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MALAYSIA IN TRANSITION

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The Malaysian economy has undergone rapid transformation within a short span of two decades and has a vision to become a fully developed economy by the year 2020. This paper provides a brief synopsis of this remarkable growth and structural change within Malaysia's historical and political developments. It also highlights the problems associated with rapid transformation. The paper argues that the spectacular transformation of the economy cannot be explained by the conventional wisdom of either neo-classical variety or statist paradigm. The paper attributes much of Malaysia's success to its racial compact at the time of independence and the subsequent pursuit of the New Economic Policy which aimed at racial and political harmony within the context of a growing economy. How successfully Malaysia can move toward an "innovation driven" society will depend very much on its success at political reforms toward a more open and plural system.

Introduction

Malaysia, the star performer among the Southeast Asian nations, has posted a sustained high growth rate of around 9 percent per annum for eight years in a row (1988-1995). The results have been a spectacular rise in gross domestic product (GDP) per capita, estimated at US$2,581 in 1991, and a rapid structural change. The share of manufacturing in GDP rose from 15 percent in 1970 to a staggering 40 percent in 1993, qualifying Malaysia as an industrialised or at least a next-tier newly industrialising economy (NIE). This rapid transition of Malaysia from an agricultural and resource-based economy to an NIE defies the conventional East Asian development paradigm which relies either on cultural

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determinism (so-called confucianism) or on a strong state autonomous from narrow interest groups. This paper seeks to locate Malaysia's transition within a political economy framework and attributes much of its success to the concept of "shared growth" enshrined in the New Economic Policy (NEP) designed to balance the economic interests of dominant racial groups. It begins with a brief outline of Malaysia's history and political developments followed by a snapshot of its economic transition. The importance of NEP can be better understood within a historical and political context that has shaped modern Malaysia.

History and Political Developments[1]

The modern Malaysia came into existence after gaining political independence from the British rule on August 31, 1957. It consists of 11 states in Peninsular Malaya and 2 states in the island of Borneo. However, its historical roots lie in the founding of the Malacca *Sultanate* (Kingdom) in 1400 AD. Malacca was a vigorous trading and cultural center which influenced the shaping of political institutions and traditional Malay culture through the succeeding centuries. Malacca was captured by the Portuguese in 1511 and subsequently by the Dutch in 1641. The colonial powers attempted to prevent the rise of another Malay state in the peninsula which could rival the distinction of Malacca. By the mid-18th century the modern geopolitical pattern of Malay states emerged in the peninsula beyond the influence of the European-fortified entrepot of Malacca.

In an attempt to secure the trade route to China through the Straits of Malacca, the British captured the Island of Penang in 1786 and Malacca in 1795. Following the establishment of a trading post in Singapore in 1819, the British formed a single administrative unit, the Straits Settlements in 1826 comprising Penang, Malacca and Singapore.

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[1] This section draws heavily from Brown (1996).

The Straits Settlements were administered from British India until 1867 when the administration was transferred to the colonial office in London.

Although initially the British did not want to get involved with the Malay states, the rivalry among Malay rulers following the discovery of major tin deposits in Perak and other mining activities slowly drew the Straits Settlements into closer political and economic ties with its hinterland. As the Malay rulers fought among themselves often using the secret societies of migrant Chinese workers to control newly found wealth, there was total collapse of law and order by the late 1860s. The local Chinese and European merchants urged the Straits Settlements to intervene and restore order. In 1873 the British Government agreed to intervene in the fear that the chaos would give the rival German colonial power an opportunity to capture the peninsula, threatening its commercial interests. Over the period 1874-88, the British entered into agreements with the Malay rulers of Perak, Selangor, Negri Sembilan and Pahang, which required the *Sultans* (Kings) to accept a British Resident whose advice 'must be asked and acted upon on all questions other than those touching Malay religion and custom'. The *Sultans* were allowed to keep all their privileges and the splendour of Malay ceremonial court. This agreement effectively turned the Malay rulers into figureheads while the executive powers rested on the British Resident.

A Federated Malay States (FMS) with the four signatory states was established in 1896 and Kuala Lumpur became its capital. By 1914 the four northern states of Kedah, Perlis, Kelantan and Trengganu and the southern state of Johor accepted permanent British advisers. Although these five states remained outside the FMS and became collectively known as Unfederated Malay States (UMS), the acceptance of permanent British resident advisers effectively allowed the British rule to extend throughout the Malay peninsula.

The British rule was interrupted by Japanese occupation during 1942-45. After the Japanese surrender, the British began negotiations with a new political force, the United Malays

National Organisation (UMNO), and the Malaya rulers to form a unified administration of Malayan Union, combining FMS, UMS, Penang and Malacca. This eventuated in the formation of the Federation of Malaya in February 1948. The new constitution of the Federation maintained the sovereignty of *Sultans* and granted citizenships to the Chinese and Indian settlers.

The restrictive citizenship requirements for the Chinese and Indians angered the non-Malay settlers, in particular the Chinese who regarded the Federation as a betrayal of the loyalty they had shown to the British during the Japanese occupation. This strengthened the hardliners in the Communist Party of Malaya (CPM) which launched a guerilla warfare against the colonial rule. However, the CPM did not enjoy much support among the Malays and by the mid-1950s the communist insurgency died down.

By then, however, the British decided to grant self-government to the Federation and worked toward finding a consensus among the various ethnic groups. The negotiation among the various groups resulted in a compromise whereby the Malays retained the political power and in exchange allowed the Chinese to continue their economic functions with the understanding that in time more equality would be achieved among the races in both economic and political spheres. The new constitution also had the provision for a single nationality, with citizenship open to all those in Malaya who qualified either by birth or by fulfilling requirements of residence and language. Independence was proclaimed on August 31, 1957 and the UMNO President, Tunku Abdul Rahman became the first Prime Minister. The government was formed by the coalition of major ethnic-oriented parties such as the UMNO, the Malayan Chinese Association (MCA) and the Malayan Indian Congress (MIC).

