

## **Working Paper No. 59/01**

### **Malaysia- The Lucky Man of Asia?**

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SNF-project No. 4425:  
Foreign Direct Investment and Development:  
Lessons for Southern Africa from the Southeast Asian Experience

The project is financed by: The Research Council of Norway

FOUNDATION FOR RESEARCH IN ECONOMIC AND BUSINESS ADMINISTRATION

BERGEN, DECEMBER 2001

ISSN 0803-4028

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**Abstract**

Malaysia has been labelled the Lucky Man of Asia due to its wealth of natural resources, such as tin, rubber, palm oil, pepper, tropical timber, petroleum and a very fertile soil. There is no doubt that this richness has helped Malaysia to achieve impressive growth rates over the last decades, but history has taught us that large endowments of natural resources by far are sufficient to generate development. Since the early 1970s Malaysia has led a relatively successful racial integration policy, and created a business friendly and relatively stable investment climate. For better or worse, Malaysia has also been successful in attracting foreign direct investments to export processing zones. Nonetheless, the high growth rates would hardly have been possible in absence of the spread of industry from Japan and the NIEs. In this sense Malaysia has been lucky, but that luck has been facilitated by timely trade liberalization, relatively prudent macro economic policy, and good social and physical infrastructures.

## **Chronology over Significant Economic and Political Events in Malaysia**

1957	Peninsular Malaysia achieves independence from Britain. Tunku Abdul Rahman elected Prime Minister.
1963	Sabah (North Borneo), Sarawak, and Singapore included in the Federation of Malaysia.
	Race riots
1965	Singapore secedes from Malaysia.
1967	Race riots
1968	Investment Incentive Act. Reflected a strategic shift to export orientation
1969	Race riots
1969	Tun Abdul Razak elected Prime Minister
1970	Launching of New Economic Policy (NEP)
1971	The Free Trade Zone Act, establishing Export Processing Zones (EPZs), implemented
1974	Race riots
1981	Mahathir Mohamad elected Prime Minister.
1986	Mahathir Mohamad re-elected Prime Minister.
1997	Asian financial crisis breaks out.
1998	Malaysia imposes capital control Deputy Prime Minister Anwar Ibrahim arrested.

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# 1 Introduction

Peninsular Malaya achieved independence from Great Britain in 1957, and the present Malaysia was created in 1963. Partly due to large endowments of natural resources Malaysia was by that time one of the richest countries in Asia. The country was a major supplier of raw materials to British industry from the outbreak of World War I and until independence, and during the 20<sup>th</sup> century Malaysia has had an openness ratio (import and export as share of GDP) that is higher than in most other Asian countries

Malaysia was not allowed to build up any strong industrial sector while it was a colony, and had a weak industrial base when it became independent. In order to diversify its economy and build a strong domestic industrial sector Malaysia therefore implemented an import substitution (IS) strategy in 1957. This policy, which implied that the home market was protected by high formal and informal trade barriers, was used by a number of developing countries after World War II. However, unlike for instance South Korea and Taiwan, Malaysia was not hostile towards inflows of foreign direct investments (FDI). On the contrary, Malaysia actively encouraged FDI as a means to increase efficiency and get access to advanced technologies from Western countries. The policy was initially quite successful in terms of growth in manufacturing employment and GDP, but the government was quick to depart from this policy when it became clear that import subsisting growth was unsustainable and primarily benefited domestic and foreign capital owners. Since 1971 Malaysia has been an export oriented economy, with exception of the years 1981-1985 when the country implemented an unsuccessful import substitution policy with emphasis on heavy industrialization.

Between 1985 and 1997 Malaysia had the sixth fastest growth rate in GDP in the world, with an annualised average of 4.9% per capita. During this period Malaysia experienced a significant increase in inward FDI from Japan, Taiwan and Singapore, who observed sharp increases in their cost levels compared to most other countries. In order to stay internationally competitive labour intensive export-oriented Japanese, Taiwanese and Singaporean firms invested in neighbouring countries with lower wage costs. Malaysia was seen as one of the most attractive locations in the area, and became one of the biggest hosts of FDI in Asia.

There are several reasons for Malaysia's success in attracting FDI. At least for the last three decades the Malaysian political system has been relatively stable, and the macroeconomic policy has been prudent. Inflation has in general been on the low end

internationally, and there have been comparatively small fluctuations in the exchange rate of the Ringgit. Undoubtedly, these factors help explain why Malaysia has been far more successful than, e.g., the Philippines in attracting FDI. Moreover, Malaysia implemented a major export-oriented strategy in the mid 1980s; this was an almost perfect timing, due to the need of Japan, Taiwan and Singapore to locate a larger share of their activities abroad. Compared to many neighbouring countries Malaysia has also benefited from a reasonably well-educated and English speaking labour force, even though it should be noted that the educational level in Malaysia is significantly below that in richest Asian countries.

The comparatively good infrastructure quality of Malaysia has also constituted an important location advantage for the country. The quality has been particularly good in the Malaysian Export Processing Zones (EPZs) that have been set up since 1971. Though many countries have set up EPZs, no one has been as successful as Malaysia in terms of manufacturing activity (both in absolute terms and as share of domestic manufacturing). Firms that have established themselves in the EPZs have received subsidized land rents and exemption from a large array of Malaysian taxes and duties, provided that the larger share of their output is exported to other countries. Indeed, firms that operate within the EPZs have generally not been allowed to sell on the domestic Malaysian market at all. Unfortunately, this has contributed to create a dualistic structure of the Malaysian economy, with few links between those firms that operate within the EPZs and those that operate outside the EPZs. Moreover, there also seem to be relatively weak linkages between foreign and local firms within the EPZs. Thus, even though cost-benefit analyses indicate that the EPZs have been beneficial for Malaysia, there is clear evidence that Malaysia has a great challenge in integrating the production sectors.

The rest of this article reviews the economic development in Malaysia from independence in 1957 until the Asian financial crisis in 1997, and is organized as follows. In Section 2 we present some economic indicators for Malaysia, and in Section 3 we discuss the economical and political climate in Malaysia before and after independence. Foreign direct investments to Malaysia are analyzed in Section 4, and Section 5 summarizes and concludes.

## **2 Some Economic Indicators**

Malaysia is a constitutional monarchy with the Prime Minister as paramount leader, and relatively free, general elections take place each fifth year. There are three major ethnic groups in Malaysia, with Malays and other indigenous people constituting 58% of the population, Chinese 26%, Indians 7% and other ethnical groups 9%. The official language is

Bahasa Melayu, but there is also a large array of other languages, like Tamil, Telugu, Thai and different Chinese dialects. Additionally, the majority of the population also speaks English, which was the official language prior to Malaysia’s independence.

With its 22 million inhabitants Malaysia is a relatively small country, though it is much larger than Hong Kong and Singapore (see Table 1).<sup>1</sup> GNP per capita in 1998 was equal to USD 3670, and Malaysia is thus an upper-middle-income developing country according to the World Bank classification.<sup>2</sup> Even though GNP per capita is far lower than those in the NIEs, Malaysia has an ambition to be a fully developed industrialized country by 2020 (*Vision 2020*). This goal is presumably too ambitious, even though Malaysia regained much of its momentum rather quickly after the Asian financial crisis.

**Table 1: Economic size of the NIEs and ASEAN-4, 1998**

	Population		GNP		GNP per capita	
	Millions	\$Billions	Rank	\$	Rank	
<b>NIEs</b>						
<b>Hong Kong</b>	7	158.2	24	23 660	21	
<b>Singapore</b>	3	95.5	37	30 170	9	
<b>South Korea</b>	46	398.8	12	8 600	51	
<b>ASEAN-4</b>						
<b>Indonesia</b>	204	130.6	30	640	149	
<b>Malaysia</b>	22	81.3	39	3 670	78	
<b>Philippines</b>	75	78.9	41	1 050	132	
<b>Thailand</b>	61	131.9	29	2 160	100	

*Source: Easterly and Yu (2000).*

The map in Figure 1 shows that Malaysia consists of one peninsular and one island. The Western part – Peninsular Malaysia, which achieved independence from Britain in 1957 – is the most developed part of Malaysia, and hosts the capital Kuala Lumpur. In the Eastern part we find the regions Sabah and Sarawak, which were included in Malaysia in 1963 together with Singapore. This happened due to a British plan of collecting all its former East Asian colonies into one Federation, and because the Singaporean Prime Minister Lee Kuan Yew

<sup>1</sup> Taiwan is one of the four NIEs, but is not included in Easterly and Yu’s data set. The population size of Taiwan is 21 millions, with a GNP per capita some 25 per cent higher than in South Korea.

<sup>2</sup> The World Bank (1998) classifies low-income countries as those with a GNP per capita of \$785 or less in 1996, while middle-income countries have GNP per capita between \$785 and \$9636. Lower-middle-income and upper-middle-income economies are separated at GNP per capita of \$3115. High-income economies are those with GNP per capita of \$9636 or more.



feared that a small and independent Singapore would be an easy target for Communist China.<sup>3</sup> However, Singapore seceded from the Federation in 1965.

