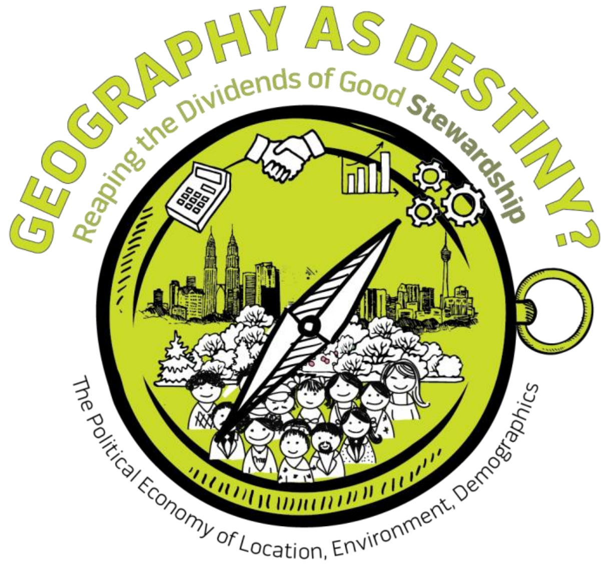
KHAZANAH MEGATRENDS FORUM 2016



"The transitions in mindset…from the paradigm of production to one of preservation; from the paradigm of maximisation to one of optimisation, and from the paradigm of resource ownership to one of stewardship – will be one of the greatest tests of our time. Indeed, successfully recalibrating our collective worldview may even take a generation – but it will be a cause which is worth fighting, and a cause which is worth winning."

DYMM Paduka Seri Sultan Nazrin Muizzuddin Shah, Sultan of Perak Darul Ridzuan

Opening Address, Khazanah Megatrends Forum 2014

Introduction

Much of Malaysia's history can be viewed via a geographic lens. Maritime trading kingdoms such as Malacca and Johor-Riau owe a large part of their success to convenient locations along India-China shipping routes. Tropical climate and appropriate soil further added to a confluence of factors that made Malaya a desirable region to establish British colonies. Indeed, according to Professors Jomo K.S. and Wee Chong Hui (2014), Malaya was Britain's most profitable colony in the immediate post-war period[1], contributing much of the export earnings that financed British post-war reconstruction. The British introduced non-native rubber and (subsequently) oil palm to Malaya, which took hold and became the engine of the Malaysian economy.

Natural resources are central to Malaysia's economic history, particularly tin and oil. Geography even subsequently shaped Malaysia's manufacturing history. Proximity to the Asian Tigers' industrial supply

[1] According to Jomo (2007), Malaysia's economic infrastructure (e.g. railways, roads, ports, utilities, etc.) was generally more developed than those in almost every other British colony except those in the settler colonies. This was a reflection of the colonial bias for British plantation and mining interests in Malaya.

chains allowed for offshore manufacturing, bringing the likes of American and Japanese multinationals such as Dell, Intel, Fairchild Semiconductor, Hitachi, Toshiba, Chugai and Hirose into Malaysia, particularly Penang. This then evolved into present-day Malaysia's largest export base: electrical and electronics exports.

To be clear, one cannot attribute Malaysia's economic successes entirely to being in the right place at the right time. Economic policymakers had to be savvy enough to exploit possible economic opportunities; political policymakers needed to create adequate institutions to govern the economy; people needed to have an open attitude to labour migration and international trade; in short, Malaysia's development required good stewardship. Together with natural endowments, these factors have allowed the economy to shift towards new and better things over time, raising living standards. However, there is no question that rich geographic endowments have played a significant role in Malaysia's development.

Manifest Destiny – The Role of Geography

Indeed, a major but underappreciated source of differences between countries worldwide is their geographic make-up. Countries with different geographical attributes, such as being land-locked, having a desert climate, or being close-to-isolated from nearly all other countries, face different sets of economic opportunities. There are three main versions of the geography hypothesis on the wealth of nations.

The first is the impact of climate on "national character," a hypothesis encapsulated best by Enlightenment philosopher, Montesquieu (1748) [2009], who wrote in *The Spirit of the Laws*: "People are… more vigorous in cold climates. The inhabitants of warm countries are, like old men, timorous; the people in cold countries are, like young men, brave." The second is the geographic impact on economic activity. In this view, initially developed by Swedish economist and Nobel laureate Gunnar Myrdal (1968, vol. 3, p. 2121), studies on the problems of underdevelopment should consider the impact of the climate on soil, vegetation, animals, humans and physical assets. This view was further expanded by geographer Jared Diamond (1998) who argued that the rise of early agriculture in Eurasia relative to elsewhere was due to the fact that of the world's 14 species of valuable domestic animals, 13 were Eurasian.

