

ASIAN DEVELOPMENT BANK

STS:MAL 97009

COUNTRY OPERATIONAL STRATEGY STUDY

MALAYSIA

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CURRENCY EQUIVALENTS

(as of December 1997)

Currency Unit	—	Ringgit (RM)
RM1.00	=	\$0.257
\$1.00	=	RM3.891

The ringgit is linked to a weighted basket of currencies of the country's major trading partners.

ABBREVIATIONS

BIMP-EAGA	-	Brunei Darussalam-Indonesia-Malaysia-Philippines East ASEAN Growth Area
CAR	-	Central Asian Republic
CFC	-	Chlorofluorocarbon
COS	-	Country Operational Strategy
DMC	-	Development Member Country
DOE	-	Department of Environment
EPU	-	Economic Planning Unit
FDI	-	Foreign Direct Investment
GDP	-	Gross Domestic Product
GNP	-	Gross National Product
HAWA	-	Women's Affairs Division
IADP	-	Integrated Area Development Project
IMT-GT	-	Indonesia-Malaysia-Thailand Growth Triangle
MTCP	-	Malaysia Technical Cooperation Program
NDP	-	National Development Policy
NEP	-	National Environment Policy
NFPE	-	Non-Financial Public Enterprises
NIE	-	Newly Industrializing Economy
ODA	-	Official Development Assistance
PAP	-	Privatization Action Plan
PMP	-	Privatization Master Plan
RETA	-	Regional Technical Assistance
TFP	-	Total Factor Productivity
TVE	-	Technical and Vocational Education
6MP	-	Sixth Malaysia Plan
7MP	-	Seventh Malaysia Plan

NOTES

- (i) The fiscal year (FY) of the Government ends on 31 December.
- (ii) In this Report, "\$" refers to US dollars.

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EXECUTIVE SUMMARY

Malaysia has experienced an economic boom since 1988. During the Sixth Malaysia Plan, 1990-1995 (6MP), overall gross domestic product (GDP) growth averaged 8.7 percent per annum. The high growth rate of the economy was achieved with price stability and since 1993, with virtual full employment. Further, the sharp decline in poverty and the high attainment levels reflected in the social indicators show that the benefits of strong overall economic growth were widely distributed. The strong growth performance sustained for nearly a decade has also resulted in fundamental structural change in the economy as evidenced by the change in the composition of output and employment. The contribution of manufacturing to total GDP increased sharply to 33.1 percent by the end of the 6MP (1991-1995) from 20 percent in 1985, while that of agriculture declined to 13.6 percent from 21 percent during the same period. The change in the composition of output was accompanied by a similar change in the composition of total employment. The growth of manufacturing was driven by the growth of exported-oriented manufactures, and the country ranked among the highest in the world in its ability to attract inflows of private foreign direct investment. The privatization program has been successful in downsizing Government involvement in the economy and has helped the Government to transform a significant fiscal deficit into a surplus by 1993. With the excellent overall economic and social progress of the past decade, Malaysia has been a top economic performer in Asia, and has made great strides towards realizing its vision of a modern industrial society.

Malaysia, however, faces new challenges in the medium to long run. Important among these, are the need to address the increasingly complex issues of macroeconomic management; further developing human resources to meet the demands of greater technological sophistication of the economy; redressing the existing socioeconomic disparity between the western corridor of the Peninsula and the rest of the country, especially Sabah and Sarawak; and managing the country's vast natural resources in a sustainable manner. The Seventh Malaysia Plan, 1996-2000 (7MP) launched this year, is the latest phase of an economic strategy envisaged to transform Malaysia into a fully developed country by 2020. Key objectives of the 7MP are to sustain overall economic growth rate at around 8 percent per annum with price stability, further enhance international competitiveness, substantially upgrade skills and achieve higher levels of technological sophistication, and shift to a productivity-driven growth strategy from the investment-driven strategy of the past. The 7MP also aims at eradicating hard-core poverty by 2000, and reducing the existing imbalance in socioeconomic development between the more developed western corridor and the less developed regions of the country.

During the 6MP, certain key developments have sharply reduced Malaysia's official development assistance (ODA) needs. These include, the Government's vastly improved fiscal position, strong inflows of foreign direct investment and the fast track privatization program which resulted in the transfer of such traditional areas of public sector investment as power, transport and communications, water supply and sewerage to the private sector. Thus, along with assistance of other bilateral and multilateral donors, the Bank's assistance to Malaysia has also diminished sharply in recent years. Over the medium term this situation is likely to remain unchanged. Despite the country's sharply reduced ODA needs, however, the Government wants to maintain an effective operational link with the Bank, involving both capital assistance and TA, albeit at modest levels.

The Bank's current Country Operational Strategy (COS) for Malaysia was formulated in 1991 to coincide with the 6MP, but lost most of its relevance due to the profound economic changes that took place in the course of implementation of the Plan. The Bank responded to the rapidly changing economic reality and has adjusted its operations under an interim strategy in 1993, which has since guided Bank operations in the country. However, the launching of the 7MP with a new set of strategic objectives, the projected low ODA requirements and the Government's desire to maintain its borrower status with the Bank over the medium term, has made it imperative for the Bank to prepare a new COS to guide its operations in Malaysia through to 2000.

The objectives of the proposed strategy are to support human development, reduce socioeconomic disparity across states and regions of the country, promote sustainable environment management and support capacity building in selected areas. The strategy focuses on a few key areas, viz., technical and vocational education, balanced regional development and subregional cooperation, environment, and capacity building and policy support. Only a modest level of lending and a reasonable TA program is envisaged under the strategy to reflect the country's sharply reduced ODA needs.

The Bank's involvement in Malaysia over the medium term would be consistent with the broader mandate of the Bank envisaged in the Medium Term Strategic Framework (1995-1998), which emphasizes Bank support to the formulation of public policies, streamlining of public sector management, and the promotion of regional cooperation and trade. Moreover, involvement in the next phase of Malaysia's development, such as in meeting the human development requirements of a maturing economy, supporting balanced regional development and subregional cooperation, and the country's technical cooperation activities will provide valuable lessons to the Bank and permit it to be the catalyst in disseminating the lessons to other developing member countries (DMCs).

I. THE MACROECONOMIC SETTING

A. Growth and Structural Change

1. Malaysia has experienced an average economic growth rate of 9 percent per annum since 1988. During the Sixth Malaysia Plan, 1991-1995 (6MP) the growth of overall gross domestic product (GDP) averaged 8.7 percent per annum, against the initial target of 7.5 percent per annum. Per capita gross national product (GNP) increased from RM4426 in 1990 to RM5815, in 1995 and is targeted to increase to RM7,213 in 2000.¹ The expansion of real output is attributable mainly to investments in physical infrastructure, technology, education and skill training, as well as large foreign direct investment (FDI) inflows. According to Government estimates, total factor productivity (TFP) growth in the economy has also been substantial. TFP growth doubled from an average of 1.2 percent in 1971-1990 to 2.5 percent during the 6MP. The contribution of TFP growth to total growth accordingly increased from 17.9 percent of GDP to 28.7 percent during the same period.² Due to the strong overall growth, the economy continued to experience substantial structural transformation during the 6MP. The share of manufacturing in GDP increased sharply from 26.9 percent in 1990 to 33.1 percent in 1995, while the share of agriculture declined from 18.7 percent to 13.6 percent during the same period. The share of agriculture is projected to decline further to 10.5 percent in 2000, while that of manufacturing is projected to increase to 37.5 percent. Among the other sectors, the share of construction increased from 3.6 percent to 4.4 percent, while that of the services sector increased from 40.6 percent to 41.9 percent during the 6MP (see Table 1).

¹ In 1978 constant prices.

² Government of Malaysia, Seventh Malaysia Plan, 1996-2000 (7MP).

**Table 1: Gross Domestic Product by Industrial Origin at Constant 1978 Prices
(% share in GDP)**

Sector/Industry	1985	1990	1995	2000 ^a
Agriculture, Forestry and Fishing	20.9	18.7	13.6	10.5
Industry	36.7	42.2	47.3	50.7
Mining and Quarrying	10.5	9.8	7.4	5.7
Manufacturing	19.7	26.9	33.1	37.5
Construction	4.8	3.6	4.4	4.8
Electricity, Gas, and Water	1.7	1.9	2.3	2.7
Services	41.8	40.6	41.9	43.1
Wholesale and Retail Trade, Hotels, and Restaurants	12.1	11.1	12.1	12.7
Transport, Storage, and Communication	6.4	6.9	7.3	8.3
Finance, Insurance, Real Estate, and Business Services	8.9	9.8	10.7	11.9
Government Services	12.2	10.6	9.7	8.1
Other Services	2.3	2.1	2.0	2.1
Plus: Import duties	3.9	3.7	4.2	3.3
Less: Imputed bank service charges	3.2	5.1	7.0	7.5
GDP at market prices	100.0	100.0	100.0	100.0

^a Government projections under the 7MP 1996-2000.

Sources: Bank Negara Malaysia, Annual Report 1995
Ministry of Finance Malaysia, Economic Report, various issues
7MP 1996-2000

2. The structural changes in output were accompanied by similar changes in the composition of employment. The share of employment in manufacturing increased from 19.9 percent of total employment in 1990 to 25.9 percent in 1995, while the share of employment in agriculture declined from 26 percent in 1990 to 18 percent in 1995. The shares of employment in manufacturing and agriculture are projected at 28.9 percent and 13.1 percent, respectively in 2000, reflecting a further decline in the importance of agriculture in output and employment. In a landmark development, virtual full employment was achieved in the economy in 1993.

3. The most significant change in the composition of aggregate demand was the increase in the share of private investment. Private investment grew 16.6 percent per annum during the 6MP in response to fiscal incentives such as lower corporate taxes, reinvestment allowance and other investment promotion policies. Consequently, the share of private investment in GNP increased from 20.7 percent in 1990 to 32 percent in 1995. Public investment grew at 14.7 percent during the 6MP, and the share of public investment in GNP increased from 12 per cent to 13.4 percent during the same period. The major structural change in the trade sector during the 6MP related to exports, as in the past. The share of total exports plus nonfactor services in GNP increased from 83 percent in 1990 to 107.9 percent in 1995, while the share of imports plus nonfactor services increased from 78.6 percent to 116.2 percent during the same period.¹ The high trade shares in GNP show increasing openness of the Malaysian economy.

B. Export-oriented Industrialization

4. The Malaysian economy has been one of the best performers in terms of income, industrial and export growth in the developing world over the past two decades. The growth of manufacturing in this period has been driven by exports, and the economy changed from a predominantly resource-based exporter to the developing world's sixth largest exporter of manufactures, just behind the four Asian Newly Industrializing Economies (NIEs) and the People's Republic of China (PRC). Exports grew at the rate of 18.4 percent per annum, and manufactured exports expanded at nearly 25.8 percent per annum during the 6MP against the targeted growth of 19.8 percent. The share of manufactured exports in total exports increased from 58.8 percent to 79.6 percent during the 6MP. More importantly, since the 1970s Malaysian manufactured exports have developed on the basis of relatively skill-intensive and technologically complex products, which presently comprise nearly 80 percent of total exports. While processed natural resources provided the early impetus for industrial exports, electrical and electronic products have accounted for the bulk of export growth after the 1970s. Electrical and electronic products which grew at 30 percent per annum during the 6MP, account for about two thirds of total manufactured exports, and contribute about 30 percent of total manufacturing value added. Malaysia has emerged as one of the world's largest exporters of disk drives, telecommunications apparatus, audio equipment, room airconditioners, calculators, color televisions, and various household electrical appliances.

5. The export drive was spearheaded by foreign investors, initially from the US and Japan and later from other countries, including the NIEs of East Asia. With the tightening of labor market conditions which caused wages to rise, production became more automated,

¹ All estimates are based on 1978 constant prices.

and more complex processes and products were introduced. Many foreign component suppliers have followed their principals and invested in Malaysia. But the export structure remains concentrated and linkages with local firms have been slow to develop. The shortages of high-level technical skills constrains further upgrading of export activity, and marketing remains the preserve of foreign investors and buyers. In this, the pattern of export growth and diversification followed by Malaysia differs from NIEs such as the Republic of Korea, and Taipei,China.