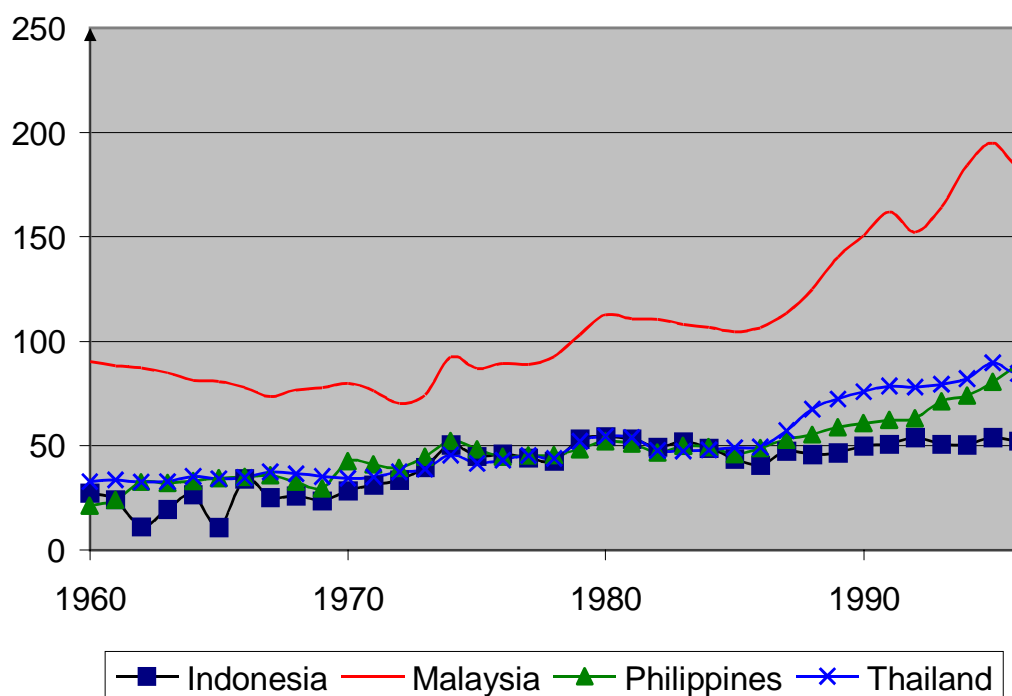
**Figure 1: Map over Malaysia**



Peninsular Malaysia observed an impressive economic growth in the first quarter of the twentieth century, and soon turned out to be the single most profitable British colony (Jomo, 1990). The economic infrastructure in terms of, e.g., railways, ports, and utilities, was better than in almost any other British colony. Due to the good infrastructure quality and British trade interests Malaysia evolved into a very open economy, and this has remained true also after independence. This is illustrated by Figure 2, which shows the openness ratio – the ratio of imports and exports over GDP – for ASEAN 4. This ratio has typically been far higher in Malaysia than in any of the neighbouring countries, with exception of the city-states Hong Kong and Singapore.

<sup>3</sup> The self-biography of Lee Kuan Yew (1999) provides an interesting subjective view of how Singapore achieved independence, the subsequent attempts to become a part of Malaysia, and the events that finally led Singapore to secede from the Federation. Interestingly, both Lee and the present Malaysian Prime Minister, Mahathir Mohamad, have recently discussed the possibility of a reunion between the two countries (see Navaratnam, 1998).

**Figure 2: Openness ratios in ASEAN-4, 1960-1996**



*Source: Easterly and Yu (2000).*

Table 1 illustrates the economic development in Malaysia since 1960 relative to the NIEs and the other ASEAN-4 countries. On average Malaysia has performed equally good as Thailand during this period, a bit better than Indonesia, but by no means as good as the NIEs. In fact, GDP per capita was higher in Malaysia than in both South Korea and Taiwan in 1960, but in 1997 these countries had a GDP per capita 30 and 50 per cent higher than Malaysia. The real outlier in this sample is the Philippines, which was perceived as one of the most promising Asian countries in the first post World War II period. However, the sample is highly biased – the Philippines has neither performed better nor worse than most other developing countries, while the economic development in the other countries shown in Table 2 has been extraordinarily good in a global perspective. Malaysia, for instance, had the fourteenth fastest growth rate per capita between 1960 and 1985 (4.2% per year), and the sixth fastest growth rate between 1985 and 1997 (4.9% per year).<sup>4</sup> Broadly speaking, it is only when measured against the NIEs that Malaysian growth rates are not striking.

<sup>4</sup> See Easterly and Yu (2000).

**Table 2: GDP per capita relative to Malaysia**

Country Name	1960	1970	1980	1990	1997
<i>NIEs</i>					
<b>Hong Kong</b>	1.58	2.09	2.30	2.90	2.44
<b>Singapore</b>	1.17	1.40	1.86	2.29	2.28
<b>South Korea</b>	0.64	0.78	0.81	1.30	1.32
<b>Taiwan</b>	0.88	1.02	1.17	1.57	1.52
<i>ASEAN</i>					
<b>Indonesia</b>	0.45	0.33	0.34	0.39	0.36
<b>Philippines</b>	0.80	0.65	0.49	0.34	0.24
<b>Thailand</b>	0.66	0.71	0.57	0.70	0.65

*Source: Easterly and Yu (2000)*

### 3 Economical and Political Climate

Today's Malaysia is heavily influenced economically, ethnically and culturally by the period it was a British colony. We will therefore provide a description of British politics in Malaysia before we discuss the political and economical development after independence in 1957.

#### 3.1 Malaysia before independence

The transformation of Peninsular Malaysia from an agrarian subsistence economy into an open economy with export-led growth started while it was a British colony, i.e., from the outbreak of the First World War. Due to its richness of natural resources Malaysia soon became an important supplier of raw materials to British industry, and it was therefore in Britain's interest to build up a good Malayan infrastructure. The infrastructure was mainly financed by taxes levied on domestic goods consumed by the Malaysian working class, while British imports from and exports to Malaysia had a relatively easy tax burden (Jomo, 1990).

Malaysian tin mining was at the focus of the British attention in the early 20<sup>th</sup> century. At that time there was intra-Chinese competition for control over the mining industry, while Malays were competing for the political control. Britain soon gained control over both, but initially found it difficult to operate the mining industry due to a lack of cheap labour: Malaysian peasants were too expensive to hire, since they had their own land. In order to solve this problem Britain imported labour with few alternative employment options, mainly from China, India and (presently) Indonesia. In order not to provoke Malay resistance Britain protected Malaysian peasantry by not allowing the immigrants to own land; they were mainly restricted to work in the growing mining sector. However, the British rulers also created poverty among peasants as they took over all control over uncultivated land. The growing

Malaysian peasantry therefore increasingly became landless, or indebted to the British government who alienated land.

The British colonial policy of labour immigration is a major cause of the ethnical and religious problems that have plagued Malaysia all since independence, and that led to serious race riots in 1969. Immigrants from India and Indonesia, and the majority of the Chinese, have remained workers, but a significant share of the Chinese entered the business sector and became the economic elite of Malaysia. The Malaysian society thus became divided into one group with economic power – the Chinese – and one group with political power – the Malays.

Over time, the political elites of the three major races learnt to accommodate each other. United Malay National Organization or UMNO (representing the Malays), Malaysian Chinese Association or MCA (representing the Chinese) and Malaysian Indian Congress or MIC (representing the Indians) are the major parties in the National Front coalition, which has remained in power from independence until today. The National Front's longevity at the helms of power is very much due to its ability to fashion together a working relationship between the three biggest ethnically based parties. Both the MIC and the MCA have tacitly agreed to surrender political leadership in the coalition to UMNO, thus appeasing the concern of the Malays with regard to political supremacy. In return they have successfully been able to negotiate policies that protect the interests of their race-based supporters. In particular, they have been able to obtain a guarantee that UMNO will not formulate policies that threaten the interests of the Chinese and Indians in the field of business, education and culture. In other words, the three main parties in the National Front have chosen to use ethnic-based support as a strategy for political survival. The main method of holding on to their supporters is by reassuring them that their key agenda or priority is to advance the interests of their respective races. The stability of the National Fronts is therefore based on the policy of each party's expectation that being inside the National Front optimises their self-interest. However, it is increasingly often questioned whether the working arrangement will soon come to an end. Since 1970s there has been a number of occasions when the arrangement seems threatened, including the most recent clash between Malays and Indians in March 2001 that resulted in a number of killings.

### *The road to independence*

The Communist Party of Malaya (CPM) was established in 1930, as the first Malaysian political party. Subsequently several other nationalistic parties followed, and the struggle for independence, with mass demonstrations and other anti-British actions, became widespread

throughout the 1930s. However, independence did not stand high on the agenda for most inhabitants in Malaysia. In fact, the first turning point seems to have occurred when Britain was defeated by Japan, who invaded Malaysia in 1941. According to Mahathir Mohamad (1999) and Lee Kuan Yew (1999) this defeat had the important psychological effect of showing that the British rulers were not superior. It was possible to defeat them, and the Japanese success after the Second World War also showed that Asians were fully able to compete commercially with Western countries.

”The Japanese rule lasted about three years. ... Before the war, when Malaysia was under British rule, our entire world-view was that we had no capability to be independent. We thought that only the Europeans could run our country, and felt we had to accept their superiority. But the success of the Japanese invasion convinced us that there is nothing superior in the Europeans. ... [Asians] have the ability to govern [their] own country and compete with the Europeans on equal footing.” Mahathir (1999: 16-17).

The second turning point, according to Mahathir and Lee, was the change in British attitude after the war. Until 1941 Malaysia was more a protectorate than a colony, and had some degrees of freedom, at least for purely internal matters. After the war, however, Malaysia was fully colonized, and Mahathir (1999, 17) argues that “this was most likely a critical mistake on the part of the British”. The labour unions became increasingly oppressive, and the communist fractions gained strength both in present Malaysia and Singapore. The fact that the US granted independence to the Philippines in 1946 further developed a pressure on UK and other colonial powers to free their colonies.

Despite the tremendous problems of keeping Malaysia as a colony, Britain was not ready to grant the country independence until the second half of the 1950s. There are at least two important reasons for this. The first one is on the economical side; UK was nearly bankrupt after the war, and was heavily dependent on the incomes from its remaining colonies. In fact, Malaya’s export earnings were greater than Britain’s during the first years after the war, and was by far the most profitable British colony (Jomo, 1990). The second reason is the fact that MCP had considerable political power. It was thus feared that communists would govern an independent Malaysia, and that this would cause major political and strategic problems for the UK. Nonetheless, during the early 1950s it became evident that the Malaysian resistance would make it impossible for Britain to hold the grip on Malaysia in the long run. Britain therefore began to support conservative nationalistic Malaysian interests, and as these forces grew in strength Peninsular Malaysia was granted independence in 1957,

with Tunku Abdul Rahman from the United Malays National Organization (UMNO) elected prime minister. Tunku was a moderate politician, who was initially supported by the majority of the Malays as well as by the Indian and Chinese communities (Lee, 1999).

