Macroeconomic Management Amid Ethnic Diversity: Fifty Years of Malaysian Experience

Jayant Menon

April 2008

ADB Institute Discussion Paper No. 102
This paper was written while the author was a senior research fellow at the Asian Development Bank Institute. It is a revised version of a paper presented to the National Economic Outlook Conference 2008-2009, “Fifty Years of Nationhood: Taking Stock, Moving Forward” organized by the Malaysian Institute of Economic Research, held in Kuala Lumpur. The author is grateful to Prema-chandra Athukorala and Hal Hill for all kinds of advice in writing this paper, and to Fidelis Sadicon for data tabulation. Address comments or queries to the author at Office for Regional Economic Integration, AD B, 6 ADB Avenue, Mandaluyong City 1550 Metro Manila; E-mail: jmenon@adb.org.

The views expressed in this paper are the views of the authors and do not necessarily reflect the views or policies of ADBI, the Asian Development Bank (ADB), its Board of Directors, or the governments they represent. ADBI does not guarantee the accuracy of the data included in this paper and accepts no responsibility for any consequences of their use. Terminology used may not necessarily be consistent with ADB official terms.

ADBI's discussion papers reflect initial ideas on a topic, and are posted online for discussion. ADBI encourages readers to post their comments on the main page for each discussion paper (given in the citation below). Some discussion papers may develop into research papers or other forms of publication.

Suggested citation:


Asian Development Bank Institute
Kasumigaseki Building 8F
3-2-5 Kasumigaseki, Chiyoda-ku
Tokyo 100-6008, Japan

Tel: +81-3-3593-5500
Fax: +81-3-3593-5571
URL: www.adbi.org
E-mail: info@adbi.org

© 2008 Asian Development Bank Institute
Abstract

This paper examines the role that macroeconomic policy management has played in the Malaysian development experience. Given the multiracial nature of Malaysian society, macroeconomic policy has not only been about economic stabilization, but also about addressing income disparities along racial lines in order to preserve social harmony. The affirmative action program under the New Economic Policy was an important signaling device, and served to demonstrate that all should share in future growth. Its actual contribution is difficult to determine, because rapid economic growth and structural change were taking place concurrently. Although its resource cost was not a major drag on growth in the past, the slowdown in FDI inflows and exports post-crisis, combined with demographic change, implies that reforms may be necessary to ensure sustainability, going forward. The key lesson to come from the Malaysian experience is that in a small open economy, the task of achieving the conflicting objectives of growth and equity is facilitated by a long-term commitment to an open and liberal trade and investment policy regime.

JEL Classification: E60, E63, E65, F41
Contents

I. Introduction

II. Phase I: From Merdeka to the May 1969 Riots


IV. Phase III: Transition from the NEP to the National Development Policy (NDP), 1987 to 1997

V. Phase IV: From the 1997 Crisis, to Recovery, to the Present

VI. Concluding Remarks

Appendix 1: Capital Account Restrictions Prior to the 1997 Crisis

References
I. INTRODUCTION

Malaysia, then Malaya, gained independence from British rule on 31 August 1957. Unlike any other colony, the process of securing independence was peaceful and almost completely devoid of conflict or violence. Another unique feature of this process was that it was realized by three peoples of different ethnic origin, each with their own culture, religion and identity. To a large extent, the process of building the new independent Malaysia has been a struggle to maintain peace and social harmony in a plural society inherited from a colonial past, while pursuing economic development and prosperity.

In this paper, we examine the role that macroeconomic policy management has played in the Malaysian development experience. Given the multiracial nature of Malaysian society, macroeconomic policy has not only been about economic stabilization, but also about addressing income disparities along racial lines in order to preserve social harmony. Thus, the Malaysian experience provides an interesting case study of macroeconomic management amid ethnic diversity. This is one challenge facing Malaysian policymakers. Another relates to the nature of the economy itself. As a small, open economy, Malaysia has always been exposed to exogenous influences and cyclical changes in world economic activity. Thus, the employment of counter-cyclical macroeconomic policy has been particularly important in cushioning the economy against such external shocks. In this context, macroeconomic management in Malaysia has necessarily been a balancing act, involving income redistribution on the one hand, and economic stabilization on the other.

We begin in 1957 and examine the whole period of independence. In terms of major policy shifts, we divide the post-independence period into four phases, and the paper is organized around them. Section II starts with Independence, or Merdeka, and examines major policy changes leading up to the May 1969 riots. This upheaval led to the introduction of the New Economic Policy (NEP), from 1970 to 1987, and this is the subject of Section III. Section IV covers the decade from 1987 up to the 1997 Asian financial crisis, when policy veered from the NEP, which emphasized redistribution, to the National Development Policy (NDP), which focused on market-oriented development policies. The last period that we identify starts with the crisis, when Malaysia bucked orthodoxy and resorted to capital controls as a crisis management tool, and traces policy changes through the recovery period leading up to the present. This section also examines the dramatic result of the elections of 8 March 2008, with a view to its likely impact on the economy and policy, going forward. This is the subject of Section V. A final section concludes.