6. The incentive framework in Malaysia has been favorable to exports, with the economy relatively open to trade and investment, prevalence of competitive exchange rates, good infrastructure and stable macroeconomic policies. Private enterprise has always been welcomed, and the policy framework has been transparent, predictable and well administered. Furthermore, the Industrial Adjustment Fund (IAF) launched in 1991 permitted the private sector to undertake structural adjustments to enhance efficiency and competitiveness of the manufacturing sector. The 1995 World Competitiveness Report placed Malaysia in second position in a list of countries which included the NIEs. The moderate levels of protection offered to industry are now being reduced, though under the industrial policy a few infant industries receive significant protection. However, the country expects to achieve zero to 5 percent import tariff structure by 2003. In the domestic market, there are few restrictions on competition. In general, Malaysia offers one of the most conducive environments in the developing world for private investment and export-oriented activity.

7. Malaysia has been among the largest recipients of FDI in the world in recent years. FDI has played a key role in the country's industrial development. The manufacturing sector is heavily dependent on FDI. The Government is now reducing the incentives offered to foreign investors and is using them as a means of guiding firms towards greater local content, skill development and technological deepening. Despite the increasingly competitive environment for FDI, Malaysia is unlikely to face major difficulties in mobilizing FDI inflows over the medium term, especially if it can strengthen skills and technological capabilities. There are encouraging signs of export growth in some local enterprises, especially in some of the heavy industrial enterprises. The new approach in industrial policy is to reorient industries, especially domestic heavy industries towards the world market from the initial stage of project implementation.

C. Privatization

8. Malaysia has implemented one of the most successful privatization programs in the region. Privatization played a pivotal role in the structural transformation of the economy under the 6MP, and was targeted primarily at alleviating infrastructure constraints and at expanding the manufactured exports sector. The Privatization Master Plan (PMP) was introduced in 1991 to guide the implementation of the Government's privatization program. The PMP contained a broad policy framework, procedures and modes for implementation; identified projects for privatization; and assigned priorities to the projects to be privatized. Apart from the projects identified by the Government, the PMP allowed the private sector to identify projects for privatization and rewarded the latter's initiatives in this regard. A key element of the PMP was the two-year rolling Privatization Action Plan (PAP) formulated to support implementation of the annual targets of the government's privatization program. To support the effective implementation of the PAP, the Government undertook major legal reforms, including amendments to the constitution, and passage of several important laws. Recent examples of

these initiatives are, the Privatization Act, 1993 and the Sewerage Services Act 1993. The legal and regulatory framework for private sector participation in Malaysia is still evolving.¹ In the 1995/96 Action Plan, a total of 200 projects were planned for privatization or corporatization, compared with 37 projects in the 1991/92 Action Plan.

9. The private sector responded with dynamism to a highly favorable policy regime which included fiscal incentives and favorable lending terms, especially for projects with high social rates of return. Privatization has been wide ranging covering all sectors of the economy with construction and manufacturing accounting for 22.5 percent and 15.2 percent, respectively of the 204 projects privatized since 1991. Several key areas such as power generation, highways, urban transport, water supply and sewerage, traditionally considered the sole preserve of public investment have been opened to the private sector. The sale of equity through the stock exchange formed the dominant mode of privatization accounting 46.1 percent of the total projects privatized. Other major modes used were direct sale of assets and build-operate-transfer (BOT).

10. The PAP has paid rich dividends to the economy. Total savings in capital expenditures to the Government from privatized projects during the 6MP amounted to RM51.6 billion. This amounts to nearly 71 percent of the total savings from privatization since 1983. The PAP also substantially strengthened the Government's fiscal position through sale of assets, corporate taxes and lease rentals, and contributed towards achieving a balanced budget. The privatization program greatly reduced the Government's administrative burden, while the efficiency and productivity of the privatized enterprises improved substantially. Most importantly, the program released scarce budgetary resources for allocation to critical areas such as social infrastructure development. Privatization has also played an important role in strengthening and deepening the capital market. Privatized entities were able to source funds from the equity market resulting in a boom in the capital market. Of the 24 privatized companies listed in the Kuala Lumpur Stock Exchange, half were listed during the 6MP, greatly broadening the market's base. About 22 percent of the total market capitalization at the Kuala Lumpur Stock Exchange at the end of 1995 was accounted for by privatized companies.

11. The privatization process will continue at a rapid pace during the 7MP. Apart from physical infrastructure, social infrastructure areas such as health, education and training, and research and development (R&D), will be targeted for privatization. Further improvements in the legal and regulatory framework for private sector participation and protection of the public interest will also be undertaken. The private sector is envisaged to play a key role in technology transfer and in strengthening and deepening the capital market under the 7MP.

D. Social Transformation

12. The high level of growth sustained over the last five years, together with the favorable impact of targeted Government programs reduced the incidence of overall poverty from 16.5 percent in 1990 to 8.9 percent in 1995.² Rural poverty decreased from 21.1 percent

¹ The Bank is assisting this process through TA No. 2498-MAL: *Strengthening the Regulatory System for Private Sector Infrastructure*, approved on 21 December 1995, for \$567,000.

² This excludes non-citizens. With this group included, the incidence of poverty is estimated at 17.1 percent in 1990 and 9.6 percent in 1995, reflecting the higher incidence of poverty among this group. Appendix 1, Table 1 shows selected performance indicators for Malaysia.

to 15.3 percent over the same period. Further, the level of hard-core poverty¹ decreased from 3.9 percent in 1990 to 2.1 percent in 1995, and the number of rural hard-core poor households declined from 121,600 to 69,200 from 1990 to 1995. Access to basic services also improved significantly during the 6MP. By 1995, 72 percent of the rural poor households had access to electricity, 65 percent to safe drinking water, 77 percent were within nine kilometers of a health clinic, 92 percent of the rural population had sanitary latrines, and 94 percent were within nine kilometers of a primary school. Life expectancy rates of both females and males increased to 74 years and 68.9 years, respectively by 1995, and infant mortality rate declined from 13 per thousand live births in 1990 to 10.5 in 1995. These indicators compare favorably with the middle income countries of the world, and in some cases, with high income countries as well. The great strides made in social development and poverty reduction, however, have been largely concentrated in the western corridor of Peninsular Malaysia. The eastern corridor and the states of Sabah and Sarawak have benefited much less from the growth process. For example, Sabah, Kelantan and Terengganu remain the states with the highest incidence of poverty, even though all three experienced significant poverty reduction during the 6MP. Sabah in particular, stands out for its relatively slow pace of development. It has the highest incidence of poverty, the lowest economic growth rate, the lowest literacy rate and the lowest provision of many services.²

13. Household incomes of all Malaysians increased along with the increase in per capita GNP. The average gross household income grew at an average rate of 9.5 percent during the 6MP.³ In addition, an increasing number of households moved into higher income groups. During the 6MP, the average income of the bottom 40 percent of households grew at 8.1 percent. However, the income of the middle 40 percent and top 20 percent grew at 10 percent and 9.2 percent. The differential rates of growth increased income inequality slightly as shown by the increase in the Gini coefficient from 0.446 in 1990 to 0.464 in 1995. However, such an increase at this stage of development is not uncommon, and basically reflects the difference in growth rates between the urban and rural sectors. The Malaysian approach to poverty reduction evolved, during the 6MP, towards a more targeted program in which individual families living in poverty were identified and provided with assistance to lift them out of poverty.

E. Recent Macroeconomic Performance⁴

1. Economic Growth

14. After experiencing a very high rate of economic growth for nearly a decade, the overall GDP growth rate declined from 9.5 percent in 1995 to 8.2 percent in 1996 which is more in accord with the growth potential of the economy. Growth in all sectors was lower in 1996 compared to the high rates achieved in 1995. The manufacturing sector continued to provide the main impetus for overall economic expansion, growing at a double digit rate in 1996. However, the sector's growth declined to 12.2 percent in 1996 from 14.5 percent in 1995. The moderation in growth was caused primarily by the slowdown in the export-oriented

¹ Defined as those with incomes below half the poverty line income.

² Appendix 1, Table 2 contains more data on selected socioeconomic indicators by State.

³ In 1978 constant prices.

⁴ The data in this section were obtained mainly from Bank Negara Malaysia, Annual Report, 1996.

electronics industry. This sector has come under pressure from increasing global competition, slower demand growth and a build up of inventories. The contribution of the manufacturing sector to overall growth increased to 51.6 percent in 1996 from 48.5 percent in 1995. Construction sector growth declined to 13 percent in 1996 from 17.3 percent in 1995, mainly due to reduced public sector investment in the sector, and contributed 4.5 percent of GDP in 1996. Growth of the agriculture sector increased from 1.1 percent in 1995 to 2.4 percent in 1996, primarily due to growth of palm oil output. The low growth in agricultural output reduced the contribution of the sector to 12.7 percent of GDP in 1996. Growth of the mining sector declined sharply to 3.9 percent in 1996 from 9 percent in 1995; and growth of the services sector declined to 9.1 percent in 1996 from 9.4 percent in 1995.

2. Resource Gap

15. Malaysia's savings and investment rates have been among the highest in developing Asia in recent years. The gross national savings rate increased to 38 percent in 1996 from 37 percent in 1995, while the investment rate declined marginally from 45.4 percent in 1995 to 43.3 percent in 1996. The overall resource gap as a proportion of GNP thus improved from 8.4 percent in 1995 to 5.3 percent in 1996. The Government took measures in 1996 to stabilize the investment rate and raise the saving rate to further reduce the resource gap. The gap continued to be financed mainly by the inflows of foreign direct investment particularly into the manufacturing sector. The large resource gap and the associated current account deficit are the result of the Government's investment-driven growth strategy, and are projected to decline over the medium term.

3. Fiscal Balance

16. The Government has maintained a tight fiscal stance, as evident from the large decline in current expenditure as a proportion of GDP since 1990. The successful privatization program has also made it possible to reduce development expenditure. Consolidated Government revenues as a proportion of GDP also declined over this period, but not by as much as expenditures, and as a result, the budget has been in surplus since 1993. With revenues increasing more rapidly than operating expenditures, the Federal Government's fiscal surplus strengthened further. This has enabled the Government to finance most of the development expenditure from its own resources, as well as to prepay the more expensive external loans. The Government's fiscal position remained strong in 1996. A revenue growth of 14.4 percent is expected in 1996 compared to only 3 percent in 1995, due to higher direct tax collections especially from corporate income taxes. However, operating expenditures of the Government also increased significantly in 1996 due to salary adjustment of civil servants and related benefits, while the growth of development expenditure was much less. The overall financial position of the Government is expected to record a surplus in 1996, and it will be about the same level achieved in 1995.

17. After recording a strong surplus in 1995 the consolidated financial position of the public sector is expected to show only a modest overall surplus in 1996, mainly due to increased development expenditures of the Non-Financial Public Enterprises (NFPEs). The Federal Government contributes 82 percent of revenues, and the NFPEs account for 54.1 percent of the development expenditure of the public sector. With the public sector net development expenditure projected to grow by 10.6 percent, an overall deficit of 1.3 percent of

GNP in the public sector account is expected in 1996 compared to a surplus of 3.1 percent in 1995.

4. Money, Inflation, and Wages

18. Bank Negara (BNM) continued to pursue tight monetary policies. The statutory reserve requirement (SRR) was raised twice in 1996 to contain credit and monetary expansion. Consequently, the three-month interbank rate increased from 6.76 percent in end-1995 to 7.39 percent in end-1996. Supported by tight fiscal and monetary policies, Malaysia continued to enjoy relative price stability in 1995 and, inflation, as measured by the consumer price index (CPI) averaged 3.5 percent in 1996, which was marginally above 3.4 percent in 1995. The slight increase in inflation reflects higher food prices. Continued price stability in the economy was the result of a combination of policies and measures, especially aggregate demand management, expanding supply and enhancing efficiency in the distribution system. Specific measures were introduced since October 1995 to increase savings, discourage consumption, increase food supply and reduce the costs of doing business, including rationalization of import tariffs on a wide range of imports. Appreciation of the domestic currency against the composite basket of Malaysia's major trading partners also contributed to domestic price stability.

19. The unemployment rate decreased from 2.8 percent in 1995 to 2.6 percent in 1996. As the rate of new job creation continued to outpace the growth of the labor force, the labor market tightened further in 1996. The average nominal wage in the manufacturing sector increased 11.4 percent in 1996, compared to 11.1 percent in 1995. In response to this, there was greater recourse to the use of foreign labor, both skilled and unskilled, as a short-term measure. However, the levy on foreign workers was doubled in certain categories of skilled labor.