Singapore joined the Federation of Malaya in 1963 when it gained full independence. But in order to prevent the Chinese from becoming a numerical majority with Singapore's entry, Sarawak and North Borneo (renamed Sabah) were also taken into the Federation to form the Federation of

Malaysia. However, Singapore's membership was always an uneasy one due to its more "radical" politics and Lee Kuan Yew's intention to participate in the politics of the mainland. Singapore was, thus, expelled from the Federation in 1965.

The formation of the Federation of Malaysia was not taken very easily by Indonesia and the Philippines which had laid its territorial claim to North Borneo (Sabah). In 1963 both Indonesia and Philippines broke off diplomatic relations with Malaysia and Indonesia launched a series of military confrontations. However, after the failed coup in Indonesia in 1965 and Suharto's accession to presidency, the tension eased. Later the formation of the Association of South East Asian Nations (ASEAN) in 1967, a quasi-security arrangement against the advancing communists, helped greatly improve Malaysia's relations with both Indonesia and the Philippines.

Malaysia has always been a multicultural society where the indigenous Malays had been interacting with the Chinese, Indians and other cultures ever since the spice trade flourished along the prosperous maritime trade route linking China and India thorough South-East Asia. The Arab traders brought Islam and the majority of Malays are Muslims. The Chinese and Indians migrated mainly during the colonial period to work in plantations and mines. In Peninsular Malaysia, the Malays constitute about 59 percent of the population, the Chinese 31 percent and Indians 10 percent. In Sabah and Sarawak, the Chinese population comprise about 14 percent and 29 percent respectively. Despite a long history of interactions among the Malays, Chinese and Indians, a common culture did not emerge and each group maintained more or less their distinct ethnic and cultural identity. The division of economic functions along ethnic lines was largely responsible for mutual distrust and perhaps prevented cultural integration to some extent.

Political Developments

Malaysia is a Parliamentary democracy with a figurehead monarch and an executive parliament elected by popular votes. The conference of independent Malay rulers (*Sultans*) elect the Monarch (*Yang di-Pertuan Agong*) from among themselves. The current Monarch (elected in 1994) is Tunku Ja'afar ibni Al-Marhum Tunku Abdul Rahman, the Sultan of Negri Sembilan. The Sultan of Selangor is his deputy.

Political developments in Malaysia are driven primarily by ethnic tensions and compromises. Malaysia, since its independence, has been ruled by a government of coalition among UMNO, MCA and MIC — the three major parties representing Malays, Chinese and Indians, respectively. The compromise that was hatched between the coalition partners at the eve of independence failed to fulfil the rising expectations of young generations. The new generation of Malays wanted more and quicker economic gains and the non-Malays (in particular the Chinese) were unhappy with the lack of their political control. The resentment culminated in a bloody race riot in May 1969.

The reassessment of the earlier compromise following the riot led to the formulation of the New Economic Policy (NEP) to be implemented over 20 years to 1990. Its primary objectives were the eradication of poverty among all races and of the identification of race with economic function. The latter was designed to give the Malays a greater share in economic wealth with a specific target of raising the share of Malays and other indigenous people (*bumiputra*) to 30 percent of commercial and industrial capital by 1990. It was also recognised that for the maintenance of racial harmony the increase in Malay shares in wealth should not be achieved at the expense of other races. (The NEP's role in economic growth with distribution in Malaysia is discussed later.)

A new legislation was also introduced immediately after the 1969 riot, which removed such sensitive matters as the powers and status of *Sultans*, Malay special rights, the status of Islam as the official religion and citizen rights from public discussion. Under the leadership of new Prime Minister Tun Abdul Razzak the ruling coalition of UMNO-MCA-MIC was reorganised as Barisan National (National Front) or BN which included other major opposition parties. This was designed to prevent public discussion of sensitive issues which was made seditious, but allowed the bargaining of communal interests to take place in a more discreet manner within the government.

As the economic growth rate declined during the early 1980s due to global economic recession, a new element surfaced in Malaysian politics. Intra-racial politics became dominant in the 1980s as coalition partners, especially UMNO and MCA, faced growing discontent among their own constituencies. The Malays, Chinese and Indians became disillusioned and blamed their respective parties in the ruling coalition for not doing enough. This resulted in the formation of new opposition parties by disaffected members who left UMNO or MCA. However, the ruling Alliance managed to fend off opposition attacks and scored victory in successive elections. The resounding victory of BN and its dominant partner UMNO, especially in opposition heartlands, in the 1995 election has strengthened the leadership of Dr. Mahathir against the opposition both within and outside his own party. Dr. Mahathir has further consolidated his position by succeeding in bringing the breakaway faction of Tenku Razaleigh into the UMNO fold, and securing an UMNO ruling that at the triennial party elections in October 1996, his and the deputy's position will be uncontested. It seems that by having neutralized a potential rival in Razaleigh and the provision of no contest, Mahathir has effectively blocked any challenge to his leadership from the more ambitious Deputy Leader Anwar Ibrahim.

The 1980s also witnessed the growing tension between the executive government of Dr. Mahathir who became the Prime Minister in 1981 and the traditional Malay rulers. Dr. Mahathir won public support in his attempt to restrict the powers and privileges of *Sultans* which shows the weaning of traditional values in a modernising society where public tolerance for the excesses of feudal rulers declines. A new code of conduct was agreed upon in July 1992 with the *Sultans* outlining the parameters of their involvement in both politics and commerce. The constitutional amendments, approved in May 1994, further curbed the powers of *Sultans* by restricting their personal legal immunity. The amendments also introduced a mandatory code of ethics for judges to be drawn up by the government. This has the potential to jeopardise the separation of the judiciary and the executive.

