consensus view is that the worst is over, and that we have shifted from reverse gear to neutral gear. The question before us is where to from here? Particularly for Malaysia, what lies ahead and what should we focus on, particularly in the context of transforming ourselves to become a developed nation?

3. Clearly, the recent global downturn has put to disrepute economists espousing the virtues of laissez faire and free market economics. In fact, as we know, the subject of economics has long been referred to as the dismal science. This morning I would like to draw upon selected lessons from other more reputable and less dismal subjects, namely **history, biology and geography**. It is not that economics does not matter, but in the face of fresh challenges in today's complex world, we should keep an open mind and take a multi-disciplinary approach.

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History

4. I would like to begin with **History**. According to Professor McCloskey, economics is really a subset of history, and that like historians, economists are basically telling plausible stories about the past. The dismal science cannot uncover axiom based laws. If it could, economics would have been able to predict precisely the booms and busts, and the recoveries. Recently, the Queen of England famously asked why the mainstream economists did not see this current crisis coming.

5. Economists merely rationalise the past, but everyone wants them to tell what the future will bring. But as the song goes, the future's not for economists to see, *Que Sera Sera*. In Lewis Carroll's celebrated children's book, the Queen says to Alice, "It's a poor sort of memory that only works backwards". Indeed, there are tremendous pressures from businesses, policymakers and media for economist to predict, which is effectively working the memory forward, based on past observed patterns of the economy.

What are the lessons from history that would be particularly useful for us at this stage of our development?

Lesson One: Openness and Success

6. In a book titled, *The Wealth and Poverty of Nations: Why are some so rich and others so poor*, David Landes attempts to isolate the various causes for relative prosperity of nations, particularly over the last 500 years. **If there is a single key to success or relative wealth, in Landes narrative, it is openness.** This is not a narrow concept of free trade as promoted by many trade economists. Rather, it is a broader sense of openness, involving a **willingness to borrow whatever is useful from others, including from abroad, combined with a willingness to experiment and progress through change.** We cannot be like the Luddites of the Industrial Revolution, resisting change, technology and new realities. The success of Europe built over the

last 500 years, were catalysed amongst others by three transformational inventions, namely the compass, gunpowder and printing presses. All three came to Europe from China and so a period of European eminence began with imitation. Landes concludes his book claiming that *the one lesson that emerges is the need to keep trying. No miracles. No perfection. No apocalypse. We must cultivate a sceptical faith, avoid dogma, listen and watch well...*

7. Going forward, openness in the context of the capacity for technology absorption and innovation will be critical for Malaysia to realise its developed nation ambitions. We have seen the benefits of openness, whether it was Japan during the Meiji period or China's great leap forward under Deng Xiaoping. Perhaps, we in Malaysia need to embrace an even broader concept of openness, namely **an openness to each other, a sense of inclusiveness.**

8. An enabling factor to the expansion of the Roman Empire was the ability to move beyond the idea of citizens based on a set national boundary. A concept of universal Roman citizenship was developed to encompass geographically dispersed peoples bound by shared beliefs and laws, rather than by proximity or ethnic identity. Professor Richard Bulliet extends this analysis to the success and expansion of the Islamic Caliphate in the 7th century, in being able to transform from a ruling class with a thin layer of Arab Muslims towards a broad participation in governance, irrespective of native language or culture, with the inclusiveness of those from Egypt, Syria and Iran. In more modern day terms, there is something to be said of the American Dream, where a black man can become President, and where half of all Silicon Valley start-ups have at least one founder, who is either an immigrant or a first generation American.

9. Realising the spirit of 1Malaysia is key to Malaysia's success. We, as a nation, must be able to fully optimise the full potential of our human capital. Every single Malaysian should believe that he can succeed through honest and hard work, irrespective of socio economic circumstances or ethnic background. **History teaches us that it is critical for future success**

that we proceed on the basis of openness – an openness to ideas, openness to change and openness to each other.

Lesson Two: Boom and Busts will recur

10. Post crisis, there is now a necessary and important debate on the need to reform the global financial architecture and its regulation. We certainly hope that the relatively quick stabilisation of global capital markets has not dampened the commitment for reform. However, notwithstanding the reform that we hope will be undertaken, **the lesson history teaches us is that cycles of boom and busts will continue to occur going forward. Investment history tells us that bubbles are forever. The only question is where and when they emerge.**

11. The neo-classical economists' view of the world, premised on rational expectations and efficient markets, is one where fluctuations are stochastic and result from exogenous shocks. In other words, booms or busts occur randomly, resulting from underlying real events or causes. This is quite unlike reality, where economic crisis have been occurring with alarming regularity and increasing severity. Prior to this crisis, we had the 1997 Asian Financial Crisis, the economic crisis of the mid-1980s, which in turn was preceded by the 1970s oil shock. Further, we continue to observe speculative bubbles which follow a cycle of irrational exuberance culminating with a crash, such as with oil prices in 2008 and the dot com bubble around 2000. These only add to a long history of speculative bubbles dating back to the South Sea bubble of the 1720s and the Dutch Tulips mania of the 1630s.