II. PHASE I: FROM MERDEKA TO THE MAY 1969 RIOTS

At independence, economic conditions in Malaysia (then the Federation of Malaya) appeared conducive to rapid growth. The colonial inheritance included a well-developed infrastructure, an efficient administrative mechanism and a thriving primary export sector with immense potential for expansion. In terms of per capita income, literacy and health care, Malaysia was well ahead of most of its neighbors. Even though population growth was already very rapid, the highly favorable ratio of land and other natural resources to total population offered great potential to raise income per head (Athukorala and Menon, 1997).

---

1 For an analysis of the extent and implications of Malaysia’s openness, see Menon (2000).
2 The Federation of Malaya comprised the 11 states in the Malay Peninsula. Sabah, Sarawak and Singapore joined Malaya to form Malaysia on 16 September 1963. Singapore left the federation in August 1965.
Despite these favorable economic conditions, building the new independent Malaysian economy proved challenging nonetheless, as it had to be done under the sometimes conflicting goals of preserving ethnic peace and pursuing economic growth. At the time, the Malays accounted for about 52% of the population and dominated politics, but they were relatively poor and were involved mostly in low-productivity agricultural activities. The ethnic Chinese, on the other hand, accounted for about 37% of the population, but enjoyed greater economic power and dominated most of the modern-sector activities. Thus, in post-independence Malaysia, economic policymaking, especially macroeconomic management policy, turned out to be a continuing struggle to achieve development objectives while preserving communal harmony and political stability.

Government policy during this early post-independence period is perhaps best described as a “holding” program, designed to suppress simmering inter-communal rivalries. The policy thrust was to continue with the colonial open-door approach relating to trade and industry policy, while addressing ethnic and regional economic imbalances through rural development schemes and the provision of social and physical infrastructure. Like in many other developing countries, import-substitution industrialization was on the policy agenda in Malaysia during this period. However, unlike in other countries, attempts were not made to achieve “forced” industrialization through direct import restrictions and the establishment of state-owned industrial enterprises.

Snodgrass (1980, p. 206) ascribes this policy neutrality to the influence of advice from a major World Bank mission to Malaysia in 1954. There are, however, two other factors which might have been at least as influential in determining the direction of Malaysian policy. First, Malaysia enjoyed a sound balance of payments position (due mainly to booming rubber and tin exports) for most of this period, and hence felt no compulsion to resort to stringent import restrictions. Second, the ethnic tension that existed between the Malay political leadership and the Chinese business community may have held back any concerted effort to promote local industry through trade protection and other means of direct government involvement (Leigh, 1992). The industrialization strategy of the Malaysian government at the time was largely a “promotional effort, geared to the provision of an investment climate favourable to private enterprise, especially to foreign private enterprise” (Wheelwright, 1993, p. 69). Very few industries enjoyed nominal tariffs of more than 30% and non-tariff barriers were almost non-existent (Alavi, 1996, p. 70).

The counterpart to a liberal trade regime was a receptive environment for foreign direct investment (FDI). Even in the 1950s and 1960s, when distrust of FDI and multinational corporations held strong sway in the developing world, Malaysia had a relatively open and welcoming policy (Athukorala and Menon, 1995). The policy regime relating to purely financial flows was more restrictive—a historical conservatism that may have underwritten, to some extent, future policy choices. Nevertheless, even in the non-FDI sphere, Malaysia’s policy regime throughout the post-war period was much more liberal than in most other developing countries (Williamson and Mahar, 1998). In terms of monetary policy, this period was typical of the general approach taken by the Central Bank, the Bank Negara Malaysia (BNM), which is one of minimal intervention. For the most part, BNM has been mainly focused on ensuring stable interest rates and has not often used its instruments to conduct counter-cyclical policy (Ariff, 1991).

By the late 1960s, there was growing recognition that the so-called easy stage of import-substitution industrialization was coming to an end, and that future prospects for industrial development would require the expansion of export-oriented industries. Through the

---

3 In 1957-58, 34.9% of households had incomes of less than RM120 per month (the official cut-off point for measuring poverty). More than half of these households were Malay, and more than two-thirds were rural (Snodgrass, 1980).
enactment of the Investment Incentives Act in 1968, policy shifted to promoting export-oriented activities, especially through FDI. The Act offered a rich assortment of incentives to export-oriented FDI, including exemptions from company tax and duty on imported inputs, relief from payroll tax, investment tax credits, accelerated depreciation allowances on investment, and some tariff protection (but not non-tariff barriers). In 1970, new legislation provided for the establishment of special export processing zones.

Economic growth during 1957 to 1969, although respectable, failed to make a substantial contribution towards improving the economic status of the Malays. At the same time, with rising urban unemployment and education and language again looming as issues, non-Malays began to question the extent to which their interests were being safeguarded in the new Malaysia. The growing disenchantment among all segments of the population ultimately erupted in the bloody communal riots of May 1969. This event resulted in a reassessment of economic and development policy in order to explicitly deal with economic imbalances along racial lines.

III. PHASE II: THE NEW ECONOMIC POLICY PERIOD, 1970 TO 1987

The Malay political leaders, who were the dominant group in the ruling coalition, decided that the ground rules for governance had to be changed. When parliamentary government was restored in February 1971, the constitution was amended to make seditious public discussion of constitutional provisions for language, citizenship, and the special position of Malays and the status of the Sultans (Malay rulers). In the economic sphere, there was a clear shift from planning and policymaking based purely on economic considerations, towards an affirmative action policy based on ethnicity. This policy shift was formalized in the New Economic Policy (NEP), which was introduced in the Second Malaysia Plan (1971-75).