5. External Sector

20. Export growth declined sharply to a low 6.3 percent in 1996 compared to 20.2 percent in 1995, reflecting a sharp deceleration of manufactured export growth and agricultural exports. While agricultural exports declined due to both weaker export prices and volume, manufactured exports declined due to slowdown of global demand for electronic products. Growth of manufactured exports is, however, expected to rebound over the medium term. Import growth also decelerated sharply to 1.5 percent in 1996 from 24.6 percent in 1995. With exports increasing faster than imports in 1996, the surplus in the merchandise account improved further. The current account deficit declined to 5.5 percent of GNP in 1996 from 9 percent in 1995. The deficit is attributable mainly to the large service sector deficit arising from higher remittances of profit on FDI, and freight and insurance charges on imports.

21. The current account deficit will be financed mainly by inflow of foreign direct investment. However, the net inflow of capital will be somewhat lower compared to 1995, due to large investments by Malaysians outside the country. The net inflow of official long-term capital will be substantially lower due to larger net payments of external debt by the Government. The overall balance of payments position, however, recorded a surplus in 1996. The country's international reserves position at the end of 1996 continued to remain strong.

F. Outlook

22. Malaysia's rapid structural transformation towards a modern industrial society continued at a brisk pace during the 6MP. It has outperformed most other economies of Asia in the past decade in terms of economic and social progress. GDP growth during the 6MP was 8.7 percent per annum, and the high growth rate was achieved with price stability and virtual full employment. The high trade-GNP ratio reflected growing outward orientation of the economy. The sharp decline in poverty and improvement in key social indicators show that the benefits of growth were widely distributed. The Government pursued an ambitious privatization program, and the country's record in the private provision of infrastructure services is, perhaps, among the best in the world. Downsizing the scope of Government involvement in the economy and a prudent fiscal policy transformed a federal budget deficit of about 4 percent of GDP in 1990 to a surplus by 1993. Factors such as the strong economic growth and the well-managed privatization and economic liberalization program attracted large FDI inflows. Political and macroeconomic stability, good infrastructure and private sector dynamism were in turn major determinants of the strong economic growth performance of the country. With the country's excellent economic performance in the backdrop, and the macroeconomic fundamentals firmly in place, Malaysia's medium to long-term economic outlook appears bright.

II. DEVELOPMENT ISSUES AND CONSTRAINTS

A. Sustaining High Economic Growth

23. Sound macroeconomic management has been a major factor in sustaining the high overall growth, containing inflation and achieving virtual full employment. Sustaining the excellent economic performance over the medium term will depend crucially on continuing the sound macroeconomic policies of the past and responding to the complex emerging domestic and global challenges. The maturing of the economy during the 6MP period poses difficult challenges for macroeconomic policy in the future. Keeping the privatization program on track will require significant streamlining of the legal and regulatory framework for private sector participation. Restraining credit to the private sector in the face of rapid deregulation and privatization will be a major issue in monetary policy, as evidenced in recent years. Fiscal and monetary policy will need to address speculation in the property market and the burgeoning investment in the construction sector in competition with the manufacturing sector.

Investment in property and in physical infrastructure at the expense of plant and equipment in industry was the result of incentives provided by the policy framework. However, this has restrained industrial capacity, slowed down growth in productivity and has not been optimal from the point of view of resource allocation. Maintaining the country's strong export growth and productivity, and diversifying its base will also be crucial in maintaining the high overall growth.

24. In all these areas there is a need to improve the capacity of public institutions to formulate and analyze policy options available to the Government to keep the economy on its projected growth path. Despite the high growth of exports driven mainly by manufactured exports, the current account deficit remains high. This is contributed by the deficit in the services subaccount. In this respect also, the country faces a structural constraint, since the outflows in the services account are expected to remain larger than the inflows over the medium term. Carefully designed policy responses are needed to reduce this imbalance over

time. Counteracting the effect of rising wages to maintain the country's global competitiveness, will also be a policy challenge in sustaining the trend growth of manufactured exports.

B. Upgrading Human Resources

25. There has been substantial progress in expanding the capacity of the education system, improving access in rural and remote areas, strengthening delivery, and improving the quality of education. However, a number of issues and constraints remain. First, the economy is in a state of virtual full employment with a tight labor market and is encountering significant shortages of skilled labor. The education and training system was unable to respond adequately to rapid expansion of jobs in the early 1990s and to developments in the demand for skilled and semiskilled manpower. Given the country's relatively small labor supply base, this has led to labor shortages in most sectors of the economy which are expected to persist throughout the 7MP. The situation has led the Government to permit the selective employment of foreign workers. Of a total workforce of 7.9 million, about 0.7 million are legally employed foreign workers. A further 1.0 million foreign workers are estimated to be employed illegally.

26. Upgrading the qualitative capacity of the education and training system to meet the skill requirements of the economy continues to be an issue of high priority. The technical and vocational education (TVE) system, including the public upper secondary TVE system and private institutions has been progressively expanded and strengthened mainly at a higher level. However, the country's strategy of increasing the capital intensity of production requires continued strengthening of science and technology education and qualitative upgrading of the education system's capability to produce technicians and engineers. At the same time, the capacity of the skill development system will require expansion, to help meet persisting demand for skilled and semiskilled workers. Measures will also be required to enhance labor force mobility and the efficient functioning of the labor market.

27. Second, problems of access, participation and lack of consistent quality of education persist, particularly in rural and remote areas. The expansion of physical facilities for education throughout the country, the provision of hostels, and the provision of financial support for health and nutrition have led to major improvements in access and participation of students from remote areas and low-income families as well as female students in primary and secondary education and TVE. Despite these efforts, there are shortcomings in the facilities, teaching staff and overall quality of education available in rural and remote areas, and persisting constraints on their access and participation. Lower participation and completion rates in basic education and TVE in rural and remote areas, including Sabah and Sarawak, and the relatively lower participation of female students in TVE indicate that further measures to enhance access and improve quality are required.

28. Third, increases in enrollment at the degree level in public institutions of higher learning have been low and have not kept pace with the expansion of enrollments at other levels of education. Only a small proportion of the relevant age-group is enrolled in higher education, and over 50,000 Malaysian students are pursuing higher education overseas. In addition to burdening the balance of payments, this prevents the economy from benefiting fully from potential research and development linkages between the domestic higher education sector and industry. To tackle this shortcoming, the Government in 1996 passed the Private Higher Educational Institutions Act, which is intended to encourage the private sector

to establish degree-granting institutions and enable foreign universities to set up branch campuses in the country. While it is premature to evaluate the impact of the Act, the initial high level of interest expressed by the private sector and foreign universities indicates that an expansion of the domestic higher education capacity and enrollments can be expected.

29. Fourth, the status and role of women in the economy is also an important issue in the context of upgrading the capacity of human resources to meet future challenges.¹ The economic progress made in the last two decades was accompanied by greater participation of women in the development process. However, the female labor force participation rate at 47 percent, is still significantly below the 86 percent participation rate for men. A higher female labor force participation rate could help alleviate the shortage of skilled and technical workers. Increasing women's participation in development is both an opportunity and a challenge for Malaysia, and success in this area could help sustain its rapid economic growth through the 1990s. The extent to which women are able to take advantage of labor market opportunities, however, will depend on how well their education and skill levels match the emerging employment opportunities and the availability of working arrangements that would enable working women with family responsibilities to combine their dual role effectively. Women enjoy equal access to education, but their enrollment is somewhat lower in TVE. Moreover, the majority of women remain in low-skilled, labor-intensive jobs in agriculture and in semiskilled assembly work in the manufacturing sector.

C. Balanced Regional Development

30. Malaysia's record of overall poverty reduction over the past two decades is all the more impressive because the official poverty line is relatively high by international standards. The rapid economic transformation of the economy has, however, been largely concentrated in the western corridor of Peninsular Malaysia from Penang in the north to Johor in the south. Consequently, states such as Sabah and Sarawak in the east of the country, and Kelantan and Terengganu in the eastern corridor of the Peninsula, have benefited less from the country's rapid economic development. In 1995, the incidence of poverty at 26.4 percent was the highest in Sabah among the states. Sabah also had the highest incidence of rural poverty at 34.3 percent, compared to the overall incidence of rural poverty of 15.3 percent in 1995. The Government's strong commitment to balance regional development has reduced the regional development gap significantly and strategies to narrow the gap further continue to receive high priority under the 7MP.

31. In terms of social indicators such as infant mortality rates, number of doctors per unit of population, literacy rates, and access to electricity, Sabah and Sarawak ranked the lowest in the country.² These two states also rank the lowest in the provision of physical infrastructure such as paved roads. In 1995, Sabah and Sarawak also had the highest unemployment rates at 5.6 percent and 4.9 percent, compared to the national average rate of 2.8 percent. The main reason for the relatively lower development level of these states is their higher dependence on traditional agriculture and the weaker economic linkage with the rest of the economy. While targeted projects aimed at reducing poverty of specific disadvantaged groups and areas will be needed, substantial investment in physical infrastructure, such as the development of industrial estates and export zones will also be needed in the poorer states to

¹ Appendix 2 provides an account of the present status of women in Malaysia.

² Appendix 3 provides more information and analysis of poverty in Sabah and Sarawak.

achieve a better regional balance in the development process. Addressing the existing regional imbalance with respect to Sabah and Sarawak will also further the Government's regional cooperation objectives relating, in particular, to Brunei Darussalam-Indonesia-Malaysia-Philippines East ASEAN Growth Area (BIMP-EAGA). Hence, the Government has accorded high priority to the development of Sabah and Sarawak in the 7MP.

D. Sustainable Environment Management

32. Malaysia faces two broad environmental challenges over the medium to long term, management of its remaining forest resources on a sustainable basis and addressing the environmental problems resulting from rapid industrialization and urbanization.¹ Some of the country's major environmental problems include: depletion of natural forests and degeneration of natural grasslands and wetlands; depletion of wildlife habitats and biodiversity; management of the large river basin systems; degradation of urban air quality; water pollution; and management of hazardous and toxic wastes. Until now Malaysia's record on environment protection has been generally satisfactory and it has enjoyed one of the least polluted urban environments in Asia. However, due to its phenomenal industrial growth in recent years the environment has come under pressure, and if the experience of other rapidly developing Asian cities is to be avoided, appropriate policies to regulate private sector developers, infrastructure providers and users of natural resources must be enforced effectively.

33. The Government's overall environment management strategy is to tackle the problems in a holistic manner by addressing the proximate causes of degradation, as well as by proactive measures to improve the environment. A number of measures were instituted during the 6MP to contain environmental degradation. The National Development Council (NDC) expanded its mandate in 1993 to incorporate environmental dimensions into development planning. Special branches under the Department of Environment (DOE) at the state level and environmental monitoring units under the local authorities as well as public and private corporations were established. The legal and regulatory framework relating to the environment were reviewed in 1993, and the recommendations are currently being implemented. Additionally new legislation was promulgated to cover areas such as solid waste, natural resources, management of hazardous chemicals, and the use of chlorofluorocarbons. At the state level, Sarawak instituted the Natural Resources and Environmental Ordinance to address its resource degradation problems.

34. Enforcement of the Government's efforts in implementing existing environmental regulations needs improvement. To improve enforcement, Government now requires that polluters be subjected to a stiffer penalty structure. Moreover, the use of market-based instruments, as well as strengthening environmental education and awareness are envisaged. Sustainable resource management is an area of priority concern for Malaysia, particularly in view of the fact that it has been designated along with the 12 other countries in the world as a "megadiversity" region. Although substantial progress has been achieved in developing the country's capacity for formulating sustainable policies and projects, assessing environmental impacts and implementing regulations, further strengthening of capacity in these areas is required.

¹

Appendix 4 provides a brief environment profile of Malaysia.

III. THE GOVERNMENT'S DEVELOPMENT STRATEGY

A. Strategic Objectives

35. The Second Outline Perspective Plan (1991-2000) and the National Development Policy (NDP) set out the Government's strategic development goals. These are to:

- (i) sustain high rates of growth with equity,
- (ii) eradicate "hard-core" poverty by the year 2000,
- (iii) promote higher levels of technological sophistication in the economy and across all sectors, and
- (iv) encourage the private sector to play the lead role in the productive expansion of the economy.

36. The policies and strategies which the Government has chosen to achieve these goals may be summarized as follows:

- (i) maintain price stability, fiscal prudence, an outward-oriented economy, and a stable exchange rate;
- (ii) generate higher levels of domestic savings and investments;
- (iii) improve economic efficiency, productivity, and competitiveness;
- (iv) promote human resource development and upgrade institutional and technology capacity;
- (v) minimize recourse to net foreign borrowing;
- (vi) strengthen domestic financial markets;
- (vii) continue to redress relative poverty and imbalance, particularly among certain target occupational groups and regions;
- (viii) continue the policies aimed at employment restructuring; and
- (ix) safeguard and improve the quality of the urban and rural environment.