12. The debate rages on amongst economists on whether business cycles are unpredictable events or whether there is an underlying regular cycle. And if it is regular, it is debated what would be the underlying periodicity, whether a Juglar cycle of between 7 to 11 years or a Kondratieff wave of 45 years or some combination of overlapping cycles. However, there is little to be gained in getting drawn into this dismal science debate. **The point is that boom and**

busts will continue to happen as irrational exuberance, herd mentality and greed will continue to feature in human psychology.

13. Given the likely recurrence of cycles, the key takeaways from history, I believe, should be:-

- **First, planning and financial management, whether of corporates or nations, must take into account cycles.** This may sound obvious, but all too often we have business plans based on an average sales growth of 10% or national plans on an average GDP growth of 6%. The problem is that revenues fluctuate, whereas overheads and debt servicing do not. Hence, as is often the case, we observe a company proverbially drowning in an average depth of 3 feet of water. **Management of debt and risks will continue to be critical going forward;**

- **Second, as surely as crisis occur, so will a recovery follow suit.** Therefore, we need to ensure that Malaysia is well placed to take advantage of the recovery when it occurs. As is often said, one should not waste a good crisis, particularly in terms of undertaking structural reforms during a downturn, to ensure a leaner and fitter economy during an upturn; and

- **Third, a crisis not only exacts losses but also offers opportunities.** For example, in the context of the current crisis, we are witnessing various multinationals consolidating in terms of production locations. We need to ensure we do not lose out, but gain from the reorganisation of corporates in the wake of the crisis.

14. Despite history repeating itself, it won't be long before financial markets throw caution to the wind with the next phase of rapid economic growth and recovery. As George Santayana famously said, *Those who cannot remember the past are condemned to repeat it.* We may not have a memory that works forward, but we should at least continually remind ourselves to have policies appropriate to the stage of the cycle we are in.

15. **The third lesson from history is that history matters.** Typical classical economists continue to suggest that markets or economic systems would optimise towards the best solution at any one given time. In reality, we very often do not get the perfect option, because the best solution for tomorrow depends largely on where we are today. **In this sense, changes in the economy exhibit hysteresis or path dependence.**

16. I remember reading about the concept of history and path dependence, beautifully encapsulated as follows: *History happens, but only just. The lives of individuals, the lives of nations, may hinge on a millimetre's difference in the trajectory of a bullet, a road not taken on a whim, or the random stray of shrapnel. But there is no undoing of what is done.*

17. The economics of hysteresis are well demonstrated by the QWERTY configuration used in computer keyboards. This layout was originally developed in the 1870s for typewriters. The layout itself is an evolution from an earlier strictly alphabetical layout – which is why you still see an almost alphabetical sequence in the middle row with the letters “DFGHJKL”. The QWERTY design layout was driven principally to reduce the incidence of the typewriter typebars from jamming or clashing, which tended to occur when adjacent buttons were struck in rapid succession. The QWERTY keyboard was also designed such that typewriter salesmen were able to type out the word TYPEWRITER using only letters from the top row of keys. These considerations are no longer an issue with modern day computer technology, but the QWERTY keyboard remains the standard. It does not get displaced despite the invention of more efficient or more ergonomic layouts such as the DVORAK configuration, which has been proven to enable faster typing.

18. **The moral of the story is that standards are sticky.** The same applies to Microsoft as an operating system. There are clear first mover advantages. **But such path dependent stickiness goes beyond the realm of technology standards. Industrial clusters are also sticky.** Once an

industrial cluster is established, there is typically a virtuous cycle. Whether it is London as a financial centre or Bangalore for outsourcing, the cluster strengthens itself over time, establishing a complete eco-system of vendors, attracting the best human capital and thus, reinforcing competitiveness. To the extent that industrial clusters are able to continue evolving its competitiveness, path dependency can result in a lasting and sustainable advantage.