The Economy

With the "Vision 2020", Malaysia aspires to reach a developed country status in the year 2020. This section provides a snapshot of the spectacular transformation of the Malaysian economy since the adoption of NEP in 1971.

Growth and Structural Change

Table 1 presents the basic macroeconomic indicators of the Malaysian economy. The global recession in the early 1980s, and the collapse of the international tin market in 1985 on top of the slump in oil prices were primarily responsible for a decline in GDP by roughly 1 percent. However, Malaysia successfully came out of the recession with a real GDP growth of 5.4 percent in 1987. Real GDP grew at about 9 percent in the subsequent four years.

Table 1 - Basic Macroeconomic Indicators

	1971-1980	1981-1990	1993	1995
Real GDP Growth Rate (%)	7.8	5.2	8.3	9.6
Inflation Rate (%)	6.0	3.2	3.6	4.2
Share in GDP (%)				
Gross domestic saving	29.1	33.0	35.9	36.7
Gross domestic investment	24.9	30.7	35.0	37.6
Current account	-1.2 [a]	-1.9 [b]	-3.3	-9.2 Debt
Servicing Ratio (% exports)	4.6 [a]	29.0 [b]	7.9	5.0

Sources : ADB, *Outlook* (various issues).
Notes : a : 1980; b: 1985

As can be seen from the table, the inflation rate, measured in terms of changes in consumer price index, has been kept in check. After a slight increase in the inflation rate, it has fallen to 3.6 percent. This was largely achieved by cuts in import duties and other statutory charges. But the economy is showing some signs of distress as the inflation rate and the current account deficits are worsening.

The economic growth and the compulsory employee provident fund contributed largely to a rapid rise in savings rate. But the economic buoyancy and ambitious infrastructure projects have resulted in a sharp rise in current account deficit, which jumped from less than 4 percent of GDP in 1993 to slightly over 9 percent in 1995.

Table 2 shows the rapid structural change of the Malaysian economy during the past two decades. Manufacturing, which contributed only 16.4 percent to the GDP of a predominantly agricultural and primary producing country, now accounts for 40 percent of the total output in the economy. Manufacturing grew by an average annual rate of 10 percent during the 1970s and 9.4 percent between 1980-1991. The average growth rate of manufacturing was 12-13 percent per annum during 1991-94. On the other hand, agriculture grew by an annual average rate of around 5 and 4 percent in the 1970s and 1980s, respectively.

Table 2 - Sectoral Contributions to GDP (%)

Sector	1975	1980	1985	1990	1995
Agriculture	27.7	22.9	20.7	18.7	15.9
Industry	26.8	37.0	36.7	38.5	44.7
Manufacturing	16.4	19.8	19.7	26.9	40.0
Mining & Quarrying	4.6	10.1	10.5	9.7	10.3
Services	45.5	40.1	42.6	42.8	39.4

Sources: ADB, *Key Indicators* (various issues).

As can be seen from Table 3, most manufacturing activities were able to hold on to their position in terms of their share in manufacturing value added (MVA) during the 1980s. The big losers, though, were food, beverage and tobacco (ISIC 31), wood and furniture (ISIC 33), and rubber products, whereas chemicals (ISIC 351, 352), electrical machinery (ISIC 383) and transport equipment (ISIC 384) registered gains. Electrical equipment which include television receivers, video cassette recorders, air-conditioners, personal computers, typewriters and domestic refrigeration was the fastest growing. Its average annual growth rate of about 19 percent was nearly 10 percentage points higher than the overall growth of the manufacturing sector during 1980-91, resulting in an increase in its share in MVA from 12 percent in 1979 to 22 percent in 1989.

Table 3 - Share in Manufacturing Value Added (at factor costs, %)

Industries	1979	1985	1989	Growth Rate (%) 1980-91
Food, Beverage & Tobacco	25	21	13	2.8
TCF & Leather Products	7	5	6	8.2
Wood Prod. & Furniture	12	6	7	n.a
Paper & Printing	5	5	5	n.a
Chemicals	6	16	11	7.6
Petroleum & Coal	4	4	2	8.1
Rubber	10	5	6	5.0
Plastic,Pottery, Glass & Non-Metal Products	7	9	9	8.9
Iron & Non-Ferrous Metal	6	7	7	8.7
Machinery	3	2	4	n.a
Electrical Machinery	12	15	22	18.8
Transport equipment	4	4	6	11.9
Professional equipment	1	1	1	n.a
Other	1	1	1	n.a

Sources : UN, *Yearbook of Industrial Statistics* (various issues).

Despite some structural change within the manufacturing sector, it still remains primarily labor-intensive. After rising very rapidly (20.0 percent per annum) during 1980-85, the growth of the capital-labor ratio dropped to -0.2 percent during 1985-91 (Rasiah, 1985, p. 84). This temporary growth in the capital-labor ratio was a result of the major restructuring of the electronic industry and the launching of heavy industries. The failure to raise capital-intensity significantly has serious implications for the labor market as discussed in a subsequent section.

External Trade

The rapid structural change of the Malaysian economy is also reflected in its external trade (Table 4). The share of agricultural products in total merchandise exports dropped from nearly 44 percent in 1980 to about 13 percent in 1993. Similarly, the importance of petroleum and other mineral products declined sharply from 34 percent in 1980 to about 14 percent in 1993. On the other hand, manufacturing's share in total merchandise exports rose from 22 percent to 74 percent during the same period. Since 1990, manufacturing exports grew on an average of 30 percent per annum.