### **3.2 Malaysia after independence**

Britain used its colonies both as suppliers of raw materials and as outlets for manufacturing goods. By and large, the colonies were not allowed to build up any strong industrial sectors. Malaya therefore had little experience with manufacturing activity before independence, with the important exception of tin and rubber processing, and some industries where trade costs were prohibitively high. Seen in this light, and under the prevailing economic doctrines at that time, it is not surprising that Malaysia embarked on an important substitution policy immediately after independence in 1957. In this sense Malaysia followed in the footsteps of the Philippines, who had embarked on import substitution in 1949 (after gaining independence from the US in 1946).

The Malaysian IS functioned well during the first years – the “easy stage” of the import substitution policy, as it had also done in the Philippines ten years earlier. For instance, Malaysian GDP grew by an average of some four per cent per year in the 1960s, and manufacturing employment increased from 217 000 in 1960 to 448 000 in 1970 (absorbing 8.4% and 11.4%, respectively, of the labour force). Nonetheless, both in the Philippines and in Malaysia it became evident that the IS policy created some serious economical problems (see Section 3.2.1). Unlike the Philippines, however, Malaysia reacted to the problems relatively fast, and adopted an export oriented policy in the late 1960s/early 1970s.

In Section 2 we noted that Malaysia has done very well compared to most other countries, but not when we compare to the NIEs. Some authors have explained the latter with an abundance of natural resources in Malaysia that has made it less imperative for the country to industrialize.<sup>5</sup> Table 3 provides an illustration of the importance of natural resources in commodity exports during the first period after independence. In 1960 rubber and tin made up 70 per cent of total commodity export income. The sharp fall in the export value of rubber

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<sup>5</sup> Jomo and Tan (1999, p. 229) note that there has been a change in economic arguments in this respect over the last decades. Early economists typically argued that resource rich countries, other things being equal, were the ones most likely to experience growth. With the industrialization of Hong Kong, Japan and Singapore, which are very poorly endowed with natural resources, and Taiwan and South Korea, which also are relatively resource poor, this argument has lost some of its force. Economists then began to argue that these countries have grown precisely because they are resource poor, and therefore had to industrialize. More recent explanations have emphasized the importance of human resources as compared to natural resources to explain why some countries grow and others not.

between 1960 and 1965 reflects that the international price of that product group fell by 35 per cent, while the export value of tin during the same period increased due to higher international prices (prices jumped by 80 per cent, while the Malaysian export volume fell somewhat). In fact, the prices of all the resource commodities shown in Table 3 have been highly volatile. This has been a common problem for most developing countries, but particularly for open economies like Malaysia.

The last two decades petroleum has generated far more export revenue than rubber and tin, and Malaysia has been a net exporter of petroleum since the late 1960s. In this respect the oil price shock in 1973 and 1978 were favourable for the country, while it was negatively affected by the sharp fall in oil prices in 1986.

**Table 3: Commodity exports, 1960-1985**

<b>Commodity</b>	<b>1960</b>	<b>1965</b>	<b>1970</b>	<b>1975</b>	<b>1980</b>	<b>1985</b>
<b>Rubber</b>	2001 (55%)	1461 (39%)	1724 (33%)	2026 (22%)	4618 (16%)	2872 (8%)
<b>Tin</b>	508 (14%)	872 (23%)	1006 (19%)	1206 (13%)	2505 (9%)	1648 (4%)
<b>Crude Petroleum</b>	147 (4%)	87 (2%)	203 (4%)	861 (9%)	6709 (24%)	8679 (23%)
<b>Sawlogs</b>	119 (3%)	263 (7%)	644 (12%)	670 (7%)	2618 (9%)	2771 (7%)
<b>Sawn Timber</b>	75 (2%)	97 (3%)	206 (4%)	441 (5%)	1344 (5%)	1136 (3%)
<b>Palm Oil</b>	61 (2%)	107 (3%)	264 (5%)	1319 (14%)	2603 (9%)	3963 (10%)
<b>LNG</b>	-	-	-	-	-	4391 (12%)
<b>Manufactures</b>	-	-	615 (12%)	1786 (19%)	6269 (22%)	12470 (33%)
<b>Total com. exports</b>	3632	3782	5163	9230	28171	38016

*Current USD (% of total commodity exports). Source: Jomo (1990).*

Manufacturing grew by 26 per cent on average each year between 1971 and 1980. Still it constituted for less than twenty per cent of commodity exports until the late 1970s, and it was only in the early 1980s that some kind of consensus developed that Malaysia deserved the label “second generation tiger”. By 1990 the share of manufacturing in exports was equal to 60 per cent, further increasing to 80 per cent in 1995 (Jomo and Tan, 1999). The impressive growth of the manufacturing sector is further underscored by the fact that manufacturing value added increased from 10.4% of GDP in 1960 to 33.1% in 1995, absorbing respectively

11.4% and 25.9% of the labour force (Jomo and Tan, 1999). During the same period total GDP rose by an average of 6.9% , and exports as a share of GDP increased from some 45% in the 1960s to above 90% in the late 1990s (World Bank, 1998).

The composition of manufacturing exports has changed significantly over the years, as shown by Table 4. In 1970 the share of Chemicals and petroleum and Food, beverage and tobacco in total manufacturing exports were equal to 32% and 18%, respectively, while the shares in 1995 were 5% and 2%. Electrical and electronic machinery and appliances, on the other hand, increased its share from 11% to 66% during the same period. This product group, whose growth to a large extent has relied on investments from foreign firms, is discussed in a companion paper of one the authors (Ismail, 2001).

**Table 4: Share in exports of manufactured goods (per cent), 1970-95**

	1970	1980	1985	1990	1995
<b>Food, beverage and tobacco</b>	18	8	5	4	2
<b>Textiles, clothing and footwear</b>	7	13	11	8	5
<b>Wood products</b>	14	8	3	3	4
<b>Chemicals and petroleum</b>	32	6	12	7	5
<b>Electrical and electronic machinery and appliances</b>	3	46	50	56	66
<b>Other machinery and transport equipment</b>	11	7	8	5	4
<b>Other manufactures</b>	15	12	11	17	14

*Source: Jomo and Tan (1999).*

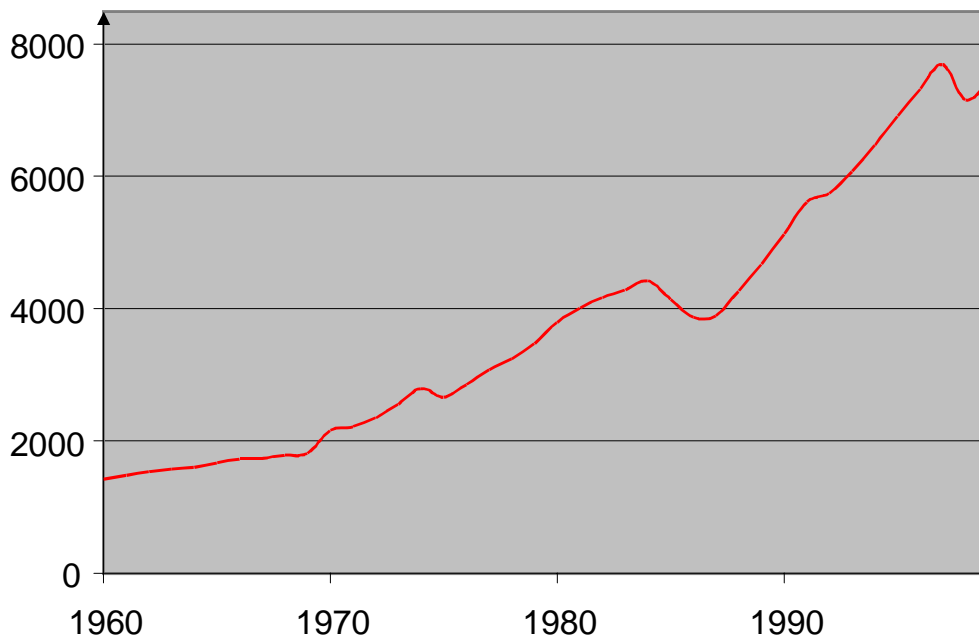
**3.2.1 Four phases of industrialization in Malaysia**

Figure 3 shows GDP per capita in Malaysia from 1960 and to 1999, and illustrates that the deepest Malaysian recessions took place in the mid 1980s and the late 1990s, while the strongest boom took place in the 1990s.<sup>6</sup> Both the recession in the 1980s and the boom in the 1990s are commonly explained by a combination of external factors and different policy-induced phases of industrialization that Malaysia has undergone after independence. This will be the focus of the discussion below.

<sup>6</sup> The figure shows real GDP per capita in constant dollars (international prices, base year 1985). The number for 1999 is estimated.