The overriding objective of the NEP was to maintain national unity through the pursuance of two objectives: eradication of poverty among the entire population and restructuring of society with a view to eliminating the identification of race with economic function. For the first objective, the overall development strategy was reformulated with emphasis on export-oriented industrialization, and an ambitious rural and urban development program. For the second objective, long-term targets were established for the Malay ownership of share capital in limited companies, and the proportion of Malays employed in manufacturing and installed in managerial positions. The NEP aimed to increase the Malay share in corporate assets from 2% in 1970 to 30% in 1990, and to have employment patterns in the urban sector reflect the racial composition of the country.

Malay participation in business was promoted in two ways: (i) through the expansion of the public sector where Malays held most of the key positions, and (ii) by providing Malays with privileged access to share ownership and business opportunities in the private sector. The Industrial Coordination Act (ICA) was enacted in 1975 to strengthen measures to implement NEP norms on Bumiputra participation at the enterprise level. Under the ICA, the conduct of medium- and large-scale enterprises was subject to licensing with the aim of improving the relative position of the Malays in the modern sector of the economy.

As part of the NEP, Malaysia moved into the promotion of heavy industries over the term of its Fourth Five-Year Plan (1981-85). The Heavy Industries Corporation of Malaysia (HICOM), a public-sector holding company, was formed in 1980 to go into partnership with foreign companies in setting up industries in areas such as petrochemicals; iron and steel; cement; paper and paper products; machinery and equipment; general engineering; transport equipment; and building materials. These industries were expected to “strengthen the foundation of the manufacturing sector ... [by providing] strong forward and backward linkages for the development of other industries” (Government of Malaysia, 1993). Even
though the new selective industrialization push was often rationalized as an attempt to emulate Japan and Korea (hence the “look East” policy, a term coined by Prime Minister Mahathir in 1981), in practice the selection of new projects was based largely on traditional import-substitution criteria. These projects were supported with subsidized credit, government procurement provisions and heavy tariff protection, without subjecting them to market-based performance norms.

Despite all this, there is little evidence that either the government leadership in industrial policy in general, or the heavy industrialization push in the early 1980s in particular, affected the export-led industrialization process. The structure of industry that evolved was still much in line with what one would have expected, given the nature of Malaysia’s comparative advantage and changing factor endowments (Athukorala and Menon, 1999). Most of the industries set up under HICOM were “born losers” artificially spawned with subsidies. By the late 1980s, HICOM had invested over RM42 billion in various projects that generated less than 5,000 jobs directly (an average RM400,000 per job), and exports from these industries were negligible (Chee, 1994, Table 10.5). Although some employment, technical and managerial skills, and scale economies were generated (see Lall, 1995), these have come at a considerable price.

According to a detailed analysis of productivity performance of Malaysian manufacturing during the period 1979-89, most of the 3-digit industries dominated by state enterprises recorded negative or zero total factor productivity (TFP) growth (Alavi, 1996, Chapter 5). A more recent analysis that separates domestic from foreign firms by Menon (1998) confirms this finding. Interestingly, the industries that topped the list in terms of TFP growth were private-sector dominated, labor-intensive industries which received little direct government support. These industries included textiles, clothing and footwear, and “other” manufacturing, such as toys and sports goods. Apart from the direct economic cost, the heavy industry push burdened downstream industries, which were forced to pay higher prices for the protected products (Lim, 1992), and worsened the macroeconomic situation.

The blow-out in public expenditure as a result of massive government investment programs under the new industrialization drive was reflected in widening budget and current account deficits between 1981 and 1986 (Table 1). The scale of fiscal expansion during this period, especially in 1981 and 1982, was unprecedented. The macro imbalance was compounded by the terms of trade decline in the early 1980s and the subsequent world recession in the mid-1980s (Corden, 1996). Between 1981 and 1983, the terms of trade declined by about 20% (Ariff, 1991, Table 2.13), shaving off about 4.5% of national income. Continued pump priming propped up growth at 6.3% and 7.8% in 1983 and 1984 respectively, but the situation with the twin deficits was reaching a critical point. As a share of GNP, the current account deficit had increased beyond 5%, while the overall public sector deficit amounted to almost 14%.

The collapse of the prices of all major export commodities in 1985 was the final straw. The ensuing 1.1% contraction in GDP was the worst performance ever recorded. The required cuts in government expenditure, in light of ballooning deficits, had further contractionary effects on the domestic economy. At the same time, the uncertainty in the policy environment dampened both local and foreign private investments.
Table 1: Selected Macroeconomic Data, 1960-2006