The composition of manufacturing exports , too, changed significantly. For example, the share of electrical machinery in manufacturing exports dropped from 40 percent in 1980 to 22 percent in 1992. This drop was taken up almost entirely by telecommunications equipment whose share rose from 3 percent to 19 percent. Sound recorders and office machines also increased their share from less than one percent to 7 and 9 percent, respectively in 1980 and 1992.

Malaysia's industrialisation process depends highly on imported capital and intermediate products. Together, they account for nearly 80 percent of Malaysia's imports. The rapid industrialisation and economic growth have been generating import demands and merchandise imports grew by 36 percent, 30 percent and 26 percent in 1989, 1990 and 1991, respectively. In the first seven months of 1994, imports of investment goods rose by 29 percent and intermediate goods by 35 percent. Total merchandise imports grew by 32 percent in 1994. Table 5 presents the composition of Malaysian imports by types of use.

The high dependence on foreign investment for industrialisation and the consequent repatriation of profits and dividends resulted in consistent deficits on services trade. Freight and insurance payments also place a significant strain on the services account. This is offset to some extent by increased international tourism revenues.

Table 4 - Major Malaysian Exports (% of total export value)

Item	1989	1992	1994[a]
Manufactures	54.7	69.8	78.3
Crude Petroleum	11.0	8.7	4.5
Palm Oil	6.7	5.2	4.5
Sawn Logs	6.3	3.7	1.7
Rubber	6.5	2.2	1.6
Liquefied Natural Gas	3.0	2.3	1.7
Tin	1.8	0.7	0.4
Other Commodities	10.0	7.4	7.3

Source : DFAT, 1995; Notes : a: January-July.

Table 5 - Malaysian Imports by Types of Use (% of total)

Item	1990 (Jan.-Aug.)	1992 (Jan.-Dec.)	1994 (Jan.-Jul)
Investment goods	36.4	42.0	40.8
Intermediate goods	41.3	41.3	43.9
For manufacturing	31.8	32.1	n.a
Consumption goods	21.5	16.1	14.7
Imports for re-exports	0.8	0.6	0.5

Source : Same as Table 4

Singapore, Japan, the US and European Union are Malaysia's major trading partners. Together they account for more than 65 percent of exports and 70 percent of imports. The Asian NIEs are also becoming important trading partners. Malaysia's competitiveness, measured in terms of real exchange rate, with Japan has registered a sharp increase in recent times, as the yen continues to strengthen. Its competitiveness with East Asia has also been increasing, albeit slowly. But there is a sign of declining competitiveness with industrial countries taken together.

Table 6 shows the geographical distribution of Malaysia's exports and imports. The discrepancy in the shares of exports to and imports from Japan and the US is a reflection of the fact that Japan is increasingly using Malaysia as a production platform for labor-intensive and medium-tech products for export to the US.

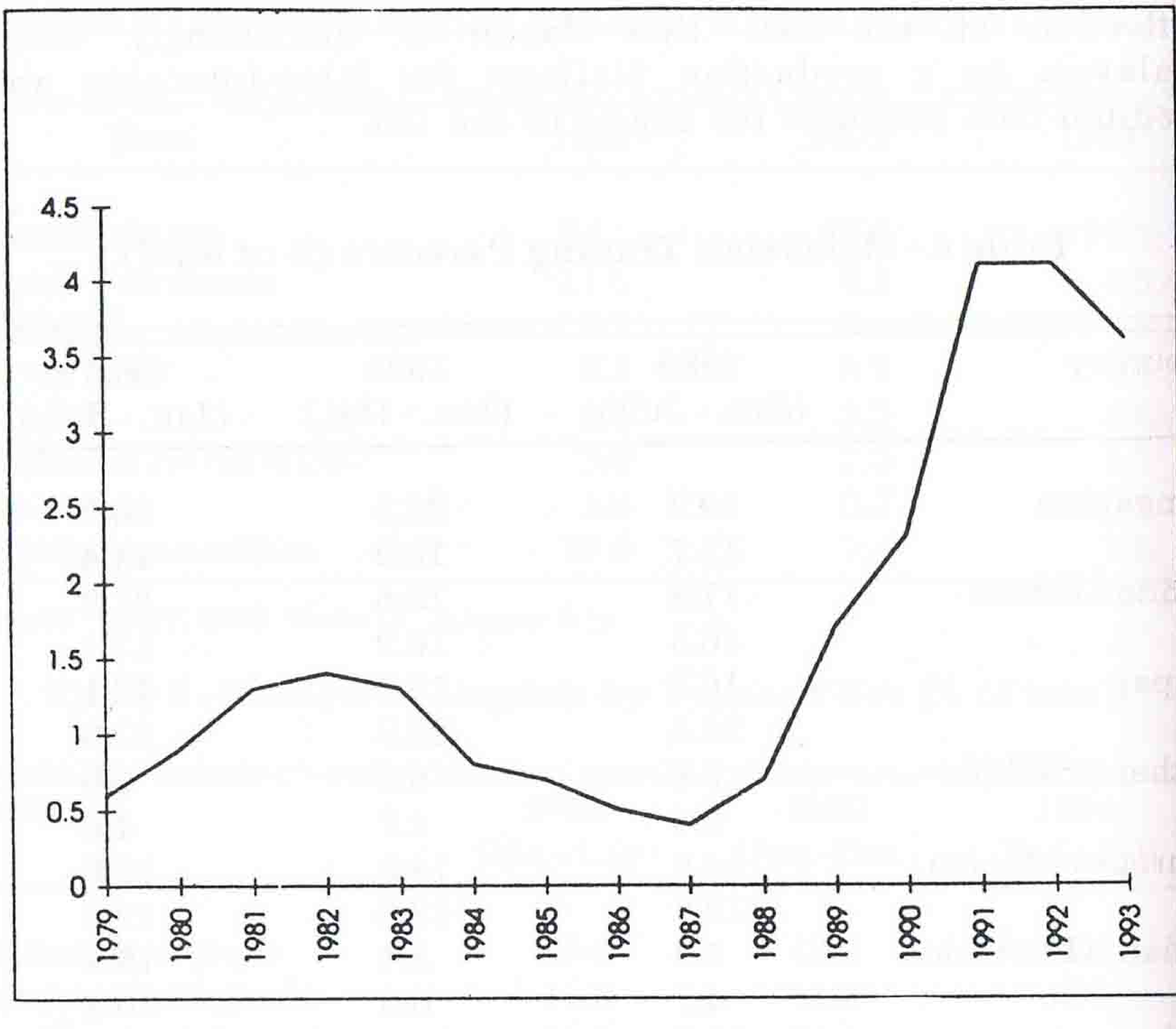
Table 6 - Malaysia's Trading Partners (% of total)