**Figure 3: Real GDP per capita, 1960-1999**



*Source: Easterly and Yu (2000)*

Jomo and Tan (1999, ch. 9) identifies four major industrialization phases in Malaysia:

1. Import substitution, ca. 1957-1971
2. Export orientation, ca. 1971-1981
3. Import substitution, with an emphasis on heavy industrialization, ca. 1981-1985
4. Export orientation, ca. 1985 -

*The first phase of import substitution (ca. 1957-1971)*

Since few industries were allowed to develop during the colonial period, Malaysia sought to diversify the industrial structure after independence. The favoured policy was import-substituting industrialization, but unlike many other import substituting countries the Malaysian government did not particularly favour domestic firms. In fact, in order to gain access to advanced technologies, foreign firms were actively encouraged to set up subsidiaries in Malaysia. The incentives ranged from direct subsidies and tax holidays for newly established firms to heavy protection of the domestic market that sheltered the firms from import competition. This policy implied that the average effective rate of protection increased from 25% of value added in 1962 to 65% in 1969, and was initially quite successful;

industrial investments increased, and the share of manufacturing in GDP rose from 9% in 1960 to 13% in 1970 (Jomo and Tan, 1999).<sup>7</sup>

According to Edwards (1975), cited by Jomo and Tan (1999), the tax incentives were largely unnecessary, and merely made the Malaysian market more profitable to exploit. Consumer prices became unduly high, and the prices of cars, for instance, were pushed up by 20%. Rent-seeking behaviour became widespread, and Malaysian politicians were offered lucrative directorships in the boards in firms that were protected by high trade barriers. Furthermore, exports were not encouraged even in industries with significant economies of scale. For instance, by 1983 the Malaysian market demand for 118 000 cars were supplied by several plants, while the average output of plants in the US and Western Europe was 250 000. This policy combination made the average Malaysian production costs very high in many industries, and there were few signs of technological spillovers from foreign firms in any industries. The IS system also led to increased regional disparities, since the domestic market was largest in the big cities. Consumer prices in peripheral regions like Sabah and Sarawak thus were even higher than the already artificially high prices in Peninsular Malaysia.

The IS policy further implied that the production became unduly capital intensive so that the employment creation effect was limited (Jomo, 1990, and Jomo and Tan, 1999). Intermediate goods and capital equipments were imported from abroad, and the domestic manufacturing actively was simple and concentrated on packing and assembly. In effect, the industrial sector became an enclave with few linkages to the rest of the economy. The IS policy also hindered efficient competition, and mainly served to protect the economic elite and the foreign firms in the country. This in turn led to increased income inequalities and high unemployment in the first decade after independence, resulting in social unrest and race riots (Yomo, 1990).

#### *The first phase of export orientation (ca. 1971-1981)*

By 1970 the IS policy had led average consumer prices in Malaysia to be 25% above world market prices, and infant industries showed no sign of growing up. It became evident that the IS policy was not successful beyond the “easy stage”, and with the Investment Incentive Act of 1968 Malaysia began to encourage exports. Interestingly, the share of local and state ownership increased along with the export orientation. In fact, during this first wave of export

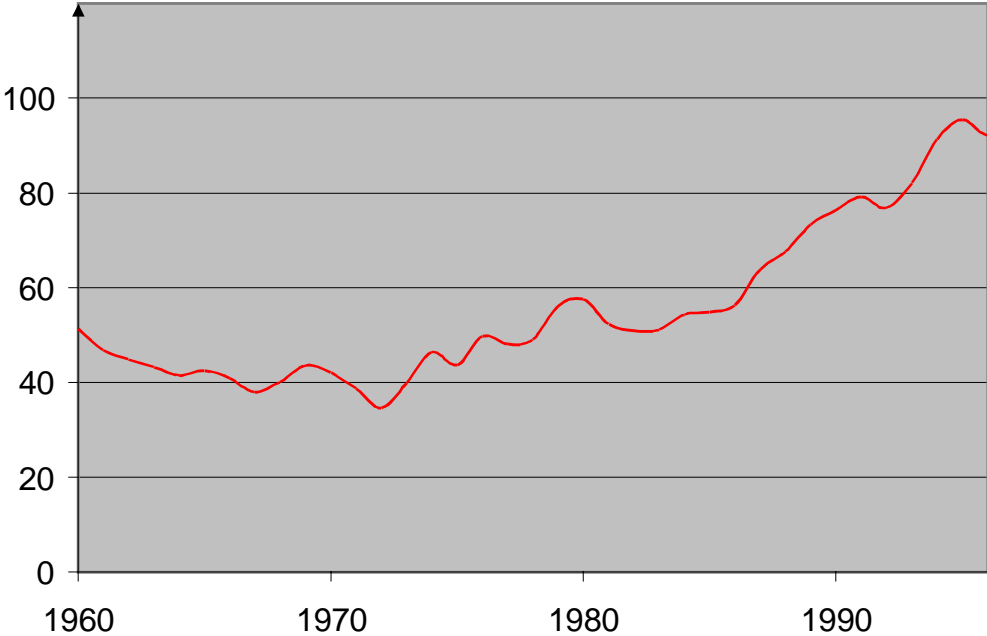
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<sup>7</sup> It should be noted that Malaysia did not target potential infant industries as such, but used investment subsidies and high trade barriers to promote manufacturing in general. In this sense the economic policy was more of the laissez-faire type than in, e.g., South Korea.

orientation Malaysia both became more closely integrated with the world economy and increased the government control of industrial activity (Jomo, 1990).

Figure 4 shows that the export orientation, which effectively started in the early 1970s, was followed by an increase in the export propensity. Many of the negative economic trends from the late 1960s were reversed, and the share of the labour force employed in manufacturing doubled from 10% in the 1960s to 20% in 1980 (Jomo and Tan, 1999). There was also a sharp increase in the ratio of investments to GDP, up from an average of 20% in the 1960s to 30% in the 1970s (World Bank, 1998).

**Figure 4: Exports as share of GDP, 1960-1996**



*Source: Easterly and Yu (2000)*

Even if the export orientation did manage to increase GDP, investments, exports, and manufacturing employment, it is still open to debate how successful the policy was. The import content remained high, and a large share of the higher manufacturing employment came in low-wage export processing zones (EPZ). Indeed, Jomo (1993), as cited in Jomo and Tan (1999), finds that average wages in the manufacturing sector in 1978 was below those in 1968. This may be explained by the fact that the government initially sought to attract labour intensive industries in order to generate more employment (unemployment fell from 7.5% in 1970 to 4.7% in 1981). Since these industries were sensitive to wage costs, and typically relatively foot-loose, the government actively held down Malaysian wages to remain competitive. During the period of import substitution, on the other hand, the typical industrial

firm was more capital intensive and paid higher wages, but unemployment was higher. There is no objective criterion to judge which of these outcomes is the best; high wages or low unemployment. Finally, it should be noted that the IS policy continued in large segments of the domestic economy even when the country adopted export orientation, and that consumer prices in Malaysia still were 25% above those in the world market in 1979, the same as in 1970 (Jomo and Tan, 1999).

Jomo (1990, p. 123) expresses a highly critical view of Malaysian export-oriented industrialization: “Malaysia’s export-oriented industrialization ‘at virtually any cost’ strategy and the inadequacy of national policies to take greater advantage of the presence of these industries have meant that the economy has been making much slower progress on the international technological ladder (in so far as it exists) à la Singapore – while also failing to nurture domestic industries capable of competing with and complementing the more technologically dynamic industries internationally – as the Japanese, Taiwanese and South Koreans have done.”

#### *The second phase of import substitution (ca. 1981-1985)*

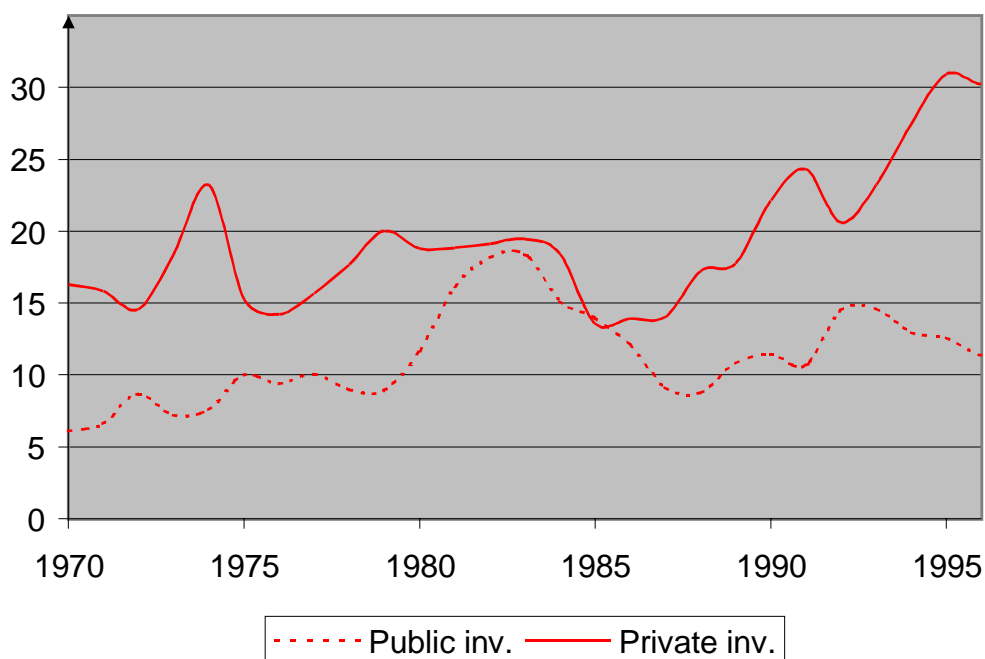
In the early 1980s Malaysia returned to an import substitution policy, this time with an emphasis on heavy industrialization. Public investments rose sharply, as shown by Figure 5 below, but it is widely believed that this policy was an expensive failure. Many of the industries soon faced stiff international competition due to a worldwide recession that created excessive global production capacities. Moreover, the home market was much too small to absorb the output of many of the new IS industries. The government thus had to make massive foreign borrowings in order to make the necessary investments and pay subsidies to, e.g., motorcar and motorcycle plants, petroleum firms, steel plants and cement factories. This inflow of capital in turn led to an appreciation of the currency against many of the most important trading partners (though not against the USD), and in the mid 1980s Malaysia was in a deep economical crisis. The Federal Government’s external debt as a share of GDP rose from 10% to 20% from 1980 to 1982, and unemployment went up from 4.7% in 1981 to almost 9% in the mid 1980s. This was also a period with rising international interest rates, and it soon became clear that the economic policy was not sustainable. Things became even worse as the world market price of semiconductors – Malaysia’s single most important export article – fell. The country thus observed a serious capital flight, and the Ringgit depreciated both in nominal and real terms against most of the trading partners.