B. Development Agenda of the Seventh Malaysia Plan

37. The 7MP is the latest phase of an economic strategy envisaged to transform Malaysia into a fully developed country by 2020. The macroeconomic goals of the 7MP are to sustain high growth (at around 8 percent per annum) with price stability, and enhance the country's international competitiveness. Maintaining competitiveness in global markets is viewed as being crucial to sustaining the high targeted growth rate. Owing to the shortage of labor and skills and the high rate of investment already achieved, the 7MP aims at shifting the focus from input-driven to productivity-driven growth. Skills upgrading, capital deepening, technology development, and organizational improvement will thus be the major factors underpinning the future transformation of the economy. Addressing the country's skills constraint is the principal challenge faced by Malaysia in the next phase of development. Therefore, along with capital deepening and technology development, the 7MP identifies human resource development as a key strategic priority, and envisages large-scale investment in human development, capacity building, and investment in modern technologies and services.

38. The strategy for industrialization under the 7MP emphasizes large-scale industrial production for export and restructuring of strategic industries, encouraging domestic production of industrial inputs, and expansion of activities in the services sector. The privatization program implemented during the 6MP will be accelerated and expanded to sustain the high growth rate, enhance efficiency and productivity, further improve the fiscal position and downsize the public sector. Sound macroeconomic management will play a crucial role in maintaining appropriate policy environment for export competitiveness and to provide appropriate incentives for private investment. The high rate of industrialization and urbanization envisaged under the Plan will, however, continue to put pressure on the environment. The 7MP proposes to address the issues of sustainable development in a more holistic and effective manner. Along with rapid economic growth, high priority is also accorded to social development to improve the quality of life of all Malaysians, in a manner that is consistent with the sociocultural values of the country.

39. The 7MP also aims at substantially reducing the existing economic imbalance between the western corridor of the Peninsula which has been the principal beneficiary of economic development so far, and the less developed states in the eastern corridor of the Peninsula, and the states of Sabah and Sarawak. Further, the 7MP also aims at reducing the incidence of poverty to 5.5 percent and to eliminate hard-core poverty all together by the year 2000 through targeted programs. Priority will be given to reducing poverty in the poorest states and districts, and reducing poverty of the indigenous peoples and the urban poor. The participation of nongovernmental organizations in this effort will be encouraged.

40. The Government is fully committed to strengthening regional cooperation in line with Malaysia's historical role in promoting economic cooperation and integration in the region. Although the private sector is envisaged to play the lead role in investment, the Government will play a supportive role in the development of BIMP-EAGA and Indonesia-Malaysia-Thailand Growth Triangle (IMT-GT) under the 7MP. A number of initiatives mostly in the private sector, are under way to implement the recommendations of the Bank's studies concerning these two subregional cooperation arrangements. Important among the private sector initiatives planned for implementation during the 7MP, are a land bridge connecting Penang Port and Song Khla, a border development zone in Bukit Kaya Hitam, and a teleport in Langkawi, will be implemented by the private sector under the 7MP.

IV. REVIEW OF PAST BANK STRATEGY, OPERATIONS, AND EXTERNAL ASSISTANCE

41. The Bank's Country Operational Strategy (COS) for Malaysia was last prepared in 1991. The 1991 COS coincided with the launching of the 6MP and the NDP and recommended that, consistent with NDP and 6MP objectives, the Bank's involvement in Malaysia should be concentrated on (i) policy environment support, particularly to enhance the role of the private sector; (ii) social and physical infrastructure investment; (iii) environmental protection and improvement; and (iv) poverty reduction and provision of basic needs. However, in view of the fundamental changes in the Malaysian economy during the 6MP, the Bank's strategy in Malaysia since 1994 has been guided by more modest objectives than those outlined in the 1991 COS, and its operations have been limited to: (i) human resource development; (ii) promoting growth in less developed states; (iii) environment management; and (iv) capacity building and policy support.

A. Assessment of Country Operations

42. The role of the Bank and other donors in supporting Malaysia's development efforts diminished substantially during the 6MP. The total value of Bank loans approved during this period was \$373.6 million, ranging from \$15 million in 1990 to \$150 million in 1992 (Appendix 1, Table 3). During the 6MP, areas traditionally reserved for the public sector, such as power generation, highways, urban transport, water supply and sewerage were opened up to the private sector. The privatization process will continue and expand to sectors such as education and health under the 7MP.

43. The Bank has post-evaluated 38 of the 64 projects approved in Malaysia between 1968 and 1988. Bank-financed projects contributed to increasing the quality of and access to technical and vocational education. Bank projects also contributed to raising productivity and reducing rural poverty through integrated area development, and to environmental improvements in both river basin management and coastal zone management. The Bank also supported the Government's health sector strategy which has been instrumental in achieving significant improvements in rural health indicators. Support for the power sector has been significant, but is no longer required in view of the strong technical and financial capability of the power utilities, and the ongoing privatization of the sector.

44. There have been only two unsuccessful projects in the post-evaluated portfolio. One was an agricultural support services project, and the other was a mini-hydropower project. However, project processing and implementation in Malaysia has been difficult. A number of projects have suffered implementation delays and cost overruns. The average delay was 2.7 years for agriculture sector projects. The major causes of delay in agriculture sector projects were inadequacy of contractors and engineering designs, delays in engagement of consultants, preparation of engineering design and delivery of equipment, changes of project scope and design at the advanced stages of project processing, and site reclamation and land settlement problems. In social infrastructure projects, the delays were caused by difficulties in land acquisition, consultant recruitment, procurement and civil works and problems related to inadequate site geological studies and design at appraisal. The major reason for cost overruns across sectors included expanded project scope, land acquisition difficulties and implementation delays. The major lessons learnt from post-evaluation experience are that thorough preparation, appropriate design and strong institutional capability of executing agencies are the key to success of projects across sectors. The Government and the Bank will have to take steps to prevent these problems from arising in future projects. While there is continued commitment on the part of the Government to borrow, albeit modestly from the Bank, stronger commitment on the part of the executing and implementing agencies is required to achieve the Bank's future operational program in Malaysia.

45. Malaysia's relatively low disbursement ratio is, in part, due to the Government often using its own resources to implement projects, and then being slow in claiming reimbursement from the Bank. In recent years, Malaysia has canceled a substantial portion of its total borrowings (Appendix 1, Table 4). The main reasons for the decline in the implementation performance of Bank-assisted projects in recent years, are the loss of project managers and staff with knowledge of Bank implementation procedures and practices, including accounting practices to the rapidly expanding private sector. More intensive project implementation reviews will thus be required to address these constraints. Further, more

realistic estimates of borrowing requirements during project preparation would assist in reducing the overall cost of borrowing for each project.

46. The TA program in Malaysia has been based on a strong Government-Bank partnership, with the Government contributing a significant proportion of the funds for each project. Notable areas of capacity building and policy support include sustainable environment management, women in development, capital market development, labor market information systems, reform of public sector corporations and regulatory framework for private sector participation in infrastructure. An impact evaluation study of Bank operations in the water supply and sanitation sector in Malaysia was published in December 1994.

47. With continuing privatization, reduction in the scope of public sector investment, a federal budget surplus, and large international reserves, Malaysia has committed fewer and smaller projects for Bank financing in recent years. The main rationale for seeking Bank assistance in recent projects has been the additionality arising from the Bank's policy advice and experience in packaging projects rather than mobilization of financial assistance. This trend is likely to continue in the future, and the processing and implementation of Bank projects will be subject to a degree of uncertainty. However, this is a risk that can not be avoided while operating in a maturing economy such as Malaysia.

B. Other External Assistance and Coordination

48. The total amount of ODA flows to Malaysia during the 6MP was about \$3 billion. Of this, about \$2.1 billion or 71 percent accrued from bilateral sources. Japan, the country's largest donor provided the equivalent of about \$1.6 billion out of the total bilateral assistance. The World Bank was the principal source of multilateral development assistance to Malaysia. During the 6MP, the World Bank approved five loans amounting to \$456.5 million, in agriculture, education, and health sectors. The World Bank's contribution to total ODA from multilateral sources during the 6MP was 52.8 percent compared to the Bank's share of 43.2 percent. The size of the World Bank's lending program also fluctuated from year to year. Close consultation with the World Bank will continue to be required, particularly in education and in economic and sector studies. Apart from the Bank and the World Bank, other multilateral donors were the Islamic Development Bank, which extended three loans worth \$35 million. Two of these loans amounting to \$18.5 million were co-financed with the Bank. Other bilateral aid agencies have small programs that emphasize human development, the environment and the expansion of bilateral economic links. Several aid agencies have advised that their programs are decreasing in response to the increasing level of development in Malaysia. UNDP's program is also decreasing because it is based on the level of income in the recipient country. Danish Cooperation for Environment and Development (DANCED) has a very active environmental program and is working in several areas which complement the Bank's support for improved environmental management.

49. Malaysia does not have an aid group or consortium to coordinate external aid activities. The Economic Planning Unit (EPU) of the Prime Minister's Department coordinates the aid programs of various aid agencies. The Bank ensures coordination of its program through formal and informal contacts with the World Bank and other aid agencies. The Bank's Country Programming Missions visit local representatives of bilateral aid agencies and exchange information about strategies and programs. Consultations are also held with the World Bank when their missions visit Manila or when a Bank Mission visits Washington.

50. In the course of consultation over the years, some areas of collaboration and specialization have developed between the Bank and the World Bank. Both institutions have been active especially in agriculture, education, energy and highways. In areas of specialization, the World Bank has been active in telecommunications, while the Bank has been involved in the development of ports. The Bank has been more active than the World Bank in the water supply and health subsectors. At present, the Bank is the most active development partner among the major donors. During the 7MP, the total ODA inflow is envisaged at about \$50 million per year mainly in specialized areas such as advanced industrial skills, environment management, and science and technology.

V. THE BANK'S FUTURE OPERATIONAL STRATEGY

A. Approach and Justification

51. Key economic factors such as Malaysia's vastly improved fiscal situation, high national savings rate, strong inflows of foreign direct investment, and the fast track privatization program, have drastically reduced its ODA needs. Concomitantly, the scope of bilateral and multilateral assistance, including that from the Bank has also declined sharply, as evidenced in recent years. This situation is unlikely to change in the future given the robust medium to long term forecasts for the Malaysian economy. Thus, Malaysia will continue to be highly selective in accessing ODA during the 7MP period. Despite this, the Government values an effective operational link with the Bank involving both capital assistance and TA, albeit at modest levels. The Government's position is based on (i) the value it attaches to the Bank's policy advice, (ii) the Bank's expertise in packaging complex projects, and (iii) a clearly perceived development niche for the Bank's involvement at the present stage of Malaysia's development.

52. Accordingly, a modest lending program and a reasonable level of technical assistance is considered appropriate for Malaysia during the 7MP. The country's ODA requirements may be further reviewed at the end of the 7MP. Based on the review, a determination of the Bank's role beyond 2000 if any, in Malaysia may be made. Involvement in the next phase of Malaysia's development in key areas such as in meeting human development requirements of a maturing economy, promoting growth in less developed states, subregional cooperation and environment management will provide valuable lessons to the Bank and facilitate its catalyst role in disseminating the lessons to other developing member countries (DMCs). The process of "cross-fertilization" between a successful and maturing economy such as Malaysia and other DMCs will be beneficial to the region. This approach for the Bank's involvement in Malaysia over the medium term would be consistent with the broader mandate of the Bank envisaged in the Medium Term Strategic Framework (1995-1998), which stresses Bank support to the formulation of public policies, streamlining of public sector management and the promotion of regional cooperation and trade.

B. Objectives of Bank Operations

53. In view of the greatly reduced scope for Bank involvement in Malaysia, the Bank's operational strategy will focus on a few key areas where the country still needs ODA. The operational areas discussed below constitute a development niche for the Bank's operations in Malaysia.