Country	1989 (Jan. - July)	1992 (Jan. - Dec.)	1994 (Jan. - July)
Singapore	19.2	23.3	20.7
	13.7	15.9	14.4
United States	17.8	18.6	21.2
	16.5	16.9	17.1
Japan	16.5	13.2	12.1
	24.3	25.9	27.0
Other ASEAN	5.8	6.5	6.6
	5.4	4.7	4.6
European Union	14.9	14.8	12.6
	13.7	12.6	12.6
Asian NIEs/China	5.3	3.4	10.4
	4.7	8.0	10.4
Others	20.5	20.2	16.4
	21.7	16.0	13.9

Source : Same as Table 4.
Notes : 1st row = exports from; 2nd row = imports to.

Foreign Investment

Malaysia's policy of wooing foreign investment through a combination of attractive incentive packages and the provision of infrastructural support in the export processing zones was extremely successful in attracting multinationals. According to the World Bank, Malaysia was one of the top five recipients of foreign direct investment (FDI) in the developing world during 1987-1991 (DFAT, 1995, p. 15). Strong economic growth, political, and macroeconomic stability, availability of trained manpower and good physical infrastructure attracted high levels of much needed foreign investment. Figure 1 shows that inflow of foreign direct



Source: ADB, Key Indicators. (Various Issues)

Figure 1 – Foreign Direct Investment in Malaysia (In billion U.S.$)

investment (FDI) increased rapidly since 1989. In response to government policy changes, FDI rebounded in 1994 after a drop in the previous year. In the first nine months of 1994, the Ministry of Trade and Industry approved 457 projects with foreign investment components of M$9.61 million compared with 390 projects worth M$3.23 million in the corresponding period of 1993. In addition to attractive tax incentives, the appreciation of the yen and the merger and acquisition activities of multinational corporations also contributed to the high inflow of foreign capital. However, Malaysia will continue to face competition from other low-wage countries.

Taiwan, Japan, the US, EEC and Singapore are the major sources of FDI into Malaysia. In 1990, Taiwan and Japan accounted for 35.8 percent and 24 percent of FDI, respectively. Taiwan's share in FDI in 1994 stood at 24.1 percent and that of Japan at 20.4 percent. Among the other major sources of FDI in 1994, the US supplied 11.6 percent, Singapore 9.5 percent and Hong Kong 8.2 percent.

Manufacturing received the bulk of FDI, with concentration in electrical and electrical activities. Chemicals, coal and petroleum products, mechanical equipment and textiles industries also attracted substantial FDI.

Malaysia is trying to reduce its dependence on multinationals and has a target of 60:40 ratio between domestic and foreign investment. The ratio has increased from 40:60 in 1993 to 46:54 in 1994. In order to accelerate the achievement of the target, the government has set up a M$1 billion domestic investment fund in the 1995 budget. This will be supplemented by an allocation of M$71.6 million to develop basic infrastructure for small and medium sized industries.

In line with the general trend observed in other NIEs, Malaysia is turning into a capital exporting country (OECD, 1993). In 1990, FDI outflow from Malaysia stood at US$205 million. The major recipients of Malaysian FDI were Papua New Guinea, Singapore, Thailand and the UK. However, recently the aviation industry in the US and the Japanese services sector attracted Malaysian funds. ASEAN as a whole received 23 percent of Malaysian investment between 1988 and 1993. About 35 companies invested in China and Malaysian investors are concentrating on the regional niche markets, such as Viet Nam and Cambodia, and on raw material-based industries in which they possess management skills (ADB, 1994, p. 107). In order to encourage Malaysian overseas investment, a new statutory board, the Malaysia Trade Development Corporation, was set up in 1993 and the 1995 budget has exempted income remitted from abroad fully from tax.

Labor Market Developments

The continued buoyancy in the economy has resulted in a steady decline of the unemployment rate from the peak of 8.7 percent in 1987 to 2.9 percent in 1994. The market for skilled work force, particularly in manufacturing and construction, is extremely tight. As the boom in manufacturing, services and construction sector draws workers from the traditional sectors, the plantation sector is increasingly becoming dependent on migrant workers. According to the Asian Development Bank estimates, at least half a million of the total labor force of eight million are foreign workers (ADB, 1994, p. 103). Another estimate shows that there are about 200,000 illegal foreign workers in Malaysia (APEG, 1994, p. 150). According to the *Economist*, (May 11, 1996, p. 26) 'at least 1M immigrants ... now fill lower-paid jobs. More worrying is the lack of qualified Malaysian staff to fill senior technical and managerial posts'.