Jomo is no less critical of the period with heavy industry than of the export orientation policies: "...Mahathir's grandiose schemes have relied almost exclusively on mostly inexperienced, often inept and even corrupt elements from the Malay-dominated government apparatus to see his ideas through. Much of their incompetence has been hidden behind secrecy and supposed political, strategic and ethnic redistribution excuses." (Jomo, 1990, p. 129)... "By the late 1980s, it had become clear that the government was quite happy to blame the bureaucrat-managers of the various heavy industries for the failures.... knowing full well that they are unable to talk, let alone fight back. ... By blaming them exclusively for the heavy industry fiascos, it is distracting responsibility from the main policy-makers themselves." (Jomo, 1990, p. 134)

*The second phase of export orientation (ca. 1985 - )*

From the second half of the 1980s Malaysia reintroduced the export orientation policy, and undertook several measures to increase its international competitiveness. The bargaining power of the labour unions was weakened, the requirements for local shareholdings were relaxed, the Ringgit was devalued, and the incentives for foreign export-oriented investments in Malaysia increased. This made Malaysia "a very attractive place for investments" (Jomo and Tan, 1999). Together with the Plaza Agreement, which led to a sharp revaluation of Yen, this implied that total foreign investments increased by more than 18 times from 1985 to 1990 (Tan, 1995). With a few exceptions the investment and export shares rose steadily (see Figures 4 and 5) until the financial crisis in 1997.

**Figure 5: Private and public investments as share of GDP (%), 1970-1996**



Source: Easterly and Yu (2000)

The export orientation that started in the second half of the 1980s did not bring an end to Malaysian import substitution policy, since the home market is still protected by high formal and informal trade barriers. Nonetheless, important changes have taken place in the Malaysian import substitution policy the last decades. As noted above, foreign investors were to some extent given preference over domestic investors during the first phase of IS, and foreign firms dominated in most of the IS sectors in the 1960s. However, since the 1980s domestic investors have been favoured in these sectors. Thereby the IS rents have gradually changed from accruing to foreign capital owners to local capital owners. Still, there are few efficiency-inducing incentives to the protected firms, and the growth of output has been significantly larger in the EO sectors than in the IS sectors. The same is true also with respect to productivity growth, even though there are some signs that the government-dominated IS heavy industries performed relatively well between 1985 and 1990 (Jomo et al, 1997).

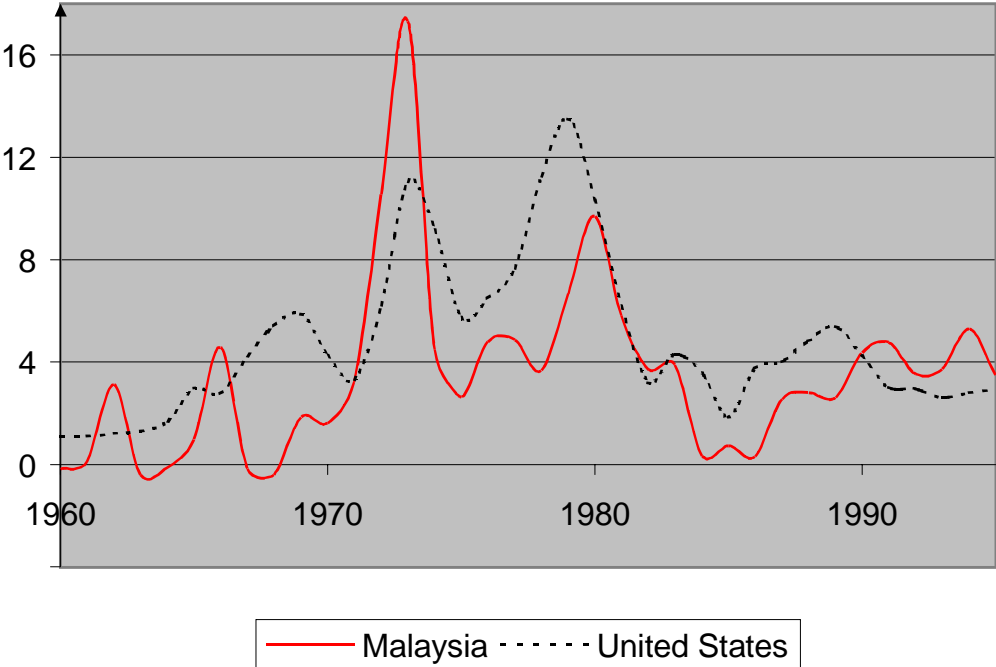
Despite the fact that the combination of export orientation and import substitution is troublesome, and has contributed to creating a dualistic industrial structure, Malaysia had the sixth fastest growth rate in the world between 1985 and 1997. In Section 4 we will argue that this success is partly caused by the timing of the export orientation. In the latter half of the 1980s many companies in Japan, Singapore and Taiwan experienced rapidly growing cost levels and deteriorating terms-of-trade, and were relocating cost sensitive production to less developed neighbouring countries. The export orientation and FDI incentives made it possible for Malaysia to attract a large share of the foreign investments from these companies.

### **3.2.2 Macroeconomic policy**

Malaysia has followed a reasonably prudent macroeconomic policy, at least with the exception of the period of heavy industrialization. The fact that the monetary policy has been held under control is illustrated by Figure 6, which shows the inflation rates in Malaysia and USA from 1960 to 1996. The Malaysian performance here has been significantly better than in most other developing countries. In fact, Malaysia (and Thailand) has had a lower and more

stable inflation than South Korea, and fared about equally good as Taiwan, Singapore and Hong Kong. The really bad countries in this respect have been Indonesia and the Philippines.<sup>8</sup>

**Figure 6: Inflation in Malaysia and the USA, 1960-1996**



— Malaysia - - - - - United States

Source: Easterly and Yu (2000)

Despite a relatively high volatility the Malaysian inflation was on average well below the American inflation throughout the 1960s. This is partly due to the fact that the country’s international terms of trade on average developed favourably, and that the import substitution policy was in its first and easy stage in the early 1960s (Jomo, 1990). Until 1970 the Malaysian currency was fixed at 3.06 Ringgit per USD. Therefore the relatively low Malaysian inflation implied that the country experienced a real depreciation against USD during the 1960s, as shown by Figure 7.<sup>9</sup>

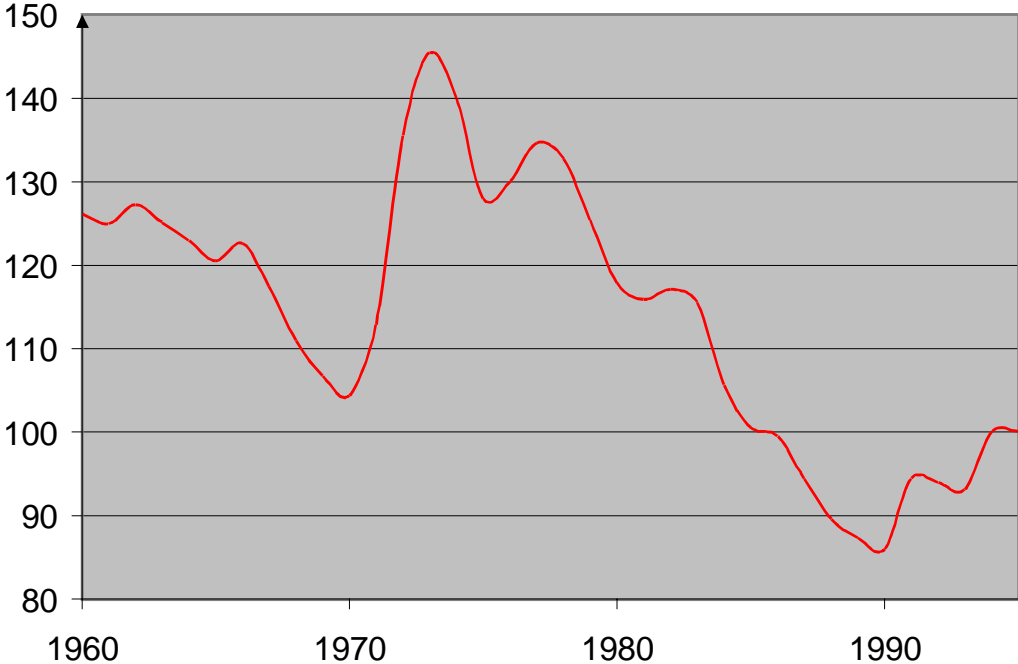
Malaysia was severely hit by the oil crisis in 1972, and prices rose much faster than in the US. This led to a period of sharp real appreciation, also because the Ringgit was upvalued in 1971. However, Malaysia – like the NIEs and Japan – seemed to handle the effects of the oil crises relatively well, and for almost the whole period 1975-1991 the Malaysian inflation

<sup>8</sup> Indonesia has had a higher and more volatile inflation rates than the Philippines during most of the time after World War II. An important exception is the period 1984-1991, when deep political problems and unrest in the Philippines lead to the People Power Revolution in 1986 and several coup attempts in the late 1980s. This period also coincided with a wave of FDIs from Japan and the NIEs to other Asian countries, which the Philippines missed out.

<sup>9</sup> The definition of real exchange rate (RER) used here is  $RER = \frac{CPI(Malaysia)}{CPI(US) \cdot \text{Official ER}}$ , where CPI is the consumer price index and ER is the nominal exchange rate. The consumer price index is the cost to the average consumer of acquiring a fixed basket of goods and services.

rate was below the one in the US. Since the nominal exchange rate was quite stable, the Ringgit therefore experienced a real depreciation against USD. From 1991 to 1997, however, there was a real appreciation of the Ringgit (by some 13 per cent points).