The third is disease burden or, in Jared Diamond's terms, 'germs.' A popular version of this view is given by economists Jeffrey Sachs and David Bloom (1998), who found that the prevalence of malaria in sub-Saharan Africa reduces the annual growth rate of the region's economies by approximately 1.3% a year. Another view, provided by Jared Diamond, argues that *because* domesticated animals were widespread in Eurasia first, Eurasians therefore had time to become immune to disease vectors borne by these animals and were thus able to dominate other regions which took time to develop that immunity[2].

Underlying all these explanations is the fundamental notion that geography impacts human behaviour. This can range from eating behaviour – such as Eskimos eating more animal fat than people living in more tropical areas – to choice of economic development policies – such as Singapore choosing export-oriented industrialisation due to its lack of natural resources and population size. At the extreme is *revolution*, where climate change and drought in Russia, Ukraine, China and Argentina and torrential

[2] Indeed, settler mortality resulting from diseases was the main driver behind the choice of extractive or inclusive institutions, as argued by Acemoglu, Johnson and Robinson (2001).

storms in Canada, Australia and Brazil drove up food prices, leading to rising tensions in the Middle East, which, at least in part, caused the events of the Arab Spring.

Firms are not escapists from geographic capture either, particularly in the short-term. In the fourth quarter of 2011, at the height of the devastating Thailand floods, Seagate actually recaptured the lead in Hard Disk Drive shipments, ousting Western Digital, whose shipments fell a whopping 51% from the previous quarter. As an IHS analyst put it, "Seagate owes its return to market leadership to a fortuitous accident in geography: Its HDD manufacturing plant in Thailand is located on high ground." In Japan, the 2011 Tōhoku earthquake and subsequent tsunami cost the insurance industry an estimated $35 billion, with firms such as Munich Re and Swiss Reinsurance Company facing losses in the $10 billion range. Lancashire Holdings, another insurance company, saw its share price fall by 10.5% within two months of the disaster.

Geography as Destiny? The Case Against

Geography is a potent force. Its various agents – climate, location, germs, domestic flora and fauna – can have serious, far-ranging implications for people, firms, and nations. Yet, is geography tantamount to being one's destiny? Consider the set of countries that were colonised by Europeans, beginning in the 15th century. A majority of these countries have seen a 'reversal of fortune,' as coined by Acemoglu, Johnson and Robinson (2002), whereby countries that were richer before colonisation became poorer, and vice versa. Peru and Mexico fall in the former category, while Canada, Australia and the United States are, more fortuitously, in the latter. Yet, geography as destiny implies fixed fortunes, not fortune reversals.

Much of economic development from the 1800s till the present was driven by industrialisation, which cannot be solely explained by geography. For instance, the growth of the textile industry in Britain is partly due to a conducive climate, but it would not have developed rapidly without the Spinning Jenny and the Steam Engine. South Korea had limited natural resources and was poorer than Ghana after the Korean War in 1953. Yet, by importing iron ore and having a conscious industrial policy, it created the steel champion POSCO[3]. From the 1970s on, South Korea's government intervened in numerous industries, creating such heavyweights as Hyundai, Samsung and LG: an economy based on manufacturing value-add and export trade.

Geography, via climate, may impose constraints on economic growth. Jeffrey Sachs has emphasised disease dictated by climate, as mentioned above. But diseases can be tamed by technological progress, so the prevailing disease environment in a country is also a consequence of its economic development. Singapore, for instance, has managed to substantially reduce and mosquito-borne diseases such as malaria and dengue. Another example of technology overcoming climate comes from Singapore as well. When asked to name the most important invention of the 20th century, Singapore's first Prime Minister, Lee

[3] The creation of POSCO was not a popular choice, by conventional wisdom. According to Cambridge economist Ha-Joon Chang, back in the 1960s, the World Bank advised the Korean government against going into the steel business. Moreover, no bank or firm in the Korean private sector had the capital or risk appetite to pioneer this industry. Indeed, it was Japan who provided the financing for the initial plant via $119 million in government grants and loans, $54 million in credit from the Export-Import Bank of Japan and technical assistance from Nippon Steel and other corporations. For more, see *Bad Samaritans*: *The Myth of Free Trade and the Secret History of Capitalism* by Ha-Joon Chang (2010).