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP growth (annual %)</th>
<th>Cash surplus/deficit (% of GDP)</th>
<th>Current account balance (% of GDP)</th>
<th>Exports goods, services (ann. % growth)</th>
<th>Imports goods, services (ann. % growth)</th>
<th>Gross capital formation (% of GDP)</th>
<th>Gross domestic savings (ann. %)</th>
<th>Money and quasi money growth (ann. %)</th>
<th>Interbank overnight money (% of GDP)</th>
<th>Exchange Rate (Ringgit/$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>1961</td>
<td>7.6</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>1962</td>
<td>6.4</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>1963</td>
<td>7.3</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>1964</td>
<td>5.4</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>1965</td>
<td>7.7</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>1966</td>
<td>7.8</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>1967</td>
<td>3.9</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>1968</td>
<td>8.0</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>1969</td>
<td>4.9</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>1970</td>
<td>6.0</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>1971</td>
<td>5.8</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>1972</td>
<td>9.4</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>1973</td>
<td>11.7</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>1974</td>
<td>8.3</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>1975</td>
<td>0.8</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>1976</td>
<td>11.6</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>1977</td>
<td>7.8</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>1978</td>
<td>6.7</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>1979</td>
<td>9.3</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>1980</td>
<td>7.4</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>1981</td>
<td>6.9</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>1982</td>
<td>5.9</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>1983</td>
<td>6.3</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>1984</td>
<td>7.8</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>1985</td>
<td>-1.1</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>1986</td>
<td>1.2</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>1987</td>
<td>5.4</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>1988</td>
<td>9.9</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>1989</td>
<td>9.1</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>1990</td>
<td>9.0</td>
<td>-2.9</td>
<td>0.6</td>
<td>19.7</td>
<td>17.8</td>
<td>15.8</td>
<td>14.7</td>
<td>15.8</td>
<td>16.9</td>
<td>3.75</td>
</tr>
<tr>
<td>1991</td>
<td>9.5</td>
<td>-0.4</td>
<td>0.6</td>
<td>19.7</td>
<td>17.8</td>
<td>15.8</td>
<td>14.7</td>
<td>15.8</td>
<td>16.9</td>
<td>3.75</td>
</tr>
<tr>
<td>1992</td>
<td>8.9</td>
<td>0.0</td>
<td>-3.7</td>
<td>12.6</td>
<td>6.4</td>
<td>1.9</td>
<td>2.6</td>
<td>3.7</td>
<td>4.2</td>
<td>1.95</td>
</tr>
<tr>
<td>1993</td>
<td>9.9</td>
<td>1.7</td>
<td>-4.5</td>
<td>11.5</td>
<td>15.0</td>
<td>15.0</td>
<td>10.5</td>
<td>2.6</td>
<td>3.7</td>
<td>1.95</td>
</tr>
<tr>
<td>1994</td>
<td>9.2</td>
<td>4.5</td>
<td>-6.1</td>
<td>21.9</td>
<td>25.6</td>
<td>25.6</td>
<td>21.9</td>
<td>2.6</td>
<td>3.7</td>
<td>1.95</td>
</tr>
<tr>
<td>1995</td>
<td>9.8</td>
<td>2.4</td>
<td>-9.7</td>
<td>19.0</td>
<td>23.7</td>
<td>23.7</td>
<td>18.5</td>
<td>2.6</td>
<td>3.7</td>
<td>1.95</td>
</tr>
<tr>
<td>1996</td>
<td>10.0</td>
<td>2.0</td>
<td>-4.4</td>
<td>9.2</td>
<td>4.9</td>
<td>4.9</td>
<td>2.6</td>
<td>3.7</td>
<td>1.95</td>
<td>1.95</td>
</tr>
<tr>
<td>1997</td>
<td>7.3</td>
<td>5.0</td>
<td>-5.9</td>
<td>5.5</td>
<td>5.5</td>
<td>5.5</td>
<td>5.5</td>
<td>5.5</td>
<td>1.95</td>
<td>1.95</td>
</tr>
<tr>
<td>1998</td>
<td>-7.4</td>
<td>0.2</td>
<td>13.2</td>
<td>0.5</td>
<td>-18.8</td>
<td>26.7</td>
<td>48.7</td>
<td>0.2</td>
<td>1.95</td>
<td>1.95</td>
</tr>
<tr>
<td>1999</td>
<td>6.1</td>
<td>-3.2</td>
<td>15.9</td>
<td>13.2</td>
<td>10.6</td>
<td>22.4</td>
<td>47.4</td>
<td>12.1</td>
<td>1.95</td>
<td>1.95</td>
</tr>
<tr>
<td>2000</td>
<td>8.9</td>
<td>-3.1</td>
<td>9.4</td>
<td>16.1</td>
<td>24.4</td>
<td>27.3</td>
<td>47.3</td>
<td>10.0</td>
<td>1.95</td>
<td>1.95</td>
</tr>
<tr>
<td>2001</td>
<td>0.3</td>
<td>-3.0</td>
<td>8.3</td>
<td>-7.5</td>
<td>23.9</td>
<td>42.3</td>
<td>9.1</td>
<td>2.7</td>
<td>1.95</td>
<td>1.95</td>
</tr>
<tr>
<td>2002</td>
<td>4.1</td>
<td>-6.3</td>
<td>7.6</td>
<td>4.5</td>
<td>23.8</td>
<td>42.1</td>
<td>3.9</td>
<td>2.7</td>
<td>1.95</td>
<td>1.95</td>
</tr>
<tr>
<td>2003</td>
<td>5.7</td>
<td>-4.3</td>
<td>12.9</td>
<td>5.7</td>
<td>4.2</td>
<td>21.6</td>
<td>42.5</td>
<td>8.1</td>
<td>1.95</td>
<td>1.95</td>
</tr>
<tr>
<td>2004</td>
<td>7.2</td>
<td>..</td>
<td>12.6</td>
<td>16.3</td>
<td>20.7</td>
<td>22.7</td>
<td>11.7</td>
<td>2.7</td>
<td>1.95</td>
<td>1.95</td>
</tr>
<tr>
<td>2005</td>
<td>5.2</td>
<td>..</td>
<td>15.3</td>
<td>8.6</td>
<td>19.9</td>
<td>43.5</td>
<td>6.3</td>
<td>2.7</td>
<td>1.95</td>
<td>1.95</td>
</tr>
<tr>
<td>2006</td>
<td>5.9</td>
<td>..</td>
<td>5.5</td>
<td>5.0</td>
<td>18.7</td>
<td>41.8</td>
<td>11.5</td>
<td>3.3</td>
<td>1.95</td>
<td>1.95</td>
</tr>
</tbody>
</table>