**Figure 7: Real exchange rate against USD (1985=100), 1960-1996**

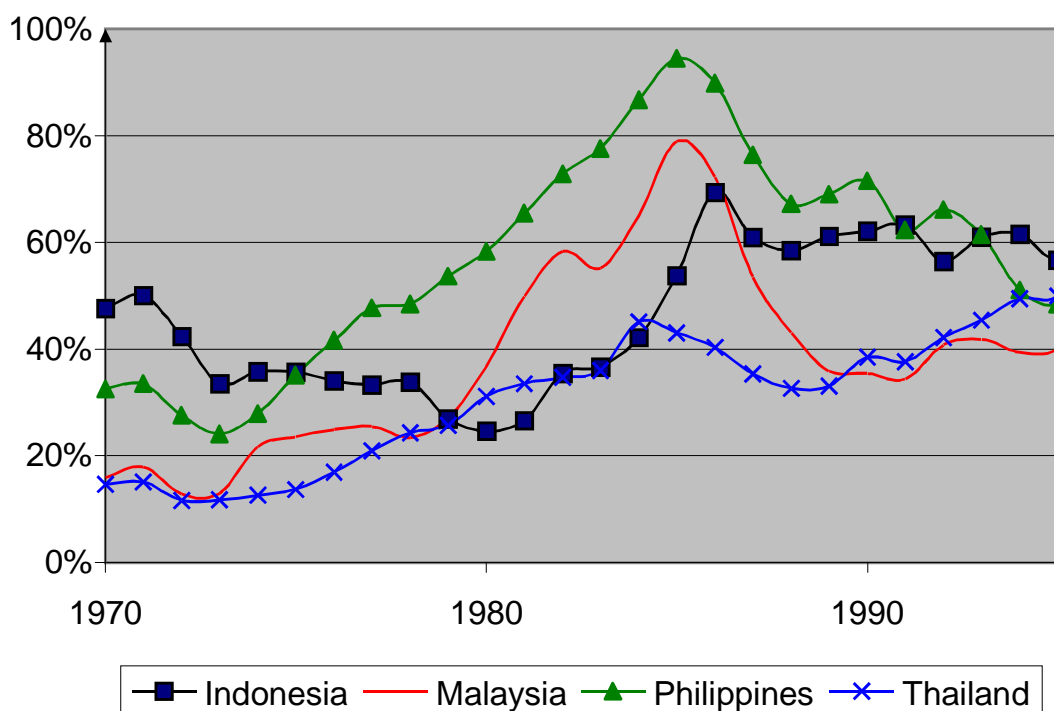


*Source: Easterly and Yu (2000)*

Normally one would expect that countries with high economic growth cover part of their capital requirements by borrowing abroad. This has also been the case for Malaysia, but the relatively prudent macroeconomic policy is also reflected by the fact that external debt as share of GDP by and large has been moderate. This is illustrated by Figure 8, which shows that the debt ratio increased from 18% in 1970 to 40% per cent in 1996. However, during the period with heavy industrialization and import substitution (1981-1985) the debt ratio increased from 30% to almost 80%, but was quickly reduced when the second phase of export orientation was implemented in 1985. Note also that Thailand typically had the lowest share of debt to GDP of the ASEN-4 in the 1970s and 1980s, but that it increased from 32% in 1990 to 50% in 1996. In any case, none of the ASEAN-4 countries had alarmingly high debt ratios prior to the Asian financial crisis that broke out in 1997 (with origin in Thailand).



**Figure 8: External debt for ASEAN-4 (% of GDP), 1970-1996**



Source: Easterly and Yu (2000)

### 3.2.3 New Economic Policy

Malaysia has had severe ethnic problems all since independence, and the first serious riot took place in 1963, followed by eight riots in 1967, three in 1969, and two in 1974.<sup>10</sup> The most serious one took place in 1969, and was the direct cause for the implementation of the New Economic Policy (NEP), which lasted from 1970 to 1990.

The two main stated objectives of the NEP were to eradicate poverty and to restructure society such that specific economic activities will not be identified with particular races. In addition, the aim was to ensure that the Bumiputera group (literally translated as ‘Sons of the Soil’ but more generally understood to refer to indigenous Malays) over time should hold approximately thirty per cent of the country’s wealth. The basic premise of the NEP was that great disparities in income levels and economic welfare between the racial groups were the main cause behind the violent racial conflicts. There was a strong perception in the country that the Bumiputera/Malays were mostly poor peasants, the Indians poor rubber estate workers, and the Chinese wealthy people involved in the manufacturing, mining and trading sectors (see also Table 5 for sector employment by race). There is no doubt that there was a basis to this perception; Bumipeturas owned only 4.3 % of the shares in limited companies in

<sup>10</sup> Source: Easterly and Yu (2000). The definition on riot here is a “violent demonstration or clash of more than 100 citizens involving the use of physical force”.

1971, while non- Bumipeturas owned 34.0 %. The rest was owned by foreigners. Moreover, in 1970 almost two thirds of the Malays in Peninsular Malaysia were below the poverty line, compared to a quarter of the Chinese population.

**Table 5: Employment in Sectors by Race, 1970**

Sectors	Malays %	Chinese %	Indians %	Others %
<b>1. Agricultural</b>	67.6	19.9	11.5	1.0
<b>2. Mining</b>	32.1	58.7	7.5	0.7
<b>3. Business/Trade, Public Sector, Education, Defence and Public Facilities</b>	42.6	45.5	10.7	1.2

*Statistics Department (1970)*

Due to the NEP the Bumiputeras were given assistance in a number of ways in the business sector, including subsidies, cheap loans, and favourable treatment when applying for government contracts. Unit trusts and government-owned corporations that provided business and investing opportunities for Bumiputeras were also established. In the education sector Bumiputeras were given scholarships to study at local or overseas universities. In addition, intake quotas into the local universities were implemented in order to ensure that adequate seats were available for Bumiputeras who wish to further their studies at the tertiary level. One of the primary purposes of the policies in the education sector was to increase the number of Bumiputera professionals in areas such as engineering, medicine, and accounting/finance. Employment opportunities for Bumiputeras with low education were further created indirectly by inviting labour intensive FDI in the manufacturing sectors.

Though the average income and wealth of the Chinese continue to be significantly higher than for any other races, the NEP did succeed in improving the employment opportunities for the Bumiputeras. The share of Bumiputeras tripled in the professions that were prioritized by the NEP, and the share of Bumiputera students in government-accredited local universities and colleges increased from 40 % in 1970 to 67 % in 1985 (Jomo, 1990). Table 6 further shows that the Bumipeturas also increased their ownership share in limited corporations from 4.3 % in 1971 to 19.6 % in 1990. Even though this is below the target of 30 % by 1990, the NEP has been relatively successful in reducing the average inequalities between the races. Indeed, Malaysia serves as a model for South Africa and many other countries that face problems related to inequalities between different races and ethnical groups.

Note from Table 6 that foreign ownership of limited companies in Malaysia has decreased significantly from 1971 to 1990. One reason for this is that after the first phase of import substitution ended in 1971 the government no longer actively encouraged foreign ownership in the sectors that serve the protected home market. The government also set up a number of new agencies (e.g., the Bumiputera Assistance Unit in the Malaysian Industrial Development Finance, MIDF) and credit institutions that allocated capital to Bumiputeras. However, Jomo (1990) argues that the real foreign control over the Malaysian economy at the end of the NEP period is larger than what is suggested by the official ownership of 23.7 % in 1990. His main argument is that many foreign investors of various reasons allow local inhabitants to own a share of their Malaysian subsidiaries, but that this share is typically too small to give any controlling ownership. Moreover, of technical accounting reasons, the actual foreign ownership is higher than what is revealed by official figures (see Jomo 1990: 161 for a discussion).

**Table 6: Ownership of Shares (par value) in limited companies.**

<b>Groups</b>	<b>1971</b>	<b>1988</b>	<b>1990</b>
<b>Bumiputera</b>	4.3	19.4	19.6
<b>Non-Bumiputeras</b>	34.0	56.0	56.7
<b>Non-Residents</b>	61.7	24.6	23.7

*Source: Statistics Department of Malaysia.*

Apart from the inequalities between the races a major reason for the riots in Malaysia in the 1960s was that income inequalities in general had risen all since independence in 1957. The rich had become richer and the poor had become poorer, particularly among the Bumiputeras. The NEP therefore also aimed at reducing poverty in Malaysia. According to official figures also this part of the plan was relatively successful. Table 7 shows that the share of people in Peninsular Malaysia that lived in poverty was reduced from 49.3 % in 1970 to 17.3 % in 1987. Similarly, the share of Bumiputeras that lived in poverty fell from 64.8 % to 23.8 %. This indicates a scale of poverty reduction that is historically unprecedented during a period of just twenty years. However, it is not straight forward to compare the figures for poverty that are shown in Table 7. First, the income figures that are used to calculate poverty in 1984 and 1987 are much broader than in 1970. This is explicitly stated in the The Fifth Malaysian Master Plan (1986), which makes it clear that income in 1984 and 1987, contrary to 1970, includes “the imputed values for own produce consumed at home and owner-occupied housing” and “the full value of public services enjoyed by the households, either free or at subsidized rates...[including] health, education, transport and utilities, and the various

subsidies granted by the Government.”<sup>11</sup> Since the poverty line moreover has been lowered after 1970, Jomo (1990:149) argues that “... one cannot honestly claim to have reduced the incidence of poverty by broadening the concept of income, and then juxtaposing essentially incomparable data to claim tremendous progress in poverty eradication.”

