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Malaysia: Adjusting to Deep Integration with the World Economy

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The Asian financial crisis has led to events that have transformed the economic and political landscape in Malaysia. In an unprecedented departure from its long-standing traditions of openness to foreign investment, and of macroeconomic orthodoxy, Malaysia began denouncing foreign hedge funds for economic sabotage in September 1997, and on September 1, 1998, it imposed comprehensive controls on capital outflows. This sharp reversal in policies had as its background an equally sharp economic collapse. Output contracted 7.5 percent in 1998, a drastic change from the average annual growth rate of 8.7 percent in the 1990–97 period, in which the lowest growth was 7.7 percent in 1997.

Other unprecedented events occurred on the political front. On September 2, 1998, Prime Minister Mahathir Mohamad dismissed his designated successor, Deputy Prime Minister Anwar Ibrahim, from the government on the grounds that Anwar was morally unfit to be a political leader. Anwar was subsequently tried and convicted on corruption charges, and he is now on trial for sodomy. Mahathir has also accused his once-designated successor of treason. Anwar's supporters have organized numerous demonstrations since September 1998, some of which turned violent. All of these actions were atypical in the political succession process in Malaysia, where external collegiality had been the norm.

In response to the vocal objections within the Malay (bumiputra) community to his treatment of Anwar, Mahathir called early elections in November 1999 to refresh his political mandate to rule. Although the ruling coalition, Barisan Nasional, again won more than two-thirds of the parliamentary seats, the election results revealed significant opposition within the bumiputra community to Mahathir's continued leadership.

Table 11.1
Malaysia: Pre-crisis situation

	1990–94	1995	1996	1997
Growth rate of real GDP (%)	8.7	9.4	8.6	7.7
CPI growth rate (%)	3.8	5.3	3.5	2.7
Exports (as % of GDP)	72.9	84.6	79.0	80.4
Fixed investment (as % of GDP)	36.7	43.0	42.3	42.8
Gross domestic savings (% of GDP)	35.4	37.2	41.9	41.0
Current account balance (% of GDP)	–5.2	–8.6	–5.3	–5.9
Reserve money growth (%)	21.4	24.7	35.2	27.8
Narrow money growth rate (%)	21.0	13.2	23.7	8.7
Broad money growth rate (%)	19.2	20.0	25.3	17.5
Government expenditure (% of GDP)	26.4	22.5	22.6	21.5
Government budget balance (% of GDP)	–0.7	0.9	0.7	2.4
Foreign debt (as % of GDP)	40.0	42.5	42.1	n.a.
Debt service ratio for all external debt	21.0	17.5	19.2	n.a.
Exchange rate (vis-à-vis US$)	2.7	2.5	2.5	3.9
Real exchange rate (1990=100, WPI based)	93.6	86.1	77.6	106.1
Current account balance (US$ million)	–2,946	–8,469	–4,596	–4,791
Capital account balance (US$ million)	5,587	7,464	9,227	2,503
Foreign direct investment (US$ million)	4,172	4,178	5,078	5,105
Export value (US$ million)	42,071	74,037	78,327	78,903
Composition of export, value of highest four exports (1996 ranking, US$ million)				
Electrical machinery, apparatus and appliances	8,119	16,277	17,953	n.a.
Telecommunications	6,147	12,305	12,157	n.a.
Office machines and automatic data processing	2,592	7,144	9,194	n.a.
Petroleum and petroleum products	4,003	3,671	4,213	n.a.
Import value (US$ million)	42,214	77,751	78,417	79,045
Composition of import, value of highest four imports (1996 ranking, US$ million)				
Electrical machinery, apparatus and appliances	10,942	24,278	25,285	n.a.
Telecommunications	2,919	5,037	4,393	n.a.
Specialized machinery	2,764	4,878	4,353	n.a.
Office machines and automatic data processing	1,464	3,097	4,261	n.a.
Exports' dependence on unaffected markets (%)	35.7	36.5	33.3	n.a

Table 11.1 (continued)