The government imposed a ban on further recruitments of foreign workers on January 8, 1994 to allow the police to complete a crackdown on illegal migrants. The heavy-handed dealing by the government has failed to stem the flow of illegal migrant workers. Rather, the trade in migrant workers has gone more underground with serious violations of human rights and rise in labor costs (*Far Eastern Economic Review*, May 23, 1996). The ban was lifted in the middle of 1995 and the manufacturing and construction sectors were allowed to recruit skilled and semi-skilled foreign workers and to hire from the pool of foreign workers already within the country (ADB, 1994, p. 104).

Education and training has received the largest ever allocation in the 1995 budget as a response to skill shortage. A host of tax incentives are also offered to the private sector for implementing technical or vocational training programs or automation projects. Under the Human Resource Development Act of 1992, firms employing 50 or more Malaysian workers are eligible to apply for government assistance. These firms are required to contribute 1 percent of their workers' wage to the Human Resource Development Fund (HRDF). Institutions which run approved training programs can also apply for the Industrial Building Allowance. Government has also embarked on the privatisation of several education and training institutions.

The tight labor market is fuelling wages growth. The wages in the manufacturing sector grew at a rate of 11-12 percent in 1993 and 1994. The labor productivity growth, on the other hand, lagged behind. According to the Malaysian Institute of Economic Research, the productivity gap is about 6 percent (DFAT, 1995, p. 32).

The tight labor market has also forced the government to allow female workers in the night shift. The female participation rate in the manufacturing labor force rose dramatically since 1980, especially in the electronic sector (Hasiah, 1995, p. 87). There has also been a narrowing of the male-female wage gap. In some industries (for example, bookbinding, weaving), the average female monthly earnings exceed that of males.

Malaysia is well-known for a very tough industrial relations legislation. To begin with, trade union activities were not allowed in the "pioneer industries" until the early 1970s. The Trade Union Act of 1959 required the unions to confine their membership to employees within a particular trade. Union power was further curtailed in the Industrial Relations Act of 1967 by prohibiting unions to bargain for better terms of employment involving promotions, retrenchments, transfers and allocation of duties. 'As a consequence, union's role in Malaysia has been limited to bargaining on limited issues; examples include wages and defending workers on certain basic rights ...' (Rasiah, 1995, pp. 77-78).

There is no legislated minimum wage in Malaysia. Industrial relations are governed by the Employment Act of 1995 which allows for enterprise bargaining. In response to an increase in industrial accidents, the government has introduced an Occupational Safety and Health Act.

The government discourages the formation of national unions and only about 10 percent of the labor force is unionised. The key private sector unions are the Malaysian Trade Union Congress (MTUC) and the Malaysian Labor Organisation (MLO). The MLO is a splinter group of MTUC and is sanctioned by the government.

Government Policies

Malaysian development and the role played by the state owe much to the ethnic 'settlement' that was bargained among the Malays, Chinese and Indians at the time of independence in 1957. The leaders of the three ethnic groups agreed at independence to a modus vivendi: recognition by the Chinese and the Indians of the primacy of Malay political power and of special rights and privileges for Malays, in return for full citizenship rights and a voice in government. This bargain also meant that the Chinese would continue to have economic dominance as long as they did not challenge the political dominance of the Malays (Bowie, 1988, p. 54; Alamgir, 1994, p. 70). This broad agreement among the three ethnic groups regarding the separation of roles severely limited the state's ability to act autonomously. The laissez faire economic policy in the 1960s can largely be explained in this light. According to Bowie (1991, p. 74):

Malay leaders, recognizing that Chinese and Indian political acceptance of UMNO hegemony was conditional on the state's not interfering in private commerce and industry, beyond the performance of its traditional regulatory functions, were constrained from imposing any particular vision of Malaya's industrial future on the private sector. Moreover, all parties to the settlement shared a common interest in suppressing claims to special treatment (i.e., state promotion of particular manufacturing industries over others).

Thus, the communal settlement of 1959 contributed to Malaysia's economic growth in the first decade of her independence in at least three ways. First and most significantly, it ensured that the Chinese economic dynamism was not interrupted. Second, it shielded the state from rent-seeking activities during the import substituting industrialisation phase of the 1960s. Third, it provided the stability which many decolonised nations like India and Pakistan did not enjoy. This made Malaysia attractive to foreign investment at the time when multinationals were looking for off-shore production platforms. It must also be mentioned that being constrained in its policy toward the industrial sector, the government's development efforts during the 1960s focused primarily on the rural-agricultural sector. As a result, the rural and agricultural sector received the bulk of the public investment. The agricultural and rural development spending accounted for 17.6 percent of public investment during 1961-65 and 26.3 percent during 1966-70 as opposed to 2.5 percent and 3.3 percent for the industrial development during the corresponding periods (Bowie, 1991, p. 69). The focus on the rural and agricultural sector also matched with UMNO's concern to establish its legitimacy with the Malay population, majority of whom lived in rural areas. The heavy infrastructural development in rural areas contributed significantly to the growth of agricultural output.

The Race Riot of 1969 and the New Economic Policy (NEP)

Although the laissez faire approach to commerce and industry was found to be congenial to economic growth as it ensured the Chinese economic dynamism, it perpetuated "separate and unequal" development of the three ethnic communities. As expected, most of the benefits of economic growth were raked in by the Chinese community. This widened the gap between the Malays and Chinese. The small number of new generation Malay entrepreneurs felt the Chinese competitive edge and began to question the validity of the 1957 bargain. At the same time, the non-Malays were resentful of Malay "special rights" and felt a keen sense of discrimination (Sivalingam, 1998, p. 38). The growing ethnic tension culminated in the violent race riot of May 13, 1969.

The events of 1969 represent a major watershed in Malaysia's economic and political history. As mentioned earlier, politically, the riot meant an end of the earlier communal settlement on the separation of economic and political roles along ethnic lines. In economic terms, it ended the laissez faire approach to commerce and industry. The Malay political leadership responded to the riot with the New Economic Policy (NEP) which provided the state with the vehicle for a more active role in economic affairs.