Kuan Yew, singled out the air-conditioner, as it allowed Singaporeans to be productive during the hottest and most humid hours of the tropical day. The rise of digital technology, which has exponentially enhanced global connectivity, is also proving "Geography as Destiny" to be a myth. Indeed, connectivity and geography have fused together into what Parag Khanna calls "connectography." In his book, *Connectivity: The Future of Global Civilisation*, he argues that this fusion manifests itself in massive investments in infrastructure and the construction of megacities – not merely dots on a given map, but, as he puts it, "vast archipelagos of development stretching hundreds of kilometers."

Another lever is institutions. In their popular book "*Why Nations Fail*", Professors Daron Acemoglu and James Robinson (2012) contrast the city of Nogales. One half of the city falls within the borders of Mexico while the other is located within the United States. On the American side, average income and life expectancy are higher, crime and corruption are lower, health and roads are better, and elections are more democratic. Yet, the geography of the region and the demographic make-up of the population are near identical. The reason for the differences between the two sides, the authors posit, is the difference in the institutional make-up of the United States and Mexico. Larger-scale examples include East Germany and West Germany before reunification, and the two Koreas today. Therefore, high quality institutions can also overcome geography, leading to a higher-equilibrium state than low-quality institutions. Indeed, Easterly and Levine (2003) "find no evidence that tropics, germs, and crops affect country incomes directly other than through institutions."

Perhaps even more crucial than institutions is culture[4]. A classic example of culture overcoming geography is given by Max Weber (1905) who argued that Protestant societies were more likely to experience better economic outcomes as the Protestant ethic was embodied among the people in those societies[5]. Thus, it was not the geographic endowments of those countries that mattered, but their particular religious beliefs. This notion of culture as a counterpoint to geography as destiny also holds true not just in Protestant nations but also in the tropics. Judith Tendler's (1997) *Good Governance in the Tropics*, using a case study of a local government in Northeastern Brazil, argues that worker dedication – what workers think and how they respond to community-based needs – can lead to beneficial and effective government performance. Nunn (2012) takes this argument even further, suggesting that the role of institutions was superseded by that of culture. Indeed, Nunn argues that it was cultural beliefs that formed the basis of the early institutions that were critical for long-term development[6].

Geography as Destiny? The Case For

It would be futile to deny the importance of institutions and innovation in economic development. Indeed, the Khazanah Megatrends Forums have long expounded the need for creative disruption and institutional

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[4] For the purposes of this paper, we take culture to be defined as per Guiso, Sapienza and Zingales (2006), as "those customary beliefs and values that ethnic, religious, and social groups transmit fairly unchanged from generation to generation."

[5] This formulation has been challenged by Becker and Woessmann (2009) who argue that it was rather the human capital channel – where Protestants had to learn to be literate as they had to learn to read the Bible – that led to more prosperous economies

[6] Nunn makes this point by showing that the understanding of the transplantation of European legal and political institutions during the colonial period, based on the hypothesis of Acemoglu, Johnson and Robinson (2001) remains incomplete unless the values and beliefs brought by European settlers are taken into account.

efficacy. Yet, why then, for instance, did all Western European countries end up richer and with better institutions than any tropical African country?

According to Montesquieu (1748) [2009], Europe's great rivers, mountain ranges, and forests made it difficult for any one European state to achieve predominance. Political competition amongst its nations required the construction of strong states with good bureaucracies and laws: without which, a state would fall prey to its neighbours. In Central Asia, on the other hand, relatively flat and open plains allowed rapid military power projection and hence, the emergence of dominant empires such as the Chinese dynasties, the Russian empire and the Mughal empire. In sub-Saharan Africa, thick jungles prevented power projection over large distances, and so tribal-level societies prevailed. In this way, geography shaped institutions and state formation.

Geography and factor endowments remain definitive insofar as they shape political institutions, which then persist. Geography determines climate, diseases, the availability of resources like precious metals, rainfall levels, and the feasibility of plantation agriculture which in turn determine the nature of institutions. In many cases, extractive institutions persist over time even when initial conditions that give rise to them have changed. Therefore, it is clear that good institutions do not show up randomly. Rather, the institutional character and the innovative capacity of a nation are *endogenous* to it – the citizens of that nation *choose* their own institutions and their own capacity to innovate.