Sources:
(1), (4), (5), (6), and (7): World Bank national accounts data, and OECD National Accounts data files.
(2), (3): International Monetary Fund, Government Finance Statistics Yearbook and data files.
(8), (9), and (10): International Monetary Fund, International Financial Statistics and data files.
On the monetary front, the ringgit was floated in 1973. Since the floating, Malaysia’s capital account has been progressively liberalized. There remain, however, a number of restrictions that, from time to time, have been increased to serve so-called national objectives. Some of the more important capital account regulations and restrictions, leading up to the 1997 crisis, are discussed in Appendix 1. Unlike fiscal policy, the monetary policy stance throughout this period has been relatively conservative, with BNM rarely employing it in a counter-cyclical manner. But there was an episode in the mid-1970s and another during the downturn in the mid-1980s that marked departures from the general hands-off approach. Monetary policy became quite interventionist in the mid-1970s, when Malaysia was faced with double-digit inflation. The money supply was squeezed, pushing up interest rates sharply, in order to quell inflationary pressures. Monetary policy for most of the first half of the 1980s continued to remain restrictive, in order to contain inflation and further deterioration in the current account. To support the currency during the economic downturn in the mid-1980s, the BNM implicitly imposed controls on capital outflows. Temporary restrictions on exchange markets were imposed in 1986.

These factors combined to bring the economic advances of the 1970s to a halt, and created an environment in which race relations became increasingly tense. This volatile climate paved the way for a series of policy reforms that placed greater emphasis on the role of the private sector and strengthened the conditions for export-oriented industrialization.

IV. PHASE III: TRANSITION FROM THE NEP TO THE NATIONAL DEVELOPMENT POLICY (NDP), 1987 TO 1997

The new policy orientation involved gradual easing of the strictures of the NEP, with the government declaring the NEP to be “in abeyance.” The Promotion of Investment Act of 1986 introduced fresh, more generous incentives for private investors, and some of the ethnic requirements of the NEP were relaxed. The NEP was subsequently replaced (in 1990) with the National Development Policy (NDP). The NDP eased the remaining strictures of the NEP, with a view to putting the creation of wealth ahead of redistributing it. The policy thrust of the NDP was to redress racial imbalance in a more overt fashion through various initiatives geared to entrepreneurship, managerial expertise and skills development within the Malay community.

The reforms since the mid-1980s have also involved a gradual process of privatization and restructuring of state-owned enterprises. By the early 1990s, state-ownership in manufacturing was limited to some politically sensitive ventures in automobile manufacturing, petrochemical, iron and steel and cement industries. Even though tariff protection had always been low relative to other developing countries (with the exception of automobiles), it was further reduced over time. The average effective rate of manufacturing protection, which increased from about 25% in the early 1960s to 70% in the early 1970s, declined continuously to fall below 30% by the late 1980s (Alavi, 1996).

By the mid-1990s, only 3% of all import tariff lines were subject to licensing requirements, and the import-value weighted average nominal tariff was as low as 15%. Unlike many other developing countries, Malaysia does not have a history of relying heavily on quantitative restrictions and other non-tariff barriers (NTBs) to protect its domestic industry. The Pacific Economic Cooperation Council (PECC, 1995) study noted that the only industry in which the frequency ratio of core NTBs was high in 1993 was ISIC 12 “Forestry and logging”—not uncommon in such an environmentally sensitive industry.

The market-oriented policy reforms were accompanied by a strong focus on restoring and maintaining macroeconomic stability, maintaining a realistic real exchange rate and meeting the infrastructure needs of a rapidly expanding economy. The Fifth (1986-90) and Sixth
(1991-95) Malaysia Plans saw a significant reduction in overall government expenditure and a shift in government spending away from public sector enterprises and towards infrastructure projects designed to enhance private sector development. Although this reduced the fiscal burden, the Malaysian car project, Proton, continued to be a significant drain on resources.

The approach that the government had adopted towards increasing Malay participation in the economy also changed. The commitment to the 30% equity participation target became less dogged, with the government placing more emphasis on entrepreneurship, managerial expertise and skill development within the Malay community (Ariff, 1991). These changes reflected a switch in the government’s approach towards support for the Malay community. The support now came in the form of assisting the Malay community to compete more confidently with the other communities, without being too dependent on the government.