**Table 7: Poverty Rates in Peninsular Malaysia**

<b>Ethnic Group</b>	<b>1970</b>	<b>1984</b>	<b>1987</b>
<b>Peninsular Malaysia</b>	49.3	18.4	17.3
<b>Bumiputera</b>	64.8	25.8	23.8
<b>Chinese</b>	26.0	7.8	7.0
<b>Indians</b>	39.2	10.1	9.7
<b>Others</b>	44.8	22.0	24.3

*Source: Statistics Dept. (1970 Census; H.I.S. 1984 &1987)*

When NEP came to its end in 1990, the Malaysian government replaced it with a new policy called the National Development Policy (NDP) in 1991. Basically, this plan was not very different from the NEP. However, its implementation strategies were formulated with the aim of rectifying the weaknesses of the NEP, and more emphasis was put on human capital development and on the role of the private sector. Interestingly, NDP also admits the need to tackle the problem of the ‘hardcore poor’ more explicitly.

”Looking back at my years as prime minister, I think it is fair to say that my single greatest achievement has been focusing the entire nation on the future. Previously, there were no truly long-term targets or plans and people just lived from day to day. My government and I created a long-term vision in which everyone knew his role and which mobilized everyone, from the main in the street to top leaders in business and politics, to work harder, for their country and themselves.” Mahathir (1990, p.23)

### **3.2.4 Export Processing Zones<sup>12</sup>**

From the mid 1960s several developing countries offered export-oriented domestic and foreign investors access to special export processing zones (EPZ), where they were granted tax privileges and other incentives. The first EPZ in Malaysia was established in Penang in 1971. Since then EPZs have become increasingly important in Malaysia, and the total manufacturing activity Malaysia’s EPZs is larger than in any other country (both in absolute terms and as share of domestic manufacturing).

<sup>11</sup> Cited by Jomo (1990: 149).

<sup>12</sup> In this paper we use the name “Export Processing Zones”, since that is best known from the literature. The present official name in Malaysia is “Free Industrial Zones”, while it was “Free Trade Zones” prior to the 1990s (Rasiah, 1998).

The Free Trade Zone Act of 1971 was set up to govern the EPZs, and the official incentive package contains the following main components<sup>13</sup> (Warr, 1987 and MIDA, 1999):

1. Exemption from Malaysian duties and taxes on imported raw materials, intermediate goods and capital equipment. The exemption does not apply for capital goods that are not directly related to production, such as office equipment, building materials and vehicles.
2. Subsidized rental prices on land for factory buildings etc.
3. Tax relieves. Originally there were three mutually exclusive tax exemption systems. Either firms would obtain tax holidays for a specified period of time if they engaged in new activities that the government considered as important (Pioneer Status), if they used a high share of labour (Labour Utilization Relief), or credit for investments (Investment Tax Credit). Additionally, firms were also entitled to credit for activities directly related to export promotion (Export Promotion Deduction). In principle these tax packages made it possible for firms to avoid any taxes during the first years of existence, but the system was changed in the 1980s. The present system implies that firms can deduct up to 70 per cent of their statutory income through either obtaining a pioneer status or through investment credits. In certain regions, like Sabah and Sarawak, this figure is 85 per cent (MIDA, 1999). Due to the increasing demand for labour in Malaysia over the last decades, and because the government seeks to upgrade the production technologies, labour utilization relieves are no longer granted.<sup>14</sup>

The tax revenues from the EPZs have certainly been small, but it is far from obvious that the tax rates should have been higher. Warr (op cit.), for instance, argues that there are some indications that firms transfer income to Malaysia from other countries to take advantage of the low taxes. This effect alone suggests that Malaysia may lose tax income by increasing the rate. Moreover, any tax increase is likely to lead to at least some relocation of firms out of Malaysia. The net effect of tax increases is likely to depend crucially on both the international possibilities of transfer pricing, and on how footloose are the firms in the EPZs. This in turn

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<sup>13</sup> The complete incentive package is rather complex, see MIDA for an overview.

<sup>14</sup> In fact, labour intensive firms (defined to be those with capital investments per employee of less than RM55000) will be excluded from any of the tax incentives unless (a) value added is more than 30%, (b) the Managerial, Technical and Supervisory Index is more than 15%, (c) the firm engages in pioneering activities using advanced technologies, or (d) the firm is located in underdeveloped regions like Sabah and Sarawak (MIDA, 1999).

depends on the linkages between these firms and the Malaysian economy. Other things being equal, weak linkages to the host country means that the firms are relatively tax elastic.

Export processing zones are regularly criticized as an imperfect alternative to reducing trade barriers, since the latter allows countries to better utilize their (static) comparative advantages. However, there is little doubt that the political costs of removing protection may be high. This is evidently true both in developing and developed countries. Though not particularly important for Malaysia, many developing countries are also dependent upon revenues from imports.<sup>15</sup> In any case, it is not obvious that a marginal reduction in overall taxes is preferable to establishing EPZs.<sup>16</sup> Taking this into account, it thus seems relevant to ask whether EPZs are beneficial, given the established protective system. Warr (1987) provides an investigation of this question, using a cost-benefit analysis with data up to 1982. At that time the EPZs stood for 14% of total merchandise exports from Malaysia, 51% of total manufacturing exports, and 8.8% of total employment.

Among the benefits included in Warr's analysis are a measure of the net gain from employment in the EPZs and from purchases of raw material, electricity and capital equipment from domestic suppliers. The cost side includes pure administration costs of the EPZs, extra costs connected to building and maintaining an adequate infrastructure, and diverse subsidies (e.g., subsidies on the land rent) to the firms that establish themselves in the EPZs. Since it is impossible to know how attractive Malaysia would have been as an export platform without the EPZ, Warr's analysis certainly can give only suggestive answers. However, Warr argues that the benefits seem to be far greater than the costs, and robust to changes in variables used in the cost-benefit analysis. The welfare gains have been particularly large in terms of absorption of unskilled and semi-skilled labour.

The tax income from the EPZs were negligible during the period covered by Warr's study, but both Warr and Jomo (1990) argue that the tax policy was important for the initial success of the EPZs. It should also be noted that the tax and subsidy policy has become less generous over time, as the fundamentals of the economy has increased the attractiveness of Malaysia as a host for FDI.

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<sup>15</sup> Net Malaysian tariff revenues were as low as 3.4% of GDP already in 1970, and are today negligible (Tan, 1997, p. 227). In general, tariff revenues are important only for the poorest developing countries. This does not mean that the actual Malaysian trade barriers are low – it has long been recognized that non-tariff barriers are the greatest hinder to trade in most countries. In this respect it should be noted that the customs procedures for firms in the Malaysian EPZs are far simpler than those faced by firms operating outside the zones (Warr, 1987).

<sup>16</sup> In a neo-classical world it would be preferable with marginally lower taxes. The pure existence of multinational firms, however, suggests that there are important market imperfections that make the neo-classical framework unsuitable.

Warr argues that a major problem of the EPZs is that there are weak linkages and little technology transfer between firms that operate in these regions and the rest of the economy. Warr did not distinguish between local and foreign firms, but the majority of FDI to Malaysia is export-oriented and located in EPZs. It is therefore not surprising that other studies from the 1980s which explicitly focus on FDI have found similar results (e.g., MIDA, 1983, and Fong, 1988). However, recent studies are often more positive (e.g., Narayanan et al, 199, and Ismail, 2001). A main reason for this, according to Narayanan et al, is that early studies analyzed periods when most foreign firms in Malaysia performed mechanical assembly-type operations with a limited scope for linkages and technological spillovers. Moreover, it takes time for firms to adjust, and it takes time to build up a cluster of supporting industries. The same is true for knowledge transfer that takes place through migration of high-skilled labour between firms. In fact, the disappointing spillovers and linkages between foreign and local firms may not primarily be a result of a dualistic production structure, but rather of the country's relative endowment of skilled and unskilled labour. Rasiah (1998), for instance, argues that one reason why Malaysia has not succeeded in further upgrading its technological capability is that the country has imported unskilled labour from Indonesia and the Philippines. This has been done to hold down wages, but has also reduced the industry's incentives to shift to more advanced (less labour intensive) technologies.

### **3.2.5 Licensed Manufacturing Warehouses**

In 1975 the government introduced a system whereby firms located anywhere in Malaysia can apply for Licensed Manufacturing Warehouse (LMW) status. If this status is granted, intermediate goods and capital equipment used to produce manufacturing exports may enter the country tax and duty free. In this sense an LMW may be seen as a separate EPZ, and the incentives are basically the same whether a firm obtains an LMW status or establishes itself in an EPZ. The major exceptions are that, on the hand, land rent is not subsidized for LMWs, and that, on the other hand, an LMW may apply for a Locational Incentive package. The latter increases the incentives to establish firms in underdeveloped areas (Warr, 1987).

In his empirical analysis of the effects of EPZs Warr has also studied the effects of the LMWs, with the same ending year 1982. At that time total exports from LMWs accounted for 2.8% of total merchandise exports and 10% of total manufacturing exports, and employed 3.5% of the total labour force. The results of the cost-benefit analysis for the LMWs are not qualitatively different from those of the EPZs, but the LMWs are more labour intensive and seem to be much more closely linked to the domestic industry. The best illustration of the

latter is the fact that LMWs purchased 26% of their capital equipment locally in 1982, as compared to 8% for firms located within EPZs.