C. Areas of Focus

1. Technical and Vocational Education

54. In the context of Malaysia's growth strategy, human resources continue to be a major constraint and a key area for further development. The education system must improve its capability to produce graduates, particularly in science and technology, to complement the enhanced technological sophistication of production techniques. At the same time, the education system will need to produce skilled personnel to meet the persisting shortages of engineers and technicians. To alleviate these shortages, the Bank will support further strengthening of the capability of the technical education system to provide science and technology graduates at the secondary and postsecondary level. This will strengthen the country's capacity to support development and adoption of skill-intensive technologies. Continued support to development of the TVE system to produce skilled labor in line with labor market needs to enhance productivity and value added, will also be provided. The Bank strategy in this area will also further improve access of students to TVE, and encourage participation of students from rural and remote areas, lower-income areas and female students in TVE. Moreover, efficient functioning of the labor market will be enhanced to ensure a close match between TVE and the changing skill requirements of industry and commerce.

55. Strengthening the capability of the education system to produce higher quality science and technology graduates will require (i) upgrading and modifying TVE programs and curricula to match the increasing technological sophistication and diversification of the economy, and (ii) upgrading and retooling of TVE facilities and equipment to implement the upgraded and redirected programs.

56. Under the 7MP, the Ministry of Education (MOE) is undertaking a comprehensive review of the TVE system and upgrading all secondary vocational schools (SVS) into secondary technical schools (STS). The shortage of qualified and experienced teachers in the TVE system poses a major constraint to the effective implementation of the proposed changes and requires urgent attention. A number of important measures will be required to support the upgrading and modification of TVE programs. These include (i) the review and further development of the TVE curriculum; (ii) the corresponding review and further development of teacher development and instructor training programs; (iii) a comprehensive upgrading of the subject-matter and technical knowledge and skills of technical teacher trainers and teachers on both long-term and short-term training programs; (iv) exposing planners and teachers to new concepts of TVE through organized external visits; (v) developing training programs for technical school principals and senior managerial staff, to improve the management and efficiency of TVE; and (vi) corresponding strengthening and retooling of facilities and equipment.

2. Promoting Growth in the Less Developed States

57. Malaysia's impressive achievements in reducing poverty notwithstanding, the progress has been uneven. Significant poverty still persists in Sabah and Sarawak is mainly concentrated in the agriculture sector. The Bank should remain involved in supporting agriculture in Sarawak, and explore opportunities to support agriculture in Sabah, since support to the sector will be the key to promoting overall growth in these states. However, the emphasis in the Bank's operations in agriculture should be on evolving innovative project designs which encourage commercialization, and involvement of the private sector in line with the 7MP strategy. The Bank can also play an important role in supporting the Government to catalyze private sector investment for growth projects in Sabah and Sarawak.¹ This approach will contribute to higher income generation in these relatively less developed states.

3. Subregional Cooperation

58. Promoting regional cooperation is a key strategic objective of the Bank. In 1994, the Bank undertook regional technical assistance (RETA) to help prepare a plan for IMT-GT and another RETA for BIMP-EAGA is under implementation. In the preparation of these RETAs, it has been recognized that, while the private sector will be the driving force, Governments and the Bank can play a supportive role in promoting subregional cooperation through capacity building of relevant institutions and infrastructure development.

59. In Malaysia, the implementation of IMT-GT initiatives mainly undertaken by the private sector is well underway, and there is little need for public sector financial assistance. As regards BIMP-EAGA, however, there may be some areas where Bank assistance may be required. Such areas include development of industrial parks and infrastructure in Sabah and Sarawak. While the main objective of industrial development in these regions would be to achieve a better regional balance in development, it would also contribute significantly to BIMP-EAGA development, by improving the opportunities for private sector investment. There may also be a role for the Bank in supporting Sarawak's investment needs for physical infrastructure relating to ecotourism development, especially as part of the BIMP-EAGA initiative. As a major catalyst in the evolution of BIMP-EAGA, the Bank should also consider active support to the establishment of the BIMP-EAGA Fund, including participation as an investor. The Government, in its capacity as the Chair of the Fund, has requested the Bank to be an investor in the Fund in collaboration with the private sector from participating countries.

4. Environment

60. The Bank's role in environment is both in the area of capacity building² and by way of incorporating environmental dimensions in projects. As regards the latter, Bank's involvement in agriculture development projects will support sustainable environment management. In the past the Bank has addressed sustainable development and poverty reduction through a series of integrated area development projects (IADPs), which typically

¹ The Government, while according high priority to the development of the eastern corridor of Peninsular Malaysia, does not foresee a role for Bank involvement in that region.

² Also see para. 63.

consisted of key rural infrastructure components and activities intended to raise the productivity of agriculture and increase income opportunities for farmers. But due to the large public expenditures required, and the Government's policy of liberalizing agriculture markets to improve the productivity and efficiency of the agriculture sector, the Government no longer sees a role for the traditional IADP approach in rural development. Further, the IADP approach was often unable to address environmental and social concerns effectively. The Bank can play an important role in promoting sustainable development of agriculture, water and forestry resources, and in helping to evolve innovative models of corporate management in agriculture. Financing environmental quality improvements in small and medium scale enterprises is also an area of possible Bank involvement.

5. Capacity Building and Policy Support

61. In view of the need for upgrading human resources and the technological base of the economy, the country faces large, varied and complex capacity building and policy support needs. The Bank has substantial experience in supporting capacity building and policy formulation in its DMCs. In Malaysia, in the area of capacity building and policy support, the Bank will accord priority to gender concerns, environment management, economic policy, and supporting Malaysia's technical cooperation with other developing countries. Apart from these areas, specific advisory TA requests made on a priority basis may also be considered by the Bank on a case-by-case basis, to respond to the varied and complex nature of the country's capacity building needs.

62. **Enhancing the Status and Role of Women:** the Bank should build on the work already undertaken with the Women's Affairs Division (HAWA). A recent Bank TA has recommended strengthening of HAWA's role in the preparation of appropriate programs and policies for enhancing the participation of women in the country's socioeconomic development. However, substantial capacity building within HAWA will be needed to enable it to play this role. There is an immediate need for example, to develop gender-specific data on key education and employment indicators to enable HAWA to respond systematically to weaknesses revealed through the monitoring of disaggregated indicators. HAWA will also need support in preparing programs to enhance gender-sensitivity of government administrators, especially decision makers. However, HAWA's capacity building needs should be addressed in the Malaysian context where family values is a priority concern. Apart from supporting HAWA, issues relating to gender will be in the mainstream of Bank operations.

63. **Environmental Protection and Management:** the Bank's support to the Ministry of Science, Technology and Environment, especially in the regulation, control and improvement of industrial and urban pollution will continue. The recent TA on Institutional Framework for Sustainable Development and the proposed TA on Toxic and Hazardous Chemicals Wastes Emergency Response System are examples of the assistance the Bank can provide for institutional strengthening in the area of industrial pollution control. The Bank will also continue to actively support the Government's efforts to protect and conserve the country's forests and other natural resources, especially in Sabah and Sarawak. Assistance in this regard will focus on strengthening the institutional capacity for sustainable resource management of Federal, state and local governments, and of public institutions concerned. Management of inland waterways and urban environment are other areas where support for capacity building may be required.

64. **Economic Policy Support:** the Bank has supported macroeconomic policy analysis over a long period through economic and sector studies. Recent examples of such assistance include, Strengthening the Regulatory Framework for Private Sector Participation in Infrastructure and Malaysia's Export Competitiveness and its Sustainability. As the Malaysian economy continues to mature, economic policy analysis and management will become increasingly complex particularly in areas such as capital markets where policy developments are unfolding rapidly. Strengthening of skills in selected areas of economic policy formulation will thus be needed on an ongoing basis.

65. **The Malaysia Technical Cooperation Program (MTCP):** the Government is actively supporting MTCP activities as part of its commitment to promoting technical and economic cooperation with other countries. The Central Asian Republics (CARs) have recently evinced a keen interest in Malaysia's development experience. Like Malaysia, the CARs are mostly rich in resources but have small populations relative to land. Their capacity building needs are also extensive, and Malaysia's success in rightsizing the scope of public investment, deregulating the economy and most of all, in privatizing successfully, could have potentially important lessons for the CARs. The Bank can play an important role in supporting Malaysia's MTCP activities relating to the CARs. In this connection, there may also be a role for the ADB Institute in designing and organizing specific training modules for development managers of CARs which will be implemented in appropriate Malaysian institutions. The annual consultation between EPU and the Bank at the time of country programming could explore appropriate areas of involvement and coordination in this regard.

66. The future TA program will also build on **governance** and related issues addressed through an earlier TA, i.e., Strengthening the Regulatory Framework for Private Sector Participation in Infrastructure. In addition, participatory approaches will be adopted in the rural environment management projects. Governance issues were also addressed under the Bank TA on Management Improvement of State Economic Development Corporations.¹

D. Private Sector Operations

67. The Bank has thus far been unable to play an active role in expanding its lending to the private sector in Malaysia mainly because it has been relatively easy for the latter to access capital from local and international sources. However, due to the ongoing massive private sector investments in infrastructure, rising investments by Malaysian firms in infrastructure projects in other Asian countries, and the opening up of nontraditional areas such as education and health to the private sector, Malaysian entrepreneurs might renew interest in the Bank's private sector window. The Government, however, views the counter guarantee requirement under the Bank's Partial Credit Guarantee facility as an impediment to private sector borrowing from the Bank. Without the relaxation of this policy, the scope for private sector operations in Malaysia will continue to be limited.

¹

TA No. 2343-MAL: *Management Improvement of State Economic Development Corporations*, approved on 27 April 1995, for \$400,000.

E. Conclusion

68. Despite the rapidly declining role of ODA in financing development, the Government wishes to maintain an effective operational link with the Bank, based on the additionality arising out of the Bank's advise and its expertise in packaging complex projects in specific areas. The Government has thus requested the preparation of a COS to guide the Bank's future operations in Malaysia. The proposed strategy addresses the Government's expectations, while identifying an important development niche for the Bank's operations in an environment of declining ODA needs and shrinking prospects for Bank involvement. The proposed strategy is focused on a few areas and takes account of the country's greatly reduced ODA requirements. The envisaged capital assistance to Malaysia is thus small. The proposed TA program is also modest and essentially entails capacity building and policy support. The Bank's continued involvement in Malaysia is recommended since it will provide important lessons for future "flying geese" applications in DMCs, and enable the Bank to play an effective role as a catalyst development institution in disseminating the Malaysian experience to other DMCs.

STATUS OF WOMEN IN MALAYSIA

A. Governance

1. From the time of Independence in 1957, Malaysian women have had the right to vote and to hold office. Today women comprise one half of the registered voters and are active in political life, many as fund raisers and campaigners, but few hold high rank within any of the various political organizations. The percentage of women in government service has increased from 27 percent in 1980 to 33.6 percent in 1991. Although most women are in low and mid-level positions, there is an increasing number of women in senior positions where they can promote the advancement of women through policy formulation and overseeing policy implementation. Women are well placed within the legal system to support reforms improving the legal status of women as they constitute one third of the registered lawyers, one half of the session court judges, 44 percent of the magistrate judges and 15 percent of the appointees to the Attorney General Chambers.

2. While Malaysians generally perceive themselves to live in a society in which little gender discrimination exists, no specific provisions against gender-based discrimination exists in the Federal Constitution. Some laws prohibit gender discrimination, the most important being the Universities and University College Act of 1991 which stipulates open membership to all, irrespective of sex. Labor policy is equal pay for equal work but there is no legal requirement for employers to pay male and female employees in equivalent positions at the same rate.

3. Social security and income laws have been amended to meet the needs of working women to pay taxes and accumulate pensions. Some ongoing issues are: that self-employed women must pool their income and file in the husband's name; women supporting families are not entitled to the same dependent allowances as men and; while men may claim their spouse as a dependent and receive a "wife relief" deduction, no such provision is made for women who support their husbands. Income tax laws may be further amended to reflect the present pattern of employment.