19. The implications for Malaysia are clear. In recovering from this crisis and transforming our economy, it is imperative for us to act quickly and seize early mover advantages. In addition, we must develop and strengthen industry clusters in areas that will be drivers for Malaysia's future growth, such as Islamic Finance, downstream palm oil and higher value add electronics. Emerging as regional or even global centres or clusters in key areas will provide a resilient and sustainable platform for future growth.

Biology

20. Economic progress is typically all about the competition for ideas, technology, products and services. **There is no better place to learn about competition than from biology, where life has been all about competition for survival since life began.**

Lesson Four: Cooperative & Adaptive Competition

21. It has been 150 years since the publication of Darwin's book On the Origin of Species. Survival of the fittest has been used to describe the law of the jungle. It tends to suggest in people's minds the idea of the strongest and largest. In actual fact, natural selection is not so much about brawn. Size in itself can be a liability. The dinosaurs' great size was advantageous for example, for digestion. However, in the end, it was believed that it was its great size that hindered adaptability to the cooling of earth's temperature that led to the mass extinction of dinosaurs.

22. Biologically, the best chance of survival is really about being adaptive and cooperative. Survival of the fittest is not so much about being best at competing individually but as a community of those best at working together. Cooperation within an animal species clearly overcomes individual size and provides strength in numbers, whether in terms of the protection of a herd, hunting in packs or functioning as a colony of insects. **An even superior form of cooperation arises in the form of symbiotic relationships between different species, whereby two species are able to leverage on the comparative strength of each other.**

23. There are numerous examples of this form of cooperation. It is reported that the plover bird cleans the teeth of the Nile crocodile from leeches, without any danger of being eaten in the process. Also as seen in the movie Finding Nemo, the clown fish resides in an anemone. The anemone's stinging tentacles protects the clownfish from predator fish and the clown fish in turn, protects the anemone against the butterfly fish that eats anemones. Yet another example is the honeyguide bird and honey badger who team up because the bird can find beehives but can't open it, whereas the badger can open beehives but can't find them. In the end, they share the spoils.

24. Of all animals, ants make up for size by being masters of cooperation. Ants function in highly cooperative colonies. In addition, they forge elaborate cooperative relationships. The Bull horn acacia tree provides a species of ant with accommodation (in the form of bulbous hollow thorns) and food (in the form nectar from special glands). In return, the ants defend the plant by attacking animals that attempt to eat the acacia. In addition, the ants protect the acacia from competition with other plants, by removing any germinating seeds or encroaching foliage from the area. There are at least 100 species of ants that have formed close partnerships with specific species of plants. In addition, ants also farm aphids, in a similar way to man farming cattle.

25. The lesson from biology for Malaysia, particularly as a relatively small economy, is to remain adaptive to the changing global environment and to build up strong symbiotic

relationships. The crisis has accelerated the trend of global growth centred in Asia – particularly, in China, India, Indonesia and the Middle East. **Malaysia is uniquely primed to benefit from the emerging new world order.**

26. **Malaysia is well positioned in the centre of ASEAN and Asia.** We can forge partnerships with other countries to jointly access regional markets, particularly in areas such as Halal products and Islamic Finance, much in the same way that honeyguide birds and badgers cooperate. We need to develop core competencies in services for the large markets in the region, just as the plover serves the crocodile or the ant services the acacia tree. And it goes without saying that like ants, cooperation begins at home, because the real battle is out there in the global arena.

27. It must be emphasised that we are speaking of cooperation in the context of a competitive environment. Animals and plants cooperate and adapt in a competition for survival. This is evident even among the most basic forms of life. Human technology applied towards developing better and better antibiotics continue to be undermined by bacteria mutating to become resistant. Animals successful in the wild, rise in population numbers and conversely, failure to adapt would equal dwindling numbers and at worst, extinction. Animals in a zoo do not stand to gain nor are at risk from the forces of competition. Not being conditioned to compete, animals from captivity generally do not fare well if released to the wild.

28. A zoo is analogous to a very planned and centralised economy. Given a dynamic global environment, an open market economy needs to respond to change. Successful ideas and adaptation should be rewarded. It is often said, in raising children that one has to be cruel to be kind. Hence, failure should be allowed and tolerated. Those who fail should be given a second and subsequent opportunity. Better to learn from failure than prop up, what should fail.