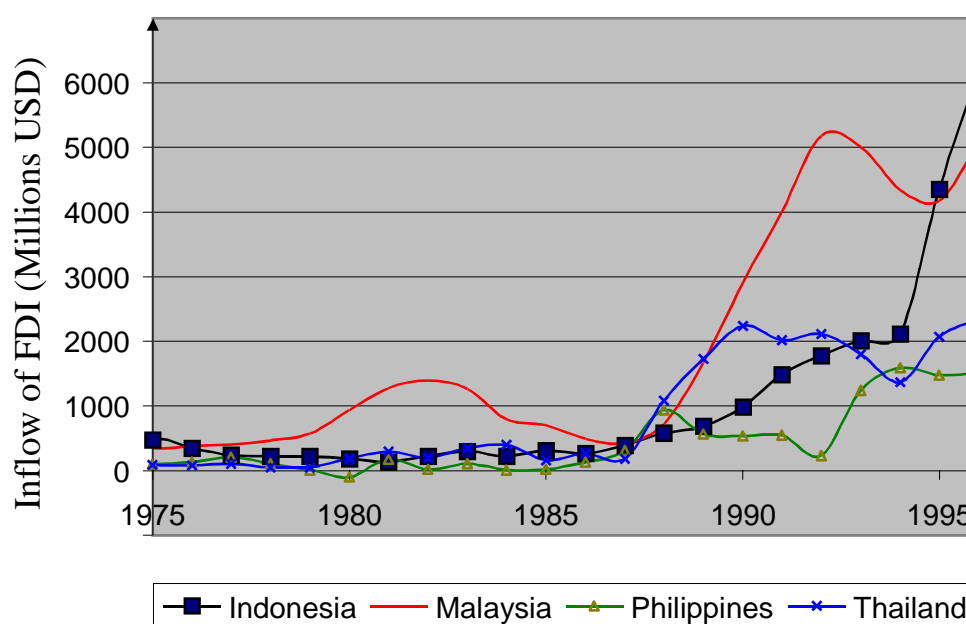
## **4 FDI in Malaysia**

Figure 9 shows inflows of FDI to the ASEAN-4 countries from 1975 to 1996. In the early 1980s Malaysia entered into the second phase of import substituting industrialization, offering foreign investors access to a highly protected and lucrative home market. During these years Malaysia experienced a significant increase in foreign investments, capturing a large share of the total inflows to the ASEAN-4 countries. However, the positive trend soon was reversed as it became evident that the policy was not sustainable and that the country entered into an economical crisis.

The outcome of this crisis was, as discussed in Section 3.2.1, that Malaysia initiated the second phase of export orientation in 1985. The effective tariff rates were reduced, and the trade unions lost some of their bargaining power. At the same time there was an overall deregulation and decontrol of foreign investments, contributing to make Malaysia a more attractive location for export-oriented foreign firms. Some of the same policy changes took place also in Indonesia and Thailand; in particular, both countries shifted from import substitution to export orientation. The Philippines, on the other hand, continued with the IS policy, and was the only one of the ASEAN-4 countries that did not observe a sharp increase in FDI from the second half of the 1980s (see Figure 9). It should be recalled, though, that this was a politically very turbulent time for the Philippines.



**Figure 9: FDI inflows to ASEAN-4 (million USD), 1975-1996**



Source: UNCTAD World Investment Report (1999) and Mercado-Aldaba (1998)

The main reason for the surge in FDI inflows to the countries that have been labelled the second generation of Asian Tigers, is presumably that they liberalized trade at a time when there was a spread of export-oriented FDI from Japan and the NIEs.<sup>17</sup>

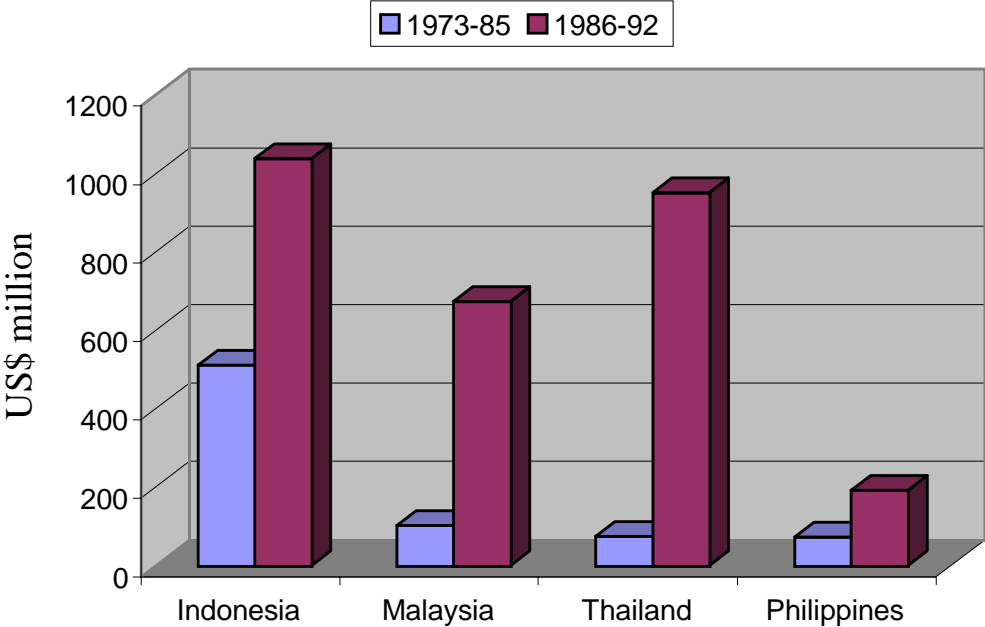
A major reason for the FDIs undertaken by Japanese firms is that they were searching for alternative production sites after the “Plaza agreement” where the Yen appreciated against the USD. The Plaza agreement was signed by the Group of Five (USA, Britain, West Germany, France and Japan) due to the increasingly larger trade surplus Japan had over the US. In 1980, for instance, the trade surplus was US\$7.2 billion, but had grown to US\$40.2 billion in 1985 (Tan, 1997).<sup>18</sup> Subsequent to the Plaza agreement the Yen appreciated from Y260:US\$1 in 1985 to Y130:US\$1 in 1988; the exchange rate was thus doubled in just three years (Tan, 1997). This appreciation caused some problems for the large share of Asian firms that had Yen-denominated loans or were heavily dependent upon intermediate imports from Japan. On the other hand, it also meant that these countries became more competitive against Japan, and there was a massive migration of relatively low technology, energy-inefficient and labour intensive industries from Japan to other Asian countries. Japanese investments thus

<sup>17</sup> The first generation of Asian Tigers are Hong Kong, Singapore, South Korea and Taiwan, while Indonesia, Malaysia and Thailand are known as the second generation of Tigers. Except for Indonesia, all these economies have regained much of their growth dynamism after the Asian financial crisis.

<sup>18</sup> Over a third of this surplus was caused by the large net export of Japanese cars, and the agreement led to a “voluntarily export restraint” of Japanese cars. Voluntary or not, there seems to be a broad consensus that the US was the loser from this export restraint (see, e.g., Salvatore (1995)).

grew very rapidly, both in the NIEs and in the ASEAN countries. Figure 10 illustrates that Thailand had the largest increase in inward Japanese FDI, rising from an average of US\$ 74 million between 1973-85 to US\$ 950 million between 1986-92. Thereafter followed Malaysia, where the averages were equal to US\$ 103 million and US\$ 673 million, respectively. Relatively speaking, the increase was smallest in Indonesia. The reason for this is both that Japan already had invested quit heavily in Indonesia, and that locational advantages of Indonesia predominately are in the primary sector. The wave of Japanese FDIs in the late 1980s and early 1990s were, however, mainly undertaken in the manufacturing sector due to the rising Japanese costs and a rising exchange rate of the Yen (see also Mercado-Aldaba, 1998, and Tan, 1997).

**Figure 10: Yearly average Japanese FDI to ASEAN-4**



*Source: Mercado-Aldaba (1998)*

To a large extent the Japanese FDIs consisted of outsourcing the most labour intensive sub-processes. This implied that both import and export costs along with the complexity of the trading system in the host countries were important, and this is presumably a main reason why the Philippines – with its high effective tariffs and a notoriously corrupt and inefficient bureaucracy – attracted relatively little of these investments. The Philippines also was in the midst of a political crisis, where president Marcos had been overthrown in the People Power Revolution in February 1986, while the other ASEAN-4 countries and the NIEs had relatively stable and business-friendly governments.

Some of the most advanced foreign direct investments from Japan were undertaken in Hong Kong, Singapore and Taiwan (South Korea has always been relatively hostile to inward FDIs). The rapid industrialization of the NIEs, however, implied that the production costs in these countries started to rise. As Japan, the NIEs were therefore outsourcing some of the most cost sensitive sub-processes. Between 1988 and 1989 outgoing FDIs from Taiwan, Singapore and Hong Kong to Malaysia increased by 155%, 117% and 229%, respectively. In fact, this is on average much larger than the Japanese increase of 120% (Tan, 1997). Japan was, nonetheless, the largest investor in Malaysia in 1989 (31.3% of total foreign investments), while Taiwan was the second largest (24.7%) and Singapore the third largest (10.6%).

## **5 Discussion and Conclusions**

There have been four waves of industrialization in Malaysia, where the focus has shifted between import substitution and export orientation. Import substitution predominated during the late 1950s/early 1960s and the first half of the 1980s, where the latter period was marked by an emphasis on heavy industrialization. Export orientation predominated in the 1970s and since the second half of the 1980s.

According to United Nations Industrial Development Organization (UNIDO, 1985) Malaysia was a latecomer to industrialization due partly to its vast endowment of natural resources, which provided for large amounts of foreign currency (see Jomo and Tan, 1999). This may be considered as a Third World version of the “Dutch disease”. The establishment of export processing zones, and a reorientation away from import substitution in the late 1960s and the second half of the 1980s, led to a massive increase in exports of manufacturing goods. Still, a large share of the domestic market is protected from foreign competition. Since the IS sector that produces for the domestic market has relatively weak linkages with the export-oriented sector, Malaysia thus has a clear dualistic economy. Malaysia faces a great challenge in integrating these sectors and in increasing the technological spillovers from the most advanced foreign firms to the local firms.

Few countries have been as successful as Malaysia in attracting FDI, particularly since the second half of the 1980s. This success is partly caused by the need of Japanese, Taiwanese and Singaporean companies to relocate some of their production to neighbouring countries with lower cost levels. Malaysia was then an attractive location, not least due to its good infrastructure quality, a business friendly and relatively stable investment climate, well-functioning export processing zones and the major export orientation that Malaysia undertook

in 1985. Malaysia has also become a politically stable country, and has been held up as a model for many other countries that face problems related to inequalities between different races and ethnical groups.

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