Malaysia is blessed with incredible 'geography,' whether it is location, climate, natural resource endowments, or protection from environmental disasters. Yet, we still find ourselves the quintessential example of a country in a middle-income trap. One potential issue is as follows – if our geographic dividend has enabled us to prosper more easily in the initial years of our development, it has also impacted our collective Malaysian political, economic and societal culture. In other words, our culture is also shaped by our geography. In particular, this pertains to the rent-seeking nature of resource economies. The political form of the 'Dutch Disease' was introduced by Economics professors Ricky Lam and Leonard Wantchekon (2003): resource booms lead to the consolidation of elite power.

Symbolic of this is the fact that Malaysia leads the world in 'power distance,' a concept developed by Professor Geert Hofstede in the 1970s, which measures the extent to which less powerful members of organisations and institutions such as the family accept and expect that power is distributed unequally. Countries with high power distance may observe traits such as those in authority openly demonstrating their rank, and class divisions within society being de facto accepted. Indeed, data from the World Values Survey finds that Malaysians tend to believe, relative to the rest of the world, that old people have too much influence. Yet, the survey data also shows that they are also more likely to agree that it is completely acceptable for a suitably qualified 70 year old to be appointed as their boss.

With these characteristics, as reported by ordinary Malaysians, it is clear that Malaysians recognise, to some extent, the elite capture of incumbents in our society. The high power distance and the belief that old people have too much influence on society clearly indicate as such. However, the data also shows that Malaysians themselves engender such beliefs – Malaysians are more likely to value older individuals relative to younger ones. Therefore, even if Malaysians do recognise that there are issues with status quo capture, they are also unlikely to be driven to change it. It is little wonder that Malaysia seems to stutter in developing truly inclusive institutions, greater innovation, and higher productivity.

Checking Ourselves before We Wreck Ourselves

One way is to begin to truly view Malaysia as our shared commons. In economics, a common good is one which is non-excludable – everyone is free to use it – but is rivalrous – one individual's usage of it prevents another's usage. In those terms, what we have seen is a cultural collective action problem – a desire to maintain the status quo *despite* knowing that breaking it is required for generating innovation and inclusion. In driving economic growth, we have capitalised on our endowments, privatising the benefits of our geography while socialising the broader economic, social and political costs.

The traditional way to solve the classic 'tragedy of the commons' problem is to issue property rights[7]. Yet, this is hardly feasible and, to some extent, unethical. Given that the traditional measures of overcoming the tragedy of the commons are underwhelming, we turn to Sultan Dr. Nazrin Shah who, in his special address at KMF 2014, raised the issue of the 'paradigm of resource ownership.' By this perspective, the ownership of resources is called into question. If property rights are man-made, and natural resources and land are not, what right does man have to 'own' things he did not create? Against this backdrop, Sultan Dr. Nazrin Shah posits that, "… it is essential for this paradigm to be altered in favour of the worldview of individuals as stewards, rather than owners, of resources. Implicit in this view is the proposition that our right to derive profits from these resources are temporary and that it is our duty to ensure that they remain undiminished and uninjured for future generations."

This perspective places individuals as trustees of our collective geography. As Gandalf the White Wizard states, as written by J.R.R. Tolkien, in The Lord of the Rings, "The rule of no realm is mine, neither of Gondor nor any other, great or small. But all worthy things that are in peril as the world now stands, those are my care. And for my part, I shall not wholly fail of my task…if anything passes through this night that can still grow fair or bear fruit and flower again in days to come. For I also am a steward." However, this is easier said than done. After all, if geography can endogenously shape our views on institutions and capacity for innovation, might it also not shape our view on ethics? This would therefore imply that the task of generating an exogenous ethical 'shock' of stewardship to the system is a truly difficult one with low probability of success. If the solution were truly as simple as 'think collectively,' then surely other resource-rich nations would have done the same. Yet, examples abound globally of political and economic Dutch Disease.

Yet, there is hope. Norway with its vast oil resources had, in 1990, set up a Government Petroleum Fund to invest part of the government's oil rents. By doing so, it prevented the Ministry of Finance from exploiting windfalls in petrol prices to undertake government spending. Domestically, the strength of Petronas in managing Malaysia's oil and gas endowments is also evident. Since its inception, it has worked to undertake proper planning for the orderly utilisation of Malaysia's petroleum resources so as to satisfy both present and future needs of the country. That oil and gas is still a pillar of the Malaysian economy is perhaps a symbol of Malaysia's lack of success in diversifying away from oil and gas

[7] For instance, allocating individual fishing permits to fishermen for a particular area within a fishing zone.

activities, but the resource management prowess of Petronas deserves much credit for ensuring that the pillar still remains. In Sabah, the Sabah Forestry Department developed a management system plan based on forest zoning whereby about 51,000 hectares of forest land was set aside for sustainable log production and 4,000 hectares for conservation in the Deramakot Forest Reserve[8].