The primary thrust of the NEP was to 'accelerate the process of restructuring Malaysian society to correct economic imbalance, so as to reduce and eventually eliminate the identification of race with economic function' (Second Malaysian Plan, 1971-75, p. 70). The state became the main instrument for this economic reorganisation. With a view to increasing the Malay share in business and employment, a large number of state corporations were set up along with the introduction of quotas on enrolments for different ethnic groups in public educational institutions. Government also used a preferential credit system to channel funds to Malay business and to preferred industrial sectors.

NEP: A Recipe for Disaster?

According to the neo-classical political economy, the above expanded role of the state as proclaimed in the NEP is a recipe for disaster as it distorts the price signals, In addition, the interventionist state becomes a fertile ground for rent-seeking and directly unproductive activities by vested interest groups, which in this case is clearly the Malay ethnic community. One can, in fact, cite numerous examples where state interventions went wrong. According to Balassa (1991, p. 148), over a half of state enterprises posted loses in 1986. Among them is the most notorious example of the M$2.5 billion loss by Bumiputra Malaysia Finance which revealed the corruption and personal interests of the management (Bowie, 1988, p. 64). Government's heavy industry initiatives of the early 1980s were also largely regarded as disappointing (UNDP/World Bank, 1985; MIDA/UNIDO, 1985). In particular, the rapid growth of public enterprises such as the Heavy Industries Corporation of Malaysia (HICOM) resulted in the "crowding out" of private sector industry. These public enterprises have enjoyed preferential access to finance and the government has not allowed private industries to compete freely with state enterprises. The public corporations have also enjoyed advantages in procuring government contracts (Bowie, 1988, p. 63).

NEP's education policy and push for Malay human resource development have also been responsible for graduate unemployment. For example, a survey in 1983 found that some six months after graduation 35.5 percent of graduates who were on government scholarships were still unemployed (Mehmet, 1987, p. 89). Yet the bonded nature of scholarships prevented them from seeking jobs in the private sector. The distortion in the allocation of skilled human resources is also reflected in the fact that more than 80 percent of graduates work for the government and statutory bodies.

There were also macro-level distortions. For example, with the NEP, the budget deficit increased by 120 percent from M$476 million in 1970 to M$1.0 billion in 1971. Between 1970 and 1981 the Malaysian government had to rely heavily on deficit budgets to sustain NEP's high economic growth targets in the face of adverse international economic trends. It could not deviate from its course of high public investment in favor of Malays (Alamgir, 1994, p. 73). As a result, the federal government debt as a proportion of GNP rose from 10 percent in 1980 to 30 percent in 1985.

Malaysia's external debt, too, increased quite alarmingly. In 1983, the total external debt as proportion of GNP was 49 percent, well above the developing country average of 36 percent. The public external debt in the same year was 39 percent of GNP. The external debt rose to 56 percent in 1985 (Jomo, 1987, pp. 124-130).

Nevertheless, the Malaysian economy grew remarkably during the past two decades (except during the mid-1980s). It is poised to graduate into a newly industrialising economy. What role did the NEP play in the transformation of the Malaysian economy? Can we regard the NEP as a recipe for disaster?

NEP: A Formula for Growth with Distribution

Although the NEP changed the nature of inter-communal settlement, in the core of it was the objective of maintaining national unity and political stability. In the words of one of the architects of the NEP, the present Prime Minister, Dr. Mahathir (1976, p. 9):

> [the NEPs] formulation was made necessary by the economic needs of the nation as much as its politico-social needs. There can be no economic stability without political stability and social stability. Thus the NEP is also a formula for economic growth.

Therefore, the most important catalytic role the NEP played in the economic growth of Malaysia is the provision of social and political stability. The NEP proclaimed the uplifting of Malay fortunes as one of the fundamental prerequisites for social stability. It was argued that a more equitable distribution of wealth and a more balanced participation of all ethnic communities in the modern sector of the economy is 'a sine qua non, an indispensable condition for a united Malaysian nation in the longer run and an essential requisite for political survival and stability in the shorter term' (Musa, 1986, p. 6).

It was also realised by the Malay political leadership that while short-term political and social stability can be achieved through redistribution of wealth and appeasing the Malays, a zero-sum distributional policy would mean longer-term disaster. Thus, the redistribution of wealth was perceived within a growing economy. As stated in the Second Malaysia Plan, 1971-75 (p. 1)

> The New Economic Policy is based upon a rapidly expanding economy which offers increasing opportunities for all Malaysians as well as additional resources for development. Thus, in the implementation of this policy, the Government will ensure that **no particular group will experience loss or feel any sense of deprivation.** (Emphasis added).

Thus, the NEP represented a Pareto-optimal solution to social and economic problems in so far as the distributional objective was pursued within the context of an expanding pie. It became almost imperative for the Malay-dominated government to pursue growth-oriented policies if it were to maintain racial harmony and draw support from all Malaysians. Thus, although the Malaysian state is captured by one particular ethnic community, the ethnic imperatives curtailed the state's ability to pursue narrow distributional objectives at the cost of long-term growth. This conclusion is in sharp contrast with Bowie's (1988, p. 53) pessimistic view of the Malaysian state that 'in fragmented societies, short-run policies favoring wealth redistribution will take precedence over policies promoting long-run economic growth.'

The NEP's explicit objective of wealth redistribution within a growing economy continued to dominate Malaysia's five-year plans. For example, the Third Malaysia Plan, 1976-80 (1976: 7) was formulated:

> to eradicate poverty among **all Malaysians** and to restructure Malaysian society so that the identification of race with economic function and geographic location is reduced and eventually limited, **both objectives being realised through the rapid expansion of the economy over time**. (Emphasis added).

