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RISKS TO WATCH MALAYSIA

Malaysian Prime Minister Najib Razak's move to reduce fuel, gas and sugar subsidies triggered a political backlash that may see him holding off more reforms 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 licenses and **rolling back parts of a controversial racial affirmative action policy**. He has also pledged to 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. Najib is wary of upsetting poorer Malays, a critical votebank who could likely be **hit initially by 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.

POLITICAL CONFLICT

Political tensions spiked after the 2008 general election when unprecedented opposition gains transformed the political landscape. The National Front 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:

- **Opposition leader Anwar Ibrahim's sodomy trial**. Anwar says the case is a **political conspiracy**; a contentious verdict would anger his supporters. A marked increase in tensions could see foreign money pulled from stocks, bonds and **the ringgit**. But with limited foreign portfolio investment in Malaysia, the impact will be muted.
- Elections in the Borneo state of 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. The National Front'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 United Malays National Organisation (UMNO) party in October.
- Internal elections in Anwar's People's Justice Party 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. With the Malays who make up 55 percent of the country's 28 million population likely to be among the hardest hit by reform measures such as price hikes, Najib has opted for a gradualist approach to economic reform. He has postponed measures such as the introduction of a goods and services tax. In July, Najib announced out fuel and other subsidy cuts to rein in a budget deficit which last year hit a 20-year high of 7 percent of GDP.



Malaysians wave in-front of a giant National flag during National Day celebrations at the Parliament House in Kuala Lumpur August 31, 2009. REUTERS/Bazuki Muhammad

The move drew protests from a coalition of student and human rights groups as well as opposition parties who have threatened to hold a mass rally if the cuts are not reversed by December, adding pressure to Najib as he tries to remain popular while stemming the country's deficit.

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.

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, making Malaysia less attractive to investors than neighbouring states. Najib has rolled back elements of the policy, axing a rule that firms must offer stakes to Malays. But his plans face **growing opposition from conservative Malay rights groups**.

RISK DATA

Sovereign foreign currency:	
S&P	A- (stable)
Moody's	A3 (stable)
Fitch	A- (stable)
World Governance Indicators:	
Voice & Accountability	31.7
Political Stability	50.2
Govt Effectiveness	83.9
Regulatory Quality	60.4
Rule of Law	64.6
Control of Corruption	62.8
IHS Global Insight	
Country risk	2.39
Sovereign	A- (stable)
Economist Intelligence Unit	
Sovereign risk	BBB
Political risk	BBB
Country risk	BBB

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What to watch:

- Phased rollout of NEM and how far Najib will accommodate conservative Malay pressure groups. The broad outline was announced in June and more details, including the timing of the new measures, will be announced in August.
- The 2011 budget which Najib, who is also Finance Minister, is due 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, postponed in February. The government says it remains committed to introducing the tax with an initial rate of four percent.

RACE AND RELIGION

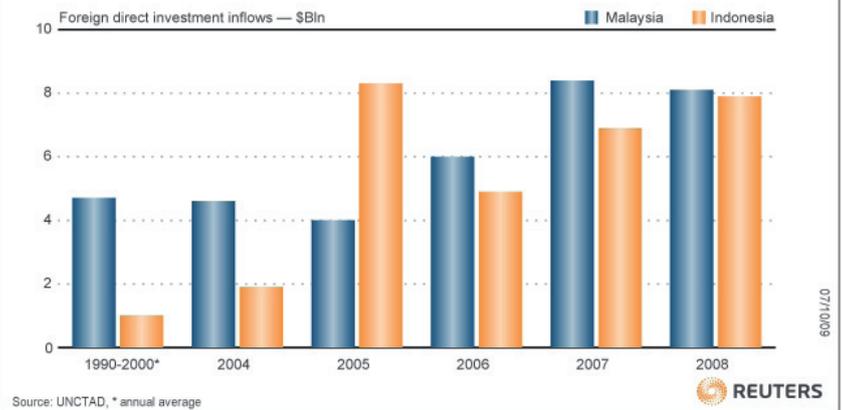
Race and religion have always been explosive issues in Malaysian politics. Najib took power pledging a more inclusive approach to ethnic Chinese and Indian minorities, but some in his UMNO party are casting this approach aside in a bid to woo conservative Malays. The **caning of three women under strict 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 Catholics, 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 set up an interfaith committee to promote religious harmony and is trying to reach an out of court settlement with the Borneo Evangelical Church over the "Allah" dispute.
- If the government tries to woo Muslim voters with conservative policies, 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.

FDI destination - Indonesia vs Malaysia

Indonesia set to overtake Malaysia as foreign direct investment destination

**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. Malaysia's corruption perception ranking dropped to a record low of 57th globally in anti-corruption body Transparency International's 2009 report.

What to watch:

- Government efforts to deal with a scandal over a port trade zone close to Kuala Lumpur 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. Last year, Najib promised to prosecute any wrongdoing with regards to the port project and this move could be an attempt to show investors that the country is serious about tackling corruption. A **veteran ethnic Chinese politician has been charged** over the case.

KEY DATES

- **September 22, 2010**
August consumer price index data released
- **September 30, 2010**
August money supply data released
- **October 15, 2010**
Prime Minister Najib Razak tables the 2011 national budget in Parliament.
- **Second half of Oct, 2010**
Annual meeting of United Malays National Organisation, the lynchpin of the ruling coalition.

RISK DATA

JLT Group	
Strikes, riots & civil unrest	3
Terrorism	2
War & civil war	2
Economic risk	4
Currency risk	4
Sovereign risk	4
Expropriation	3
Contract repudiation risk	5
Legal & regulatory risk	5
Coface	
Country rating	A2
Business climate	A3
Transparency International	
Corruption Perceptions Index Score	4.5
Rank (of 180)	56
World Bank Doing Business	
Rank (of 183)	23
WEF Global Competitiveness	
Score	4.87
Rank (of 133)	24
Reporters Sans Frontières	
World Press Freedom Index Score	44.25
Rank (of 175)	131

Malaysia's governing coalition share of vote

Malaysian governing coalition's declining share of vote among major races in 2008 versus 2004