29. The only constant in life is change. Therefore, a sustainable economic system must provide the necessary incentives to continuously improve and enhance the quality of life. It is

for this reason that a number of countries have introduced quasi-markets into the sphere of public sector. Quasi markets are created in social services by giving the citizen choice and reflecting these choices in the funding to public institutions. By simulating demand for public services, it encourages institutions to adapt and compete. Quasi markets have been introduced in certain countries, through public private partnerships, in areas such as education and healthcare. To better facilitate choice, information on quality of services is made transparent and readily available. An equally important objective in this undertaking is to promote empowerment of citizens and private sector in making choices and taking responsibility for these choices. Such measures to enhance incentives to compete are akin to **'bringing the jungle into the zoo'**. We may need to consider such mechanisms, not only in the context of public sector reform, but also towards engendering a truly private sector led economy.

Geography

Lesson Five: Geography matters

30. Just as history matters, in the context of economic development, **geography matters as well**. This was particularly well articulated in the World Bank's publication, **The World Development Report (WDR) 2009: Reshaping Economic Geography**.

31. The following are some of the key messages of WDR 2009:-

- **First, growth will be unbalanced**. In particular it will be concentrated in urban areas. Attempting to spread out production is counter-productive. **With today's globalisation, competition necessitates focusing production in urban centres to reap the economies of agglomeration;**
- **Second, development however can be inclusive. Persistent differences in urban rural living standards are neither desirable nor inevitable. Whilst production should be concentrated, social services such as education and utilities should be well spread out;**

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- **Third, unbalanced growth and inclusive development requires economic integration.**
This involves, among others, easing labour mobility towards urban production centres, achieving agglomeration through specialisation and facilitating ease of trade to support such specialisation.

32. A key conclusion is the need to formulate policy by locality and by geography. This is consistent with the lessons of history and biology, in terms of formulating the most appropriate development option for a particular place by taking into account the path of development to date and what would be best adapted for the environment. **In the Malaysian context, as we forge forward towards our ambition of developed nation status, this would imply the need to articulate distinctly a development strategy for each of the major urban centres, including Klang Valley, Penang and Johor Bharu, Kuching and Kota Kinabalu to become developed regions, each with potentially different industry focus.**

33. Akin to promoting urban centres, the national strategy in terms of human capital must be to nurture and develop the best and brightest, in order to have the necessary resource to spearhead globally competitive industries. At the same time, development must be inclusive and living standards raised for all through ensuring equality of opportunity, especially in terms of education and jobs.

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Lesson Six: Unity of Purpose

34. I would like to conclude with a lesson from the beautiful game, football. National football teams, more often than not, do not perform to potential. Argentina is replete with individual stars but is struggling to qualify for the upcoming World Cup. Previously, we had also seen England failing to qualify for Euro 2008. We see star players, who are highly skilled and effective playing for their clubs week in week out, but not gelling together for the few

international games. **National teams do not perform when individual stars are not galvanised as a team and not united in purpose.**

35. As an analogy for the country as a whole, **we have no shortage of talented Malaysians, working both here and abroad. The challenge is whether the nation is able to galvanise its pool of talent to have some unity of purpose towards contributing in one way or another to the advancement of the nation.** This can be achieved in a variety of ways, for example, in terms of leveraging on the Malaysian diaspora to act as informal ambassadors for the nation, helping Malaysian businesses enter new markets. Even attending forums such as today is part and parcel of taking some time away from day to day work and engaging with peers on national issues. As we aspire towards becoming a developed nation, **we should also be able to unite on matters of national interest, even between those of different political leanings.** This is key, if we are to overcome the challenges of crisis and undertake a major transformation of the nation.

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Conclusion

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36. Today, there is general consensus that the worst is behind us, but strong growth going forward should not be taken for granted. We need to work at it. The Government of the day continues to maintain great ambitions for Malaysia. We not only intend to recover from this downturn but undertake a major transformation to become a developed nation by 2020.

37. We have been successful in the past in overcoming numerous crises and transforming ourselves during 52 years of nationhood from a poor country to a high middle income and industrialised nation today. The second round of transformation into a developed nation requires the ability to rally together as a nation and embody a sense of openness required to succeed. In today's increasingly globalised and rapidly evolving world, we will need to be willing to embrace change, be adaptive to the environment and forge close cooperative alliances, particularly within ASEAN, within ASIA, within OIC, within the Commonwealth and with the United States and Europe.

38. Transformation involves moving beyond our comfort zone, making difficult decisions, thinking out of the box and venturing into uncharted territory. As we contemplate transformation for Malaysia, I leave you with one last thought. The summit of Mount Everest is marine limestone. It certainly took some time, but what was once under the sea, subsequently rose up to become the highest point on earth. Likewise, I am confident that together, we can take Malaysia to greater heights.

Thank you.

(Economic Planning Unit)
5 October 2009