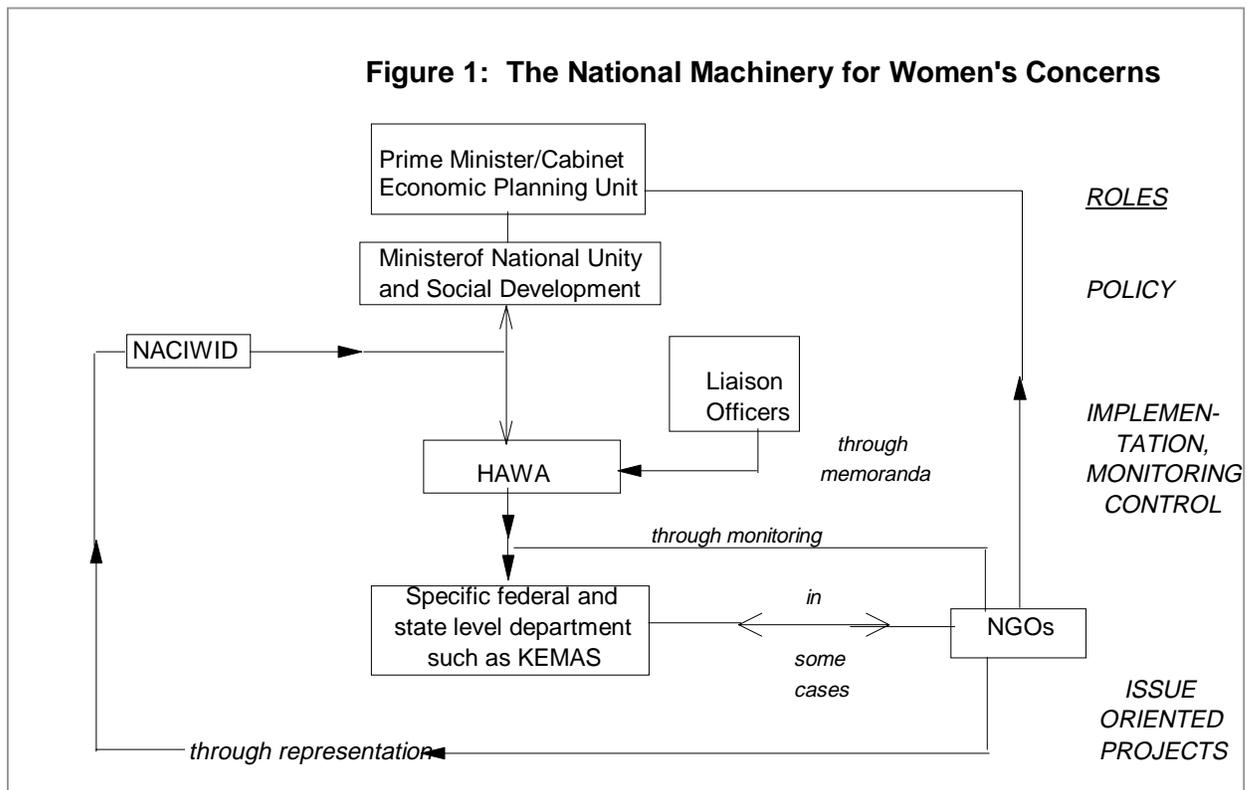
4. Marriage and family laws are based on religious and customary laws and may vary by state. The Guardianship of Children Act of 1961 assigns the legal guardianship of children to the father regardless of who is in actual custody, which is generally with the mother. In the case of desertion a woman can apply for legal guardianship. In June 1996, a Domestic Violence Act was amended and provided for increased penalties and improved safety and treatment for victims.

B. National Machinery to Address Women's Concerns

5. In addition to legal and constitutional provisions, the national machinery provides the venue for addressing women's concerns be they legal, economic, or social. The structure is shown in figure 1 and discussed below.

C. Women's Affairs Division

6. The Women's Affairs Division (HAWA) under the Ministry of National Unity and Social Welfare and is the lead agency in the national machinery for women for the integration of women in the national development process through coordination, monitoring and evaluation, planning, policy formulation, and reporting. HAWA's extensive responsibilities are not matched by its human, financial, and institutional resources; however, it makes the best use of the resources available. Under TA 2459-MAL the Bank assisted HAWA and the Government execute an institutional assessment of HAWA in consultation with the major parties concerned: HAWA, its ministry, Economic Planning Unit, Treasury, Public Service Department, and other Government and non-government organizations concerned with the welfare of women. The upgrading of HAWA from a division to a Department was the most important recommendation agreed upon under the study and is expected to occur in 1997.



Source: Jamillah Ariffin

7. The upgrading of HAWA is expected to redress its most serious constraints. As a division it is at a lower level than other departments within the ministry as well as with the departments outside of the ministry which it must coordinate. Senior experienced staff are reluctant to be assigned to such posts and turnover is high. As a result HAWA lacks sufficient prestige and recognition to influence and coordinate activities within the Government. Moreover, HAWA's capacity to carry out policy planning, identification of issues, monitoring and evaluation, or research is limited by insufficient staff with limited analytical skills for gender

issues. Finally the system for information gathering and for information dissemination needs to be improved. As a result of upgrading and strengthening, HAWA will be better able to act as a catalyst and leader in influencing and assisting other Government agencies and departments to undertake gender-responsive planning and policy formulation and deliver women-specific or gender-responsive programs after upgrading.

D. National Advisory Council on the Integration of Women in Development

8. The National Advisory Council on the Integration of Women in Development (NACIWID) was formed in 1976 in accordance with the UN resolution to integrate women in mainstream of development. Its members are nominated by the Ministry of National Unity and Social Development and appointed by the Prime Minister. Nominees are drawn from women leaders in the community, non-government organizations (NGOs), retired civil servants, and the private sector. It serves as an advisory body to Government and to non-government organizations. As HAWA serves as the secretariat, a strengthened HAWA would foster a more active NACIWID.

E. State and District Consultative Committees

9. State consultative committees (SCCs) were established in 1992, chaired by the state legislature and with secretariat support by a welfare department officer of the Ministry of National Unity and Social Development. District Consultative Committees (DCCs) are composed of representatives of women's organizations, and counseling agencies. These committees were intended to provide HAWA with a direct link to state and local government however the lines for communication have not yet been well established although a significant number is active at the local level.

F. National Council of Women's Organizations

10. The National Council of Women's Organizations (NCWO), was formed as an umbrella organization for non-government women's organizations in 1960. At present, the NCWO has over 250 affiliated welfare, political, professional and labor organizations and has served as an effective bridge between groups working at the community level and the Government. An improved dialogue can be expected upon the upgrading of HAWA as resources as staff time becomes available to consult and respond to the needs of the NGOs.

G. Liaison officers

11. In 1986, female liaison officers (LOs) were appointed to gather information and identify issues regarding women and development in their respective line ministries. No mechanism for regular meetings, coordination, and accountable reporting has been established nor have the LOs received support or credit for their additional work load. As a result the liaison officers have not played a significant role.

H. Inter-agency Coordinating Committee

12. An Inter-agency Coordinating Committee for Women's affairs was established in 1996 to address coordination issues. It is chaired by the Secretary General of the Ministry for National Unity and Social Development with members from the planning bureaus of key line ministries.

I. National Policy for Women

13. The National Policy for Women (NPW) was passed in December 1989 through the efforts of the NACIWID, HAWA, and NCWO. The objectives of NPW are to mainstream women across all sectors and develop their maximum potential contribution to society. Under the NPW, the Government committed to the integration of women in development policies, sectors, and resource allocations. HAWA was to be strengthened as focal point of the national government machinery for women as a stronger government agency was needed to fully address gender issues within government.

J. Women's Programs

14. The major organizations that implement women's programs are listed below:

- (i) **Community Development Division (KEMAS)** was established in 1972 under the Ministry of National and Rural Development. Programs for women focus on family development including home economics, nutrition and family health; on work oriented classes such as tailoring, handicrafts, and agriculture to supplement family incomes; on visits by home economics workers to help housewives to improve their socioeconomic conditions; on community pre-school child-care centers; and on adult literacy programs.
- (ii) **National Population and Family Development Board (NPFDB)** was established in 1966 to promote among other functions, development, functions related to reproductive research, population growth, and distribution.
- (iii) **Department of Agriculture** activities for women includes leadership development, improvement of quality of life, and entrepreneurship for target groups. A Farm Family Development Program for Rural Women started in 1967 to enhance the home-making roles of rural women through home economics courses and activities.
- (iv) **Rubber Industry Smallholders' Development Authority** was established in 1973 to assist smallholders in the rubber industry. Local Women Rubber Smallholders Groups were formed to promote increased family income and encourage small-scale business.
- (v) **Federal Land Development Authority (FELDA)** was established in 1956 as the government land development agency. A family development program was initiated in 1957 to encourage participation of FELDA family members. Women's

programs promoted income-generating through training, financial assistance and materials or equipment.

K. Health and Education

15. Demographic country indicators are positive. In 1994, women represented 49.8 percent of the total population of 19.7 million. The fertility rate declined from 4.9 in 1970 to 3.3 in 1993 and crude birth rate dropped from 32.2 per thousand in 1970 to 27.5 per thousand in 1990. Most maternal deaths are preventable therefore a significant improvement in health care services is shown by the decrease in the maternal mortality rate from 0.7 per thousand in 1970 to 0.2 per thousand in 1990. Neonatal mortality also decreased from 14.2 per thousand in 1980 to 8.6 per thousand in 1990. Another consequence improved health was the increase in the number of persons over 65. There are now about 0.4 million women over 65.

16. Family planning services are provided through government sponsored clinics although couples are increasingly making use of family planning services through private clinics and pharmacies. Family planning services coverage has been more comprehensive in urban areas and has been gradually expanded in remote rural areas as part of an integrated package of services provided through the rural health program. As a consequence, urban fertility is lower than rural fertility rates and regional differences exist with better coverage in Peninsular Malaysia than in Eastern Malaysia.

17. Malaysia has successfully extended access to education for both males and females and has nearly achieved universal literacy among young people. In 1970, the literacy level was 47 percent female and 69 percent male. By 1990 the literacy rate was 80 percent for female and 89 percent for males. The introduction of free primary education was one of the measures responsible for changing parental attitudes on female education. The gender gap in primary and secondary school enrollment is closed and at the tertiary level it is nearly closed.

18. The National Education Policy of 1960 has promoted a modern labor force through investment in science and technology education. Investment in technical and vocational education resulted in an increase in enrollment from 20,340 in 1985 to 52,180 in 1995. The enrollment rate of male students in science and technology is greater than female in both vocational and technical streams as female students opt for more traditional subjects early. In lower secondary school, female students comprise less than half of the enrollment in science, vocational, and technical streams.

19. Judicious policies has helped remove barriers leading girls to a traditional course of education. A Government program building dormitories for female students at vocational schools led to an increase in female enrollment from 22.2 percent in 1990 to 45.9 percent in 1992. In technical and vocational schools, there is a need for further dormitory facilities for female students and for a review of other constraints to increased female participation, particularly in engineering subjects. At the tertiary level, female enrollment increased from 38.6 percent in 1983 to 47.5 percent in 1993 however early patterns of gender stereotyping continues and women are over-represented in streams leading to traditional vocations such as teacher training and under-represented in polytechnic schools.

20. Education patterns show that the present patterns of employment reflect correspondent patterns in the educational system. Self-selection and access rather than

Government policy is responsible for continued enrollment in traditional courses, perpetuating employment patterns and concentrating women in low technology, low skill, or low status occupations. Parents and girls are responsive to efforts geared to changing traditional education patterns. Other efforts such as introduction of vocational counseling could increase the pool of highly skilled and technically trained female labor to meet the increasing demand for a technically skilled work force. A gender based assessment of recent secondary and tertiary school graduates in terms of time to first job, unemployment rate, salaries, and suitability of job to education would provide important inputs towards improving the efficiency of the educational system.

L. Issues: Geographic Disparities — The Case of Sabah and Sarawak

21. The small scattered population of Sabah and Sarawak renders expansion of education and health services more difficult than in peninsular Malaysia. As a result, literacy rates are lower and morbidity and mortality rates higher than average. In 1991 the national literacy rate was 89 percent for men and 80 percent for women. In 1995, the overall literacy rate increased to 91 percent compared to 85 percent in 1990. In Sabah it was 72 percent overall and 76 percent in Sarawak. These states also had the lowest proportion of population aged six years and over who had ever attended school, 71 and 76 percent compared to 90 percent in Selangor. Increased access to basic services such as education and health are needed in Eastern Malaysia to improve the level of literacy and the quality of life.

M. Participation in Economic Development

22. Female participation in the labor force kept pace with population growth and the number of female workers doubled between 1970 and 1995, while the female participation rate remained relatively unchanged from the 1980's onward. The expansion in numbers was enabled by the pull of the manufacturing sector and had a profound impact on rural to urban migration. The main social impact was to move women out of self-employment and unpaid family labor into the formal labor market. Over 40 percent of the manufacturing labor force is female which represents 30 percent of the total female labor force. Wholesale and retail services, financial services, and the Government sector are all significant employers of women. Employment in the agriculture sector declined as women moved from the relatively poorly paid and unskilled jobs of agriculture to higher skilled and better paying opportunities in other sectors.