Malaysian Industrial Policy Studies (MIPS) and Industrial Master Plan (IMP)

As the completion year of NEP drew nearer, the government commissioned two studies to evaluate the achievements of NEP and formulate policies to ensure that NEP targets are met. The first is the Malaysian Industrial Policy Studies (MIPS) and the second, Industrial Master Plan (IMP) covering the period 1986-95. The MIPS examined tax and tariff incentives for industrialisation and recommended reductions in the rate of protection. The IMP emphasised 12 key industries and gave details of how linkages and diversification of the manufacturing base could be achieved.

Following the recommendations of IMP, the government introduced a series of legislation to encourage foreign investment. These included the relaxation of foreign equity rules in 1986, the freeing of credit restrictions in 1987 and the withdrawal of proposals to abandon tax incentives for foreign firms. The government also introduced the New Investment Fund in 1985 and the Industrial Adjustment Fund in 1987 to encourage domestic private investment.

New Development Policy (NDP) and Recent Policy Developments

In June 1991, the government announced the New Development Policy (NDP) to succeed NEP. The NDP replaced the racially based economic and social policy with national unity. Although the 30 percent target for *bumiputra* corporate ownership was retained, no specific deadline was set for its achievement. It was regarded that the shortage of Malays with relevant management and technical qualifications was an impediment to the achievement of *bumiputra* ownership target. Thus, the NDP emphasises human resource development as is reflected in the Sixth Malaysian Plan (1991-95). The Seventh Malaysian Plan (1996-2000) will continue to place strong emphasis on technical and vocational skills training and investment in R&D capabilities in order to reduce dependence on foreign investment and technology.

As a means of reducing the dependence on multinationals, the NDP targeted the development of small and medium sized industries (SMI). The Domestic Investment Initiative (DII) has been launched with a view to encouraging domestic value-added production, strengthening SMIs and improving the accessibility of the local capital market.

The NDP forms the basis of Prime Minister Mahathir's 'Vision 2020', the date by which he intends Malaysia to attain a developed country status. The NDP's macroeconomic and social targets are contained in the Outline Perspective Plan for 1991-2000. According to the Outline Perspective Plan, the real GDP is projected to grow at an average annual rate of 7 percent and the share of manufacturing in exports is projected to increase to more than 80 percent.

Although the Malaysian government is very proactive in its industrial and economic policy, close cooperation between the government and the private sector is an important aspect of the NDP's economic policy agenda. It envisages that the private sector in the new era will play a more leading role. Thus, the government has one of the most comprehensive and broad-ranging privatisation programs in the region (DFAT, 1995, p. 16). The government has privatised 103 entities by May 1994, and over 15 previously government-owned companies which include the national energy company, Tenaga Nasional, Heavy Industries Corporation of Malaysia (HICOM) and Telekom, have been listed on the Kuala Lumpur Stock Exchange. Under the Rolling Action Privatisation Plan 1994/95, 78 projects have been identified for privatisation, followed by 77 projects in 1995. The 1994 program includes the development of seaports in Penang, Johor and Kelang, the commissioning of independent power producers and the development of a new television station. Parts of the new Kuala Lumpur International Airport, the ports of Kuantan and Kemaman, the National Savings Bank and the housing loan division of the Ministry of Finance are earmarked for privatisation in 1995.

The foreign companies are allowed to participate in these projects provided relevant local expertise is not available, local capital is insufficient and the participation is necessary for export promotion. Foreign equity is, however, restricted to 25 percent of share capital.

Export-oriented industrialisation remains the main vehicle for achieving the "Vision 2020". The government policy is to encourage core dynamic industries that are capable of competing internationally without significant protection. Thus, the government has embarked on an ambitious trade liberalisation program. In 1994, tariff duties on 600 items have been cut and the 1995 budget targets over 2,600 products, most of them food and consumer goods, for tariff reductions. However, the agricultural sector as a whole and some key manufacturing activities such as automobiles, paper and plastic resins and a range of processed agricultural products continue to receive high protection. There is also limited protection for some key service sector activities.

Although the government desires to reduce the dependence on foreign investment and achieve a 60:40 ratio between domestic investment and FDI, it still actively seeks FDI. In order to remain competitive with emerging low cost countries in Indochina, and China, the Malaysian government in October 1993 introduced attractive incentive packages which included reductions in corporate taxes and import duties on wide-ranging items.

Concluding Remarks

To the extent labor was repressed and the government pursued a "directive" industrial policy, the remarkable transformation of Malaysia fits the conventional "statist" paradigm. But the authoritarian feature of the "strong state" derived from Confucian ethics certainly does not apply to ethnically diverse Malaysia. The state is also not autonomous as it follows explicit pro-bumiputra policies, and is not free from rent-seeking as various corruption cases show. The durability of Malaysian success also defies neo-classical explanation which regards active sector-specific government interventions in the economy as a recipe for disaster. This paper has argued that the rapid transformation of the Malaysian economy lies in its desire to maintain racial harmony within the context of an expanding economy. Thus, the policymakers never traded off growth for redistributive objectives.

Malaysian economy has reached a critical juncture in its march toward becoming a fully developed country. In the short run, while it has to deal with labor shortage in general, in the longer run it must move to restructuring its manufacturing toward skill and capital intensive activities. The question is: will the present system serve Malaysia equally in its move to an "innovation driven" society? There is a growing body of literature which shows that innovation thrives most in an open political system, where the state plays only a supportive role (Chowdhury and Islam, 1993). Thus, how Malaysia handles the growing desire of its citizens for a more open and plural democracy will determine the success in its next phase of transformation.

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