At a broader scale, the world is becoming more and more cognizant of the importance of sustainability in future global development. In 2015, the United Nations launched the Sustainable Development Goals ("SDGs") – an enhanced continuation of the 2000 Millennium Development Goals – which aims to end poverty, fight inequality and injustice, and tackle climate change by 2030. The SDGs are meant to set the global development agenda from 2015 to 2030. Closer to home, in 2010, Malaysian Prime Minister Dato' Sri Najib Tun Razak introduced the New Economic Model ("NEM"), with its triumvirate goals of achieving a high-income, inclusive and sustainable economy for Malaysia. In particular, the Sustainability goal of the NEM is focused on meeting present needs without compromising future generations. It is also along these lines that Khazanah seeks to fulfill its mandate of building true value by generating not just financial returns, but, just as importantly, strategic *and* societal returns as well. The key, or true north, to all these goals and objectives – ambitious and idealistic as they are – is good stewardship. Indeed, whether or not Khazanah, Malaysia and the global community achieve their objectives comes down, in the end, to good stewardship.

The Sessions

In the past 12 years since its inception, the KMF has discussed themes ranging from a shifting global economic climate to a reclamation of the global 'commons', a new context where uncertainty is normality to the need to generate growth with inclusion in an age of paradox, and most recently, the need to harness creative disruption to unlock inclusive innovation. In those discussions, the KMF has always emphasised the need to move beyond the maximisation of shareholder value to the maximisation of stakeholder value – in this case, the nation, the firm and the individual.

Thus, in keeping with the tradition of KMF, panel discussions on "Geography as Destiny – Reaping the Dividends of Good Stewardship: The Political Economy of Location, Environment, Demographics" will continue to be organised along four perspectives: on how the various markets are affected, what does the theme mean to firms and society in general, and what are the imperatives of leadership? In addition, the KMF will delve deeper into the theme via special panel sessions on Innovation as well as Ethics. The programme and theme will be further enhanced and rounded out by the various Special Addresses and Luncheon Addresses.

[8] According to Lagan, Mannan and Matsubayashi (2007), the Deramakot Forest Reserve is the first natural forest reserve in Southeast Asia managed in accordance with sustainable forestry principles.

Core Session 1: Macro and Markets

Invisible Hand versus Velvet Fist – This House Believes that Markets are More Effective than Regulation at Addressing Externalities

The largest driver of environmental impact is human consumption, a direct consequence of economic growth and increasing prosperity of individuals and nations. This can be seen via Carbon Dioxide (CO2) emissions, where CO2 parts per million (ppm) in our atmosphere was 280 ppm in pre-industrial times have risen to some 400 ppm today, and is on track to hit 700 ppm by 2100. As such, the true costs of consumption extend beyond just the price of goods and services – there is an added cost, not borne directly by the individual, that is imposed on society. These costs are negative externalities. There are two typical responses to address externalities. The first is to regulate them. However, some are critical of regulators' track records: industries manipulate the regulatory process to serve their vested interests. The second is to create markets. But so far, carbon market "cap-and-trade" approaches to curbing CO2 emissions, have been dismal. The EU carbon scheme has been plagued by low prices due to oversupply. In light of ever-increasing negative externalities, to which scheme should we turn? Are markets more effective than regulation at addressing externalities? Or should governments prevail at this task?

Core Session 2: Firms and Transformation

Solving the Corporate Impossible Trinity? Can Firms Simultaneously Deliver Financial Value, Economic Value and Societal Value in a Low Growth World?

The Impossible Trinity, or 'Trilemma', of international macroeconomics is the impossibility for nations to simultaneously have a fixed exchange rate, free capital flows, and monetary independence. In the case of firms, we posit the existence of a Corporate Impossible Trinity where firms face a near-impossible task to simultaneously deliver financial value for their shareholders, economic value for national development, and societal value for citizens and the community. This is especially true in a low growth world, which is the circumstance in which firms find themselves today. When the financial pie is stagnating, how then do firms distribute dwindling returns to all their stakeholders, as they would in high growth environments? In other words, how do firms continue to create value but also 'do good' in a difficult low growth world?