The government also relaxed regulations on foreign equity participation in Malaysia, and parts of the Industrial Coordination Act were liberalized. Up to 100% foreign equity ownership of export-oriented companies was allowed, and work permit requirements for foreign employees of companies with foreign paid-up capital of US$2 million or more were eased. In addition, guidelines for the approval of new investment projects were relaxed (Athukorala and Menon, 1996).

The ballooning fiscal deficits of the mid-1980s were reversed in the 1990s. In 1993, and for the first time in Malaysian history, the federal government achieved a balanced budget. The fiscal position continued to improve leading up to the 1997 crisis. There are a number of reasons for the turnaround in fiscal performance during this period. The first was the growth dividend, with higher tax revenue collections as a result of sustained strong economic growth. Fiscal reforms to broaden the tax base and improvements in the efficiency of tax collections also contributed to the public coffers. Furthermore, non-finance public enterprises as a group recorded a current surplus from the early 1990s, increasing the consolidated public sector current surplus from 5.2% to 7.7% of GDP between 1990 and 1996 (Athukorala, 2001).

Although the fiscal position leading up to the crisis appeared rosy, there were other signs of vulnerability emerging in the economy. Following capital market liberalization initiatives in the early 1990s, designed to promote Kuala Lumpur as an international financial center, Malaysia had started attracting large amounts of short-term capital, chasing high-yielding money and share markets. The real exchange rate also started to appreciate, affecting the competitiveness of the tradeable goods sector (Athukorala and Warr, 2002). In an attempt to stem the appreciation of the ringgit, BNM again imposed controls on short-term capital inflows in 1994, and kept them in place until mid-1995. Banks were prohibited from conducting swaps and forward transactions which were unrelated to trade, investment or inventory. BNM also set a ceiling on domestic banks’ net external liabilities; raised and extended reserve requirements on all deposits from abroad, including the vostro accounts of foreign banks with Malaysian banks; and prohibited residents from selling short-term financial instruments to foreigners in January and February 1994.

Although these restrictions stemmed the surge in short-term capital inflows, they quickly regained lost momentum when the controls were lifted in mid-1995. By 1996, short-term flows again constituted more than half of total inflows. Share market capitalization as a percentage of GDP was hovering around 250%, the highest in the Asia-Pacific region. Signs of vulnerability to a speculative attack, in the form of a quick and large reversal of these short-term flows, were clearly present.
V. PHASE IV: FROM THE 1997 CRISIS, TO RECOVERY, TO THE PRESENT

The Asian financial crisis that started in Thailand on 2 July 1997 spread relatively quickly to neighboring countries, including Malaysia. The BNM intervened heavily to try and stem the speculative attacks on the ringgit that followed the collapse of the baht, but finally gave way on 14 July and allowed the currency to float. Between the float and January 1998, the ringgit had depreciated by about 50% against the US dollar. The crisis in Malaysia was characterized by a significant and dramatic reversal in foreign portfolio capital, a reflection of the stock market boom that preceded the crisis.

Another distinguishing feature of the Malaysian crisis was that its banking sector had only very limited exposure to foreign debt. Perhaps as a result of this, Malaysia was able to deal with the initial phase of the crisis without an IMF-sponsored rescue package. After “muddling through” the crisis for about five months, then-Finance Minister Anwar Ibrahim announced an IMF-like policy package to deal with the crisis. Some of the key elements of this package included cutting government spending by 18%; postponing indefinitely all public sector investment projects; freezing new company share issues and company restructuring; and banning new overseas investment by Malaysian firms. The fiscal tightening was accompanied by monetary tightening by the BNM. BNM increased its inter-bank lending rate from 7.6% to 8.7% in December 1997, and then 10% in January and 11% in February 1998.

Following a growing and much publicized rift between then-Finance Minister Anwar Ibrahim and Prime Minister Mahathir, which culminated in the dramatic dismissal and incarceration of the former, a policy rethink ensued. With the Malaysian economy contracting by 7.4% in 1998 (Table 1), the effectiveness of the IMF-type policy prescriptions in delivering recovery were being questioned.

In a radical turnaround, Malaysia opted for a Keynesian-style reflationary program, on the premise that financial markets had over-shot. In order to implement this program, capital controls had to be introduced in order to circumvent additional capital outflow associated with loosening monetary policy and the lowering of interest rates. In short, the government chose to temporarily disconnect the domestic capital market from the global economy in order to pursue its stimulatory policies (Hill, 2005).

The expansionary macroeconomic policy package involved both increased spending and loosening of monetary policy. The 1999 Budget, presented in October 1998, foreshadowed increasing the budget deficit from 1.8% to a target 3.2% in 1999, while the 2000 budget predicted a further increase to 4.4% of GNP. On the monetary front, the BNM successively cut the statutory reserve requirement from a pre-crisis level of 13.5% to 4% by late 1998. The inter-bank lending rate, which had risen to 11% in February 1998, was brought down gradually to 4% by early 1999. An assortment of other monetary measures was also introduced to reduce the cost of bank credit, free-up capital for banks, and boost credit expansion (see Athukorala, 2001, for details). It would appear that monetary policy was assigned the greater role in stimulating the economy, and this was only possible with capital controls in place. Unlike fiscal policy, the impact lags associated with monetary policy are shorter, and rather than running the risk of crowding-out private investment, lower interest rates would work to stimulate it.