23. The overall increase in the number of women in the labor force reflects a positive change in the perception of family regarding the role of women. The more women achieve higher levels of education and success in the work force, the more parents' views and social norms support their education and subsequent work. Changing views of gender roles in marriage means that women are less often viewed as solely responsible for domestic work which make possible more participation in the workforce. There is also evidence pointing to the increased importance of female remittances to rural income which is another factor contributing to female rural to urban migration and postponement of marriage. A final contributing factor has been the availability of relatively higher wage employment for previously underemployed women from the agricultural or informal sector. Thus changes in social norms and the pull of the market place have been instrumental in promoting women's participation.

N. Issues: Gender Differences in the Labor Force

24. Gender differentiation is seen in the wage structure of the labor force and the average gap for all types of labor may be as much as 50 percent in the private sector. It is Government policy to pay male and female civil servants according to the same pay scale. In the private sector, differences in responsibilities and designation make comparisons difficult at the managerial level. There are indications, however, that the gap exists. At low skill levels, jobs for males and females are often not identical which complicates the measurement of gender based wage differentials, however, jobs that are considered “heavy or important” are generally carried out by men and pay better than “light” female work. Some studies also show that even where men and women perform the same job, men are sometimes paid more.

25. At the administrative and managerial level there are proportionally fewer women (1.8 percent) than men (4 percent). However at the combined professional and technical level there are proportionally more women (12.7 percent) than men (8.4 percent) due to the size of the health and education sector and the preponderance of women in teaching and nursing. Women are also more likely to be found as clerical and service workers than men. Despite the importance of the manufacturing sector, proportionally more men are production workers (38.2 percent) compared with women (25.3 percent). The balance are agriculture and related workers, 21.9 percent male and 16.6 percent female.

26. While Malaysian women have benefited from increased employment opportunities in the private sector, these have been concentrated in low skill, labor intensive jobs requiring little job training or previous experience and consequently the most vulnerable to fluctuations in demand. As a result they have the least bargaining power which results in wage discrimination in the private sector. Although critical labor shortages occur, these are in skilled labor slots where women are under-represented and under-trained. As Malaysia moves from labor intensive manufacturing to more capital intensive forms of production, female workers stand to be displaced. Policies adjustments are needed to maintain Malaysia’s competitive edge, reduce its dependence on foreign labor and promote gender equity.

O. Strategies for the Future

27. The Government has systematically promoted a society enabling women (and men) to make their best contributions. The improvement in the status of women is demonstrated in the improvement in demographic statistics and in the high level of participation of women in the work force. Gender gaps remain in the concentration of women in particular industries and at particular levels, wage differentials, and gender stereotyping in education. Regional development has been uneven across states with Sabah and Sarawak below the national average in a number of crucial social indicators.

28. Resolving constant labor shortage, particularly of skilled labor while pre-empting the need to re-deploy female workers as Malaysia moves from a manufacturing based industry to capital intensive technology is crucial. Some solutions may include longer compulsory education, improved access and increased participation in vocational and technical education, elimination of gender stereotyping in education, skills upgrading and retraining, legislation supporting part-time employment and provision of child care facilities, employer training in gender neutral selection of employees, alleviation of private sector wage discrimination, and redressing regional and urban-rural disparity in access to basic services.

29. Policy formulation and fine tuning would be enhanced by the availability of routinely collected gender disaggregated data. Institutional strengthening of the HAWA will support the monitoring, evaluation, policy making, and implementation process to ensure that future policies and programs are based on well understood perceived needs of women in various socio-economic situations, synchronized with the direction of economic development and grounded in Malaysian social and cultural values.

POVERTY PROFILE

A. Introduction

1. The high level of sustained growth over the last five years, together with the impact of Government programs directed at raising incomes of the poorest groups has resulted in a reduction in the general incidence of poverty from 16.5 percent in 1990 to 8.9 percent in 1995. The figures are slightly higher if non-Malaysian citizens are included. Rural poverty decreased from 21.1 percent to 15.3 percent over the same period.

2. Besides, the direct outcome of the Government's poverty eradication programs the decline in rural poverty is also attributed to the migration of the rural poor to urban areas to take up employment. In terms of the number of poor rural households in each state, the overall pattern, shows a fairly stable pattern. In 1970 the states with the highest number of poor rural households were Kedah and Kelantan. In 1993 the numbers of poor rural households were highest in Sabah and Sarawak, in addition to Kedah and Kelantan.

3. The level of hard-core poverty (defined as those with incomes below half the poverty line income) decreased from 3.9 percent in 1990 to 2.1 percent in 1995. The number of rural hard-core poor households declined from 121,600 (5.2 percent) to 69,200 (3.7 percent). Access to services also improved during the 6MP. By 1995, 72 percent of rural poor households had access to electricity, 65 percent had access to safe drinking water, 77 percent were within nine kilometers of a health clinic, and 84 percent were within nine kilometers of a primary school. Sabah, Terengganu and Kelantan remain the states with the highest incidence of poverty even though all three experienced significant reductions during the 6MP. The relative lack of development in Sabah in particular stands out. It has the highest incidence of poverty, the lowest economic growth rate, the lowest literacy rate and the lowest provision of many services.

B. Poverty Profile in Sabah and Sarawak

4. In Sabah and Sarawak, there is concentration of socioeconomic facilities and services in few growth centers, while large rural areas remain relatively undeveloped. The majority of Sabah and Sarawak's population reside in rural areas and are involved in low productivity, labor intensive traditional activities. The lack of infrastructure in these two states is evident, as large areas are still inaccessible by road. In the absence of good road infrastructure and strong economic and social linkages between the modern and traditional sectors, the spread of development has been slow. In addition, inadequate access to education and employment opportunities in the formal sector, coupled with fluctuating income from traditional agricultural activities perpetuates poverty.

5. In the 6MP, the incidence of poverty in Sarawak and Sabah was targeted to decline from 21 percent and 34.3 percent, respectively in 1990 to 17 percent and 28.5 percent, respectively in 1995. By 1993 the incidence of poverty in Sabah declined marginally to 33.2 percent. In absolute terms, the number of poor households in Sarawak declined from 70,900 in 1990 to 68,000 in 1993, while the number of poor households in Sabah increased from 99,600 to 123,900 for the same period.

6. Data for the first three years of the 6MP indicates that the present poverty eradication programs in Sabah have not contributed significantly to reducing poverty. The sharp increase in the number

of poor households in Sabah during this period is mainly due to migrant population.

1. Sabah

7. The incidence of poverty in Sabah, at 33.2 percent in 1993, is more than triple that of Peninsular Malaysia. The poverty is predominantly a rural phenomenon since 82.1 percent of poor households live in rural areas. In addition, 40.2 percent of rural households are below the poverty line, compared to 18.5 percent of urban households.

8. In the first three years of the 6MP, the incidence of rural poverty decreased from 39.1 percent to 36.8 percent. In absolute terms, the number of poor urban households increased from 91,100 to 108,100. Similarly, the incidence of hardcore poverty in the rural areas decreased slightly from 10.1 percent in 1990 to 8.0 percent in 1993, or in absolute terms, from 23,700 to 23,600 households.

9. On the other hand, the incidence of poverty in the urban areas increased sharply from 14.7 percent in 1990 to 19.8 percent in 1993. In absolute terms, the number of poor urban households increased from 8,500 to 15,800. For the same period, the incidence of hard-core poverty in the urban areas also increased from 1.7 percent to 2.3 percent. In absolute terms, the number of hard-core poor households has increased from 1,000 in 1990 to 1,800 in 1993. The increase in urban poverty was the result of migration of the rural poor to urban areas in search of job opportunities and has caused social problems in the major urban centers, such as increasing numbers of squatters and high unemployment.

10. The most vulnerable group is in the agricultural sector where 54 percent of households live below the poverty line. Agricultural households also comprise over 65.1 percent of Sabah's poor, and the sector employs 40 percent of total households of Sabah.

2. Sarawak

11. In 1993 the incidence of poverty in Sarawak at 19.1 percent was considerably lower than in Sabah (33.2 percent). Like Sabah, poverty in Sarawak is primarily a rural problem, with 88.3 percent of poor households living in rural areas. The incidence of urban poverty is only 5.5 percent compared with 28.4 percent in rural areas.

12. In the first three years of the 6MP, the incidence of rural poverty decreased from 24.7 percent to 23.6 percent. In absolute terms, the number of poor households decreased slightly from 3.9 percent in 1990 to 3.7 percent in 1993, or in absolute terms 10,700 to 9,800 households. The majority of the rural population consists of agricultural households and hence bear the highest risk of being poor.

13. On the other hand, the incidence of poverty in the urban areas increased from 4.9 percent in 1990 to 6.0 percent in 1993. In absolute terms, the number of poor urban households decreased from 3,100 to 5,000. For the same period, the incidence of hard-core poverty in the urban areas also increased from 0.6 percent to 1.0 percent. In absolute terms, the number of hard-core poor households increased from 400 in 1990 to 900 in 1993.

14. Both Sabah and Sarawak experienced an increase in urban poverty during the period 1990-1993 primarily due to the migration of the rural poor to urban areas in search of employment. The problem is further accentuated by the inflows of migrant labor from neighboring countries. Factors

contributing to the poor performance of the anti-poverty programs in these states include:

- (i) poor accessibility of the rural areas which hinders effective deliveries of the various development support services, programs and projects in redressing poverty;
- (ii) lack of employment opportunities; and
- (iii) fluctuating incomes from traditional agricultural activities due to the volatility of commodity prices.

C. Government Policies and Objectives

15. The Malaysian approach to poverty reduction evolved during the 6MP towards a more targeted program of identifying individual families living in poverty and providing specific assistance to them. During the 6MP, income inequality increased slightly, the Gini coefficient increasing from .446 in 1990 to .464 in 1995. Such an increase at this stage of development is not uncommon and basically reflects the difference in growth rates between the urban and rural sectors.

16. During the 7MP, priority will be given to reducing poverty in the poorest states and districts, the indigenous community and the urban poor. The range of programs of assistance to the hard-core poor provided by the Program Pembangunan Rakyat Termiskin will continue with an allocation of RM522 million for the 7MP period. While direct welfare assistance and provision of basic amenities will continue, the primary emphasis will be on income-generating projects. The efforts of nongovernmental organizations are also expected to increase. The Government will provide an interest free loan of RM200 million to the Amanah Ikhtiar Malaysia to enable it to expand its lending activities to cover a further 57,930 households. The 7MP goals are to reduce the incidence of poverty to 5.5 percent (6 percent including non-Malaysians) and to virtually eradicate hard-core poverty by reducing its incidence to 0.5 percent by the year 2000.

STATUS OF THE ENVIRONMENT

A. Environmental Policy

1. Malaysia has been remarkably successful in achieving its development objectives over the past 25 years. In many instances, however, this sustained rapid economic growth and social progress has been accompanied by a deterioration in the country's natural resource base and environment. Under the Sixth Malaysia Plan, 1991-1995 (6MP), a number of initiatives were undertaken to improve environmental management. The National Development Council's mandate was expanded to incorporate environmental dimensions into development planning and the capacity of the Department of Environment (DOE) was strengthened. On the legislative side, new environmental-related legislation were promulgated to cover sewerage services, natural resources, the management of hazardous waste, the use of chlorofluorocarbons (CFCs) as well as occupational safety and health. The DOE also initiated the formulation of new legislation to address various environmental problems, and new environmental guidelines for investors and developers were prepared.

2. The recently released Seventh Malaysia Plan, 1996-2000 (7MP) contains a major chapter on the environment which sets out the Government's current policy priorities, stresses the need for policy coordination, and recognizes the close relationship between the efficient utilization of resources and the development of the states which are dependent on them. Under the 7MP, environment and resource management will be guided by the National Environmental Policy (NEP). The NEP aims at promoting economic, social and cultural progress through environmentally sound and sustainable development. The objectives of the NEP are:

- (i) to achieve a clean, safe, healthy, and productive environment for both present and future generations;
- (ii) to conserve the country's unique natural resources and diverse cultural heritage with effective participation by all; and
- (iii) to promote lifestyles and patterns of consumption and production consistent with the principles of sustainable development.