Core Session 3: Growth and Development

Going Dutch or True North? Extracting the Blessings, not the Curse, of Rich Endowments

One of the most common challenges facing endowment-rich countries is the Dutch Disease. The Dutch Disease is the negative impact on an economy resulting from anything – typically resource booms – that gives rise to a sharp currency appreciation, which adversely impacts the manufacturing sector. Thus, countries fail to diversify away from the resource sectors into the more productive manufacturing or industrial sectors. Furthermore, Dutch Disease may also infect the political sphere, engendering rent-seeking behaviour which results in elite capture and high power distance. Yet, there is still hope for not every country with resources goes the way of the Congo, or Nigeria or, indeed, the Dutch. Indeed, some manage to turn the resource curse into a blessing, as in the case of resource-rich Norway, the United States and, to an extent, China. Thus, how do governments and policymakers ensure that it is the blessings, and not the curse, of rich endowments that is extracted?

Core Session 4: People and Leadership
Reclaiming the Commons – From the Paradigm of Ownership to the Paradigm of Stewardship

Many areas of our global commons today are at threat: our oceans face plastic pollution, our air is infused with greenhouse and poisonous gases, and our forests and grasslands are plagued by deforestation and overuse. In many cases, boundaries and private property rights are hard to establish for these common-pool resources, so a paradigm of stewardship requires a buy-in from not just governments, but also firms, and ultimately individuals. To drive this, leaders are, as always, critical. Yet, not all leaders are born the same, and, more so, not all leaders are made the same. If our ethics are also a product of our environment and hence, our geography, how would leaders who practise stewardship naturally arise? What sort of leader is required for a development path that places stewardship at its core?

Special Session in collaboration with TedxKL
Innovation without Borders 2.0 – Unlocking the Power of Inclusive Innovation

In KMF 2015, we explored how by harnessing Creative Disruption, we could unlock the power of inclusive innovation to better understand and improve lives and livelihoods. Indeed, one of the greatest contributions of innovation and technology in an increasingly complex and rapidly shifting world is to helps us better make sense of our world. From big data to virtual reality to social enterprise to machine learning, this panel explores how innovation and technology helps us better understand, and more importantly, empathise with our fellow human beings and our shared global commons.

Special Session: The Ethics of Managing Geography
Stewardship in Action

Sultan Dr. Nazrin Shah posits that, "Implicit in [individuals as stewards] is the proposition that our right to derive profits from these resources are temporary and that it is our duty to ensure that they remain undiminished and uninjured for future generations." This proposition places individuals as trustees of our collective geography, a notion that, like many other perspectives of idealism, while attractive, is much easier said than done. Examples abound of leadership gone wrong, with corruption, rent-seeking and selfish pursuits familiar stories across the world. Yet, all we have to do is to look carefully around us to see individuals that are already walking the walk as stewards. This panel demonstrated stewardship in action, looking at individuals who in their day to day lives embrace the notion of stewardship in managing geography, be it environment, location or demographics.

Principal Authors: Nick Khaw and Aidan Chan

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For further readings on these topics, the authors recommend the following books:

Geography

- *“Why Nations Fail”* by Daron Acemoglu and James Robinson
- *“Guns, Germs and Steel”* by Jared Diamond
- *“Collapse: How Societies Choose to Fail or Succeed”* by Jared Diamond

Stewardship

- *“Good Governance in the Tropics”* by Judith Tendler
- *“Bad Samaritans: The Myth of Free Trade and the Secret History of Capitalism”* by Ha-Joon Chang
- *“Political Order and Political Decay”* by Francis Fukuyama

Location

- *“Malaysia@50: Economic Development, Distribution, Disparities”* by Jomo Kwame Sundaram and Chong Hui Wee
- **“***Connectography: Mapping the Future of Global Civilisation”* by Parag Khanna
- *“Location Is (Still) Everything: The Surprising Influence of the Real World on How We Search, Shop, and Sell in the Virtual One”* by David R. Bell

Environment

- *“Economics and the Environment: Selected Readings*” by Robert Stavins
- *“Markets and the Environment”* by Nathaniel Keohane and Sheila Olmstead

- *"The Importance of History for Economic Development"* [Article] by Nathan Nunn

Demographics

- *"The Big Ratchet: How Humanity Thrives In The Face Of Natural Crisis"* by Ruth DeFries
- ***"****Common Wealth: Economics for a Crowded Planet"* by Jeffrey D. Sachs
- *"The Demographic Cliff: How to Survive and Prosper During the Great Deflation Ahead"* by Harry S. Dent Jr.