With these measures in place, recovery came relatively quickly. GDP growth returned to positive territory by the second quarter of 1999, and annual growth for the year was an impressive 5.4%. This was massive turnaround, especially when considering that the economy had contracted by 7.4% the previous year. Growth accelerated in 2000 to a remarkable 8.9%, and the economy had regained its pre-crisis level of GDP by mid-2000 (Table 1).
Contrary to initial and widespread skepticism, the radical reform measures centering on the use of capital controls appeared to have worked in Malaysia. So why did they work? A number of commentators, such as Athukorala (2001), Zainal-Abidin (2002) and Hill (2005), identify a number of factors that may have contributed to the success of this unorthodox response to the crisis. Three such factors are often highlighted.

The first relates to the exchange rate peg itself. The level at which the exchange rate was pegged, at RM3.8 to the US dollar, was considered to be on the "low" side, thus conferring a major competitive boost to the tradable goods sector. The second relates to the implementation of the controls. It was made very clear that the target of the controls was purely short-term flows. The government went out of its way to reassure foreign equity investors of this. It would seem that they succeeded because FDI flows actually increased in the wake of the controls. The final point relates to policy credibility and institutions. The government was at pains to avoid being seen as playing political favorites with its bail-outs and expenditure projects. This has been a long-standing concern relating to corporate governance in Malaysia. In the context of a financial crisis involving an unorthodox policy response, it was paramount that the reflationary program did not appear to be politically tainted. In this context, and as highlighted by Hill (2005), it was highly beneficial that the two key macroeconomic policy institutions, BNM and the Ministry of Finance, both had long-established policy credibility.

These three factors, along with a host of other related circumstances, combined to ensure the success of Malaysia’s unique crisis management and recovery program.

Apart from a sharp drop in growth to 0.3% in 2001, mainly as a result of the downturn in the electronics cycle, Malaysia has been growing at a robust but slightly slower pace than in the years leading up to the crisis. Growth in the last few years has averaged about 5.5% and the Ninth Malaysia Plan, issued in 2006, targets an average annual growth rate of 6% for the period 2006-2010. Malaysia’s decision in mid-2005 to move off the fixed currency peg came immediately after the People’s Republic of China announced that it would do the same. This was preceded by a gradual easing of various restrictions relating to capital movements. The ringgit has been appreciating steadily ever since then. Removing the peg has allowed greater flexibility in the conduct of monetary policy, especially in terms of curtailing inflation owing to higher energy prices. The fiscal deficit has also been falling, coming down from above 5% of GDP in the early part of this decade to 2.6% in 2006. Furthermore, as a net hydrocarbons exporter, high international energy prices have provided government with a windfall. ADB (2007) estimates that a US$1 per barrel rise in the price of crude oil corresponded to RM228 million (US$62 million) higher oil-related revenues in 2006. Such revenues represented 37% of central government income, although retail fuel subsidies could absorb up to one quarter of these receipts.

But FDI inflows have not returned to their pre-crisis levels, and the emergence of the People’s Republic of China as a major competitor in export markets suggests the need for change, going forward. Skills shortages and other bottlenecks also appear to be impeding Malaysia’s progression up the technology ladder. More recently, there has also been concern over rising inflation and crime.

It was against this backdrop that elections were called on 8 March 2008. The result of these elections were remarkable for a number of reasons. Not since 1969 had the ruling coalition lost its two-thirds majority in Parliament. Apart from Kelantan, which had been under opposition control, four additional states—Penang, Perak, Selangor and Kedah—also fell to the opposition. Indeed, the ruling coalition actually lost the popular vote by a narrow margin in Peninsula Malaysia. Such an outcome could not have been possible unless all three major ethnic communities had rejected the government and its programs, to varying degrees, and this is exactly what happened.
On the whole, the impact of the elections on the economy is likely to be relatively muted. This is mainly because regional and global conditions are likely to dominate domestic factors in determining Malaysia’s economic performance. The current global financial volatility, swings in commodity prices and even more medium term issues like the emergence of the People’s Republic of China as a competitive threat are likely to be more important, and will continue to play the determining role.

But there will be impacts, and the degree of such impacts will be largely determined by how the government responds—both state and national. The broad based rejection of current policy implied by the election results itself provides an opportunity to make change and push forward with reforms. The most important policy change would be a revamping of the NEP. The focus should shift to eradication of poverty among the entire population, as the goal of reducing inter-ethnic income inequalities has been largely achieved. In its place, *intra-ethnic* income disparities have worsened (Hill, 2005), and some of this must be attributed to the way in which the NEP has been implemented. Like most affirmative action programs, the main beneficiaries are usually the ones least requiring support. They are not only inefficient, however, but tend to breed corruption and cronyism. In this respect, the moves by the new Penang state government to remove distortions in procurement of government contracts is a welcome reform. Hopefully it will spread to other states. Without a two-thirds majority, the ruling coalition may not be able to impede reform emanating from the more progressive states.