3. A plan of action will be drawn up to operationalize the different aspects of the NEP. The focus will be on providing a framework for an integrated approach to development, enhancing the effectiveness of the regulatory and institutional framework, recommending suitable mitigation measures, improving environmental education, communication and awareness, and training programs as well as incorporating environmental considerations in resource management and development planning. Additionally, under the 7MP, a National Conservation Strategy has recently been developed in order to provide a framework for the conservation of living and physical resources. Conservation strategies have also been formulated for most states.

B. Priority Sectoral Issues

4. Malaysia currently faces a large number of important environmental issues. In the natural resources sector, important issues include deforestation, pollution of inland and marine waters, soil and coastal erosion, overfishing and coral reef destruction. In the urban and industrial sectors, relevant issues include air pollution, water pollution and the problem of waste disposal — particularly toxic and hazardous waste.

1. Natural Resource Management

5. Sustainable management of Malaysia's natural resources is of central importance. About 59 percent of the total land area is presently under natural forests, this and Malaysia's long coastline and numerous rivers are an essential part of the country's resource base. Malaysia is one of the 12 countries in the world identified as a "megadiversity" region.

a. Forest Management

6. The extent of land under forest cover has declined over the past few decades, although in recent years this rate of decline has diminished somewhat due to better enforcement. In comparison with Peninsular Malaysia, Sarawak and Sabah still have nearly 70 percent and 60 percent respectively of their land area under natural forests. However, much of these areas have been logged.

7. The key issues in forest management in Malaysia include the control of logging in production forests in order to minimize environmental damage; restoration of forests degraded by shifting cultivation; protection of surviving mangrove forests; the size of areas set aside as protection forest, national parks, wildlife reserves and natural reserves; and ensuring that taxation and appropriate revenue sharing policies to ensure resource rents are adequately captured by the public sector and that incentives are in place for efficient use of resources.

8. Under the 7MP, Malaysia has set the goal of maintaining a forest cover of at least 50 percent in the long term. The development of an environmentally sound harvesting system is identified as the most important factor towards achieving sustainable forest management. In addition, the Plan advocates the use of other policy options, including taxes in the form of forest premiums, royalty and silvicultural cess, subsidies for setting up forest plantations, pollution charges on forestry activities that are damaging and rehabilitation of forests. The Bank has provided two sector loans and one TA to the Malaysian forestry sector.¹ There is little scope for further Bank assistance to the sector for forestry management.

b. Inland Water Resources Management

9. The main environmental concerns with regard to water pollution in inland and coastal waters are land use changes in catchments, sedimentation/siltation due to soil erosion, and domestic sewage and solid waste. Other activities that influence water quality include agricultural wastes (including animal wastes and toxic materials such as pesticides and fertilizers), aquaculture, industrial waste, sand mining, dredging and shipping.

¹ Loan No. 709-MAL: *Compensatory Forestry Sector Project*, approved on 20 November 1984, for \$24.5 million; Loan No. 921-MAL: *Second Compensatory Forestry Sector Project*, approved on 17 November 1988; TA No. 118-MAL: *Natural Forest Rehabilitation Study*, approved on 14 July 1989, for \$240,000.

10. River quality is monitored using the Water Quality Index which appraises water quality on five parameters, including biological oxygen demand (BOD), chemical oxygen demand, ammoniacal nitrogen, suspended solids and hydrogen levels. Out of the 119 rivers monitored in 1995, 52 were found to be clean, 53 slightly polluted and 14 highly polluted. Sedimentation of rivers, not viewed as "pollution" under Malaysia legislation, results from both widespread land use practices including agriculture, mining and forestry, as well as from specific development projects for housing infrastructure. In the Klang River basin, it is estimated that approximately 2.3 million tons of soil are eroded each year, which is very high by both Malaysian and international standards.

11. The Government has sought to address the issue of river quality in recent years. Sewerage facilities of 143 local authorities areas were privatized in 1993 to reduce water pollution from domestic sewage. Other initiatives carried out include the Klang River Ten year Rehabilitation Program and the Love Our Rivers Campaign. In addition, the Government has recently stepped up efforts to control soil erosion, following the tragic loss of life in several landslides in the Genting Highlands and in Kuala Lumpur. Under new regulations, the Government can now revegetate eroded or potentially eroded areas and charge property owners for the costs.

12. Under the 7MP, it is envisaged that river management will be increasingly the responsibility of the state governments. An appropriate mechanism will be instituted to improve water resource planning and development of catchment and watershed areas to ensure adequate and clean water supply. In terms of sedimentation control, steps will be taken under the Plan to integrate soil conservation planning with physical development, and review current legislation and guidelines governing land development in relation to soil conservation. In particular, the existing Guidelines for the Management of Land to Control Soil Erosion and Siltation will be reviewed and the need for a Soil Conservation and Sediment Control Act will be studied.

13. The Bank has extended a loan to the Government to finance the Klang River Environmental Improvement and Flood Mitigation Project. The purpose of the project is to achieve a comprehensive and coordinated approach to the problems of soil erosion, sedimentation, solid waste disposal, water pollution and flooding in the Klang River basin. The project includes components for integrated river basin management, solid waste management, sediment trapping, tributary river corridor improvement, and flood forecasting and warning system.

2. Urban and Industrial Environment Management

14. Malaysia once enjoyed the reputation of having one of the least polluted urban environments in Asia. Lately, however, sustained rapid economic growth has started to impose costs in terms of industrial pollution and degradation of the urban quality of life. The key issues in urban and industrial environment management are air quality and waste disposal.

a. Air Pollution

15. Suspended particulates and lead are the principal forms of air pollutants in Malaysia, with levels of sulphur dioxide emissions from vehicles also rising rapidly. Kuala

Lumpur is one of the 15 Asian cities that have the greatest level of pollution from Total Suspended Particles, with average reported concentrations far exceeding World Health Organization (WHO) standards. Both industry and transport pollute the environment, but the latter is mainly responsible for air pollution in Malaysia, accounting for over 75 percent of total emissions in 1995. Lead pollution is entirely due to transport. Among the industrial sources, the worst polluters are wood-based, palm oil, food processing, non-metals, textiles, rubber products and iron and steel industries. Open burning (including forest fires) is also a large contributor to air pollution in Malaysia.

16. During the 7MP, the Government plans several initiatives to combat air pollution. In the transport sector, these include: stricter control of motor vehicle emissions through the use of cleaner diesel engines and efficient exhaust systems, comprehensive traffic management systems, and implementation of an inspection and maintenance program for all vehicles prior to renewal of licenses. In the industrial sector, the Government will promote the use of clean technology, pollution control equipment, alternative fuels and the proper siting of industries. In addition, the Government will continue to work with major industrial users to control and reduce the consumption of CFCs and other ozone depleting substances.

b. Waste Disposal

17. Income growth and urbanization have changed consumption patterns which in turn have placed a heavy burden on urban solid waste disposal facilities. Unsafe solid waste landfills and illegal dumping of wastes remained a problem since enforcement was hampered by a lack of capacity and legal power of the local authorities. At the same time, the rapid growth of technology-intensive industries led to an increase in the import and consumption of chemicals and its related products, some of which are toxic. All these resulted in an estimated hazardous waste generation of 417,000 tons in 1994. To migrate this problem, the Government granted exclusive rights to a consortium to build, operate, treat and dispose hazardous waste at Bukit Nanas, Negeri Sembilan which became operational in March 1997.

18. Despite the long delay in the construction of a new 400,000 ton capacity hazardous waste facility in Bukit Nanas in Negeri Sembilan, the Government has made significant progress on other aspects of hazardous waste management, namely, the intensification of enforcement, the preparation of a code of practice, the institution of environmentally sound management of toxic chemicals, and the enhancement of chemical safety. Progress has also been made in developing comprehensive legislation to control the storage, handling, transport, labeling, treatment and disposal of hazardous waste.

19. Under the 7MP, existing environmental protection measures, laws, regulations, and guidelines will be complemented by the provision of further incentives for the proper management of hazardous waste and the promotion of cleaner technology and processes. Public sector R&D agencies will focus their efforts towards identifying suitable and effective disposal systems and technologies, training of relevant personnel and instilling greater awareness among the public and relevant industries.

20. The Bank will provide technical assistance for a toxic and hazardous chemicals emergency response system with a view to helping the Government make formal institutional arrangements for minimizing the risks associated with production, transport, storage and disposal of toxic and hazardous waste.

D. Priority Cross-sectoral Issues

1. Environmental Capacity Building

21. Malaysia has strengthened the capacity of some of the agencies involved in environmental management in recent years. For example, the capacity of DOE was recently strengthened with the setting up of separate branches in the Kuala Lumpur Capitol Region and in the States of Negeri Sembilan and Kelantan. Likewise, special environmental units were established in some local authorities as well as in public and private corporations. There is, however, an immediate need to revitalize the training and skills upgrading programs currently operated by both the Government and the tertiary sector. Technical certificate courses covering a range of environmental topics — including enforcement issues, process technology improvement and waste minimization practices — should be established.

22. The 7MP does places emphasis on promotional environmental auditing among businesses through seminars and workshops to introduce top management to the benefits of environmental auditing and to provide training in the area. The Department of Statistics is envisaged to remain the central depository for environmental statistics. Both central and line agencies will upgrade their database through an improved collection and information system. In addition, the Malaysian Center for Remote Sensing will provide real time monitoring of the environment and natural resources through the use of satellite and other remote sensing sources.

23. The Bank has provided two TAs for environmental capacity building in government agencies. The first TA was to strengthen the capability of the State Planning and Development Unit of the Selangor in order to enable them to integrate environmental considerations into the development planning policies.¹ The second TA, recently completed, entitled Strengthening of the Institutional Framework for Sustainable Development² assessed the appropriateness of current institutional mechanisms related to environment and development in Malaysia. This report identified several areas where the Bank could provide further assistance for environmental capacity building, including:

- (i) establishment of a working group to coordinate and promote the training activities of the various institutions engaged in environmental training and education;
- (ii) provision of enhanced training opportunities for urban and land use planners for effective planning control;
- (iii) the establishment of institutional mechanisms and corresponding capacity building at the state government level for effective coastal resources management planning;

¹ TA No. 1168-MAL: *Establishment of Environmental Planning Sector*, approved on 19 June 1989, for \$255,000.

² TA No. 2299-MAL, *Strengthening the Institutional Framework for Sustainable Development*, approved on 14 February 1995, for \$142,000. Final Report, December 1995.

- (iv) enhancement of training opportunities for small and medium sized industries in environmental management; and
- (v) the upgrading skills of local authorities through environmental management programs, such as those given by the National Institute of Public Administration (INTAN).

24. The Bank should continue to provide assistance for capacity building initiatives at the Federal, state and local levels in line with the recommendations of the Report on Strengthening of the Institutional Framework for Sustainable Development cited above.

2. Private Sector Initiatives

25. In line with the Government's policy to promote private sector involvement in environment management, several initiatives were undertaken during the 6MP. Areas in which the private sector now plays an important role include air and water pollution monitoring, toxic and hazardous waste management, solid waste management and management of a 12-km reach of the Klang River.

26. In recent years, the Government has been moving towards the privatization of the DOE's monitoring function in several areas. The Government approved the privatization of ambient air quality monitoring in early 1995. This is now being performed by a private company. In addition, the inspection of private vehicles has also been privatized by the Government and it is expected that the inspection of public vehicles will follow suit.

27. The Government has also taken steps towards the privatization of solid and toxic and hazardous waste disposal. In 1993 the Government invited proposals for the privatization of the urban solid waste disposal services of local authorities in order to put in place an integrated solid waste management system incorporating recycling and safe environmental management considerations. Likewise, the Government gave exclusive rights to a consortium to build, operate and maintain a centralized and integrated facility for the collection, storage, treatment and disposal of toxic and hazardous waste.

28. Private sector involvement in improving the Klang River within Kuala Lumpur, in conjunction with commercial development, is being planned for a 12-km stretch of the river dubbed the "linear city." The development and management of the linear city, to begin in 1997, calls for privatization of the Klang River where it flows through Kuala Lumpur; construction of a rapid transit system along the river; river cleanup through solid waste removal, sediment removal, and flood mitigation; and removal and resettlement of squatter families, all to be undertaken by the developer.

29. Under the 7MP, the private sector will be urged to improve its operations within the context of increasing productivity of both human and natural resources. Efforts will also be undertaken to create niches in environmental products and technologies in which Malaysia will be able to achieve comparative advantage and cater to the growing international demand. In addition, in order to encourage the private sector to take on a major role in promoting public awareness, the Government will actively seek partners in the corporate sector to adopt as well as to promote environmentally responsible practices and processes.