As noted earlier, the NEP has played an important signaling role, and has played its part in delivering the peace and stability that Malaysia has enjoyed. It is now past its expiry date however. Furthermore, changes to Malaysia’s demographics as a result of Chinese outmigration and significantly higher Malay fertility rates imply that the current system is simply unsustainable. As the share of the Malay population approaches 75%, up from just over 50% at the time of the Program’s introduction, it will no longer be easy, or fiscally responsible, to continue with this tax-transfer scheme. Unless Malaysia is willing to sacrifice macroeconomic stability, then the resource requirements of the current system will soon be too demanding. Malaysia has always opted for economic pragmatism during times of economic stress or impending crises and it is to be hoped that this approach will prevail this time as well.

**VI. CONCLUDING REMARKS**

Looking back on the fifty years since Independence, there is no doubt that Malaysia is a development success story. While Malaysia’s economic performance has been impressive by developing-country standards throughout the post-independence period, the achievements have been truly remarkable in the decade from the late 1980s (prior to the 1997 financial crisis), when there was a decisive shift towards greater outward-orientation of economic policy. The rapid economic growth in the years leading up to the crisis was accompanied by sharp increases in living standards, and some improvement in the distribution of income, ameliorating the twin problems of poverty and racial income imbalances. Although the crisis had devastating effects on output, recovery came relatively quickly and Malaysia soon returned to brisk growth, but at a slower and more sustainable pace. This looks likely to continue into the foreseeable future.

The macroeconomic management policy experience in Malaysia over the past fifty years is one best described as conservative pragmatism. Apart from the period of crisis management, when monetary policy played the dominant role in reviving the economy, fiscal policy has been the major discretionary instrument. As a small, open economy, fiscal policy
has served the role of a counter-cyclical stabilizer, to minimize the impact of exogenous shocks, with monetary policy playing an accommodating role. But fiscal policy has also been actively employed in an attempt to address the disparities in income along racial lines. The affirmative action policies of the NEP, designed to improve the status of the Malay population, did constrain the flexibility of fiscal policy to some extent, but never in a significant way.

It would appear that the affirmative action program under the NEP played an important role in ensuring political stability and social harmony. It was an important signaling device, and at the very least it served to demonstrate the intention that all should share in future growth. The actual role that it played in delivering these outcomes is difficult to determine, especially when rapid economic growth and structural change were taking place almost concurrently and may have been the key drivers. The important point is that the resource cost of these direct redistributional policies was not a major drag on growth, given that FDI flows and rapid export expansion were available to augment the domestic resource base.

But that is now history. FDI inflows have not returned to their pre-crisis levels, and the emergence of the People’s Republic of China as a major competitor in export markets suggests the need for change, going forward. Skills shortages and other bottlenecks also appear to be impeding Malaysia’s progression up the technology ladder.

The huge swing against the ruling coalition, resulting in the loss of its two-thirds majority in Parliament following the 8 March 2008 elections, provides both the opportunity and imperative for reform. The most important policy change would be a revamping of the NEP. The focus should shift to eradication of poverty among the entire population, as the goal of reducing inter-ethnic income inequalities has been largely achieved. In its place, *intra-ethnic* income disparities have worsened, and some of this must be attributed to the way in which the NEP has been implemented.

As noted earlier, the NEP has played an important signaling role, and has played its part in delivering the peace and stability that Malaysia has enjoyed. It is now past its expiry date however. Furthermore, changes to Malaysia’s demographics as a result of Chinese outmigration and significantly higher Malay fertility rates imply that the current system is simply unsustainable. Unless Malaysia is willing to sacrifice macroeconomic stability, then the resource requirements of the current system will be overwhelming. Malaysia has always opted for economic pragmatism during times of economic stress or impending crises and it is to be hoped that this approach will prevail in the future.
APPENDIX 1: CAPITAL ACCOUNT RESTRICTIONS PRIOR TO THE 1997 CRISIS

Foreign currency loans from non-residents which exceed 1 million ringgit require the prior approval of the Bank Negara. Foreign currency loans in excess of 200 thousand ringgit and less than 1 million ringgit must still be reported to the Controller of Foreign Exchange. Loans in foreign currency by banks in Malaysia to residents must be for business or productive purposes, including (but not limited to) payment for imports, payment of principal or interest on loans from non-residents, or payments for the purchase from non-residents of property in Malaysia or shares. There are three further conditions that apply to loans in foreign currency by residents for the purchase of property or shares: (i) the Foreign Investment Committee must give its approval; (ii) the amount borrowed must not exceed 25 million ringgit; and (iii) repayment of principal cannot be made with funds borrowed in ringgit from residents (IMF, 1995). Borrowing in ringgit from a non-resident, regardless of the amount or purpose, requires the prior permission of the Controller of Foreign Exchange. Offshore borrowing in ringgit is not encouraged by Bank Negara, in line with its stated policy of discouraging the internationalization of the ringgit. All applications for credit facilities by non-residents and non-resident controlled companies require the approval of the Controller of Foreign Exchange; as a matter of policy, domestic financing solely for property acquisition and development purposes are not granted.
References


Pacific Economic Cooperation Council (PECC, 1995), *Survey of Impediments to Trade and Investment in the APEC Region*, Singapore: APEC Secretariat.