	1990–94	1995	1996	1997
Volume of exports (index)	119.3	165.5	172.4	190.8
Volume of imports (index)	118.0	186.0	195.3	218.9
International reserves minus gold (US$ million)	18,107	23,774	27,009	20,788
Value of total foreign debt (US$ billion)	21.6	34.3	39.8	40.0
Short-term foreign debt (US$ billion)	4.2	7.3	11.1	n.a.
DS Stock Market Index ($)	377.1	510.3	635.5	197.4
DS Stock Market Index (local currency)	415.5	539.1	667.8	319.7
Kuala Lumpur Composite Index	790.5	995.2	1,238.0	594.4
Nominal lending rate (%)	8.3	7.6	8.9	9.5
Nominal deposit rate (%)	6.6	5.9	7.1	7.8
Non-performing loans	14.3	5.5	3.9	6.7

Table 11.2
Malaysia: Changes in labor employment and output composition

	Composition of output		Composition of labor force	
	1986	1996	1970	1990
Agriculture	19.2	12.8	53.7	27.3
Industry	35.5	46.2	14.3	23.2
Services	45.3	41.0	32.0	49.5

Table 11.3
Malaysia: Forecasts for the 1999–2001 situation

	GDP growth (%)			CPI inflation (%)		
Forecasting institution and date of forecast	1999	2000	2001	1998	1999	2001
International Monetary Fund, October 1999	2.4	6.5	—	3.0	2.4	—
HSBC Asia Economic Weekly, January 2000	4.7	5.5	5.0	2.7	3.5	4.0
Economist Intelligence Unit, 2000:1Q	5.1	6.1	5.2	2.8	3.5	4.3

The United Malay National Organisation (UMNO), the bumiputra party headed by Mahathir, has traditionally dominated both the ruling coalition and Parliament. Compared to the 1995 elections, in which UMNO captured 94 of the 162 seats won by Barisan Nasional in the then 192-seat Parliament, in 1997 UMNO won 71 of Barisan Nasional's 148 seats in the now 193-seat Parliament. UMNO's share of Barisan Nasional's seats had declined from 58 percent to 48 percent, and its share of parliamentary seats fell from 49 percent to 37 percent.

For the first time since national elections began in 1955, it is likely that UMNO had received less than half of the Malay votes cast.[1] Also for the first time, UMNO's chief competitor for Malay votes, the Islamic Party (PAS), has broken out of its political isolation in northeast peninsular Malaysia. PAS has won control of one more state government (a total of two states are now under its control), and obtained strong support in Mahathir's home state, Kedah. The implications of UMNO's decline from overwhelming political domination are not clear. Will UMNO be unable to continue to dictate the national socioeconomic agenda to the non-Malay parties in Barisan Nasional, and hence have to settle for a new agenda that would be less discriminatory against the non-Malay communities? Or will UMNO now push for even more radical discrimination against the non-Malay communities in an attempt to attract back the Malay votes that it has lost?

The extraordinary economic and political events are the products of many factors, the foremost being the struggle for political power between Mahathir and Anwar, and their differences in economic policies. Furthermore, these events have causal connections: Mahathir had foreseen that Anwar's expulsion would lead to violent street demonstrations that, in turn, would induce large capital outflow, given the extreme nervousness among investors in the midst of the Asian financial crisis. Hence, the imposition of capital controls preceded the firing of Anwar by a day.

If the capital controls had not been in place when the street demonstrations began, the Malaysian ringgit (MR) and the Kuala Lumpur stock market would most likely have gone into a free fall in the manner that the Indonesian rupiah and the Jakarta stock market did in May 1998, just before Soeharto stepped down from the presidency. Such a free fall, as we shall explain, would have bankrupted many powerful groups within the UMNO, and weakened Mahathir's grip on UMNO.

1. See "Dr. M's grim results," December 2, 1999 in http://www.freemalaysia.com.

Another important reason for the imposition of capital controls was that the government could undertake expansionary fiscal and monetary policies to boost employment and the stock market without significantly worsening the balance of payments. The short-term interest rate has dropped from 11.06 percent on June 10, 1998 (when Anwar was in charge of economic policy) to 6.58 percent on December 16, 1998, and then to 3.16 percent on February 2, 2000. The stock market has rebounded in line with the fall in interest rate; for the same dates, the stock market index has risen from 489.9 to 543.0 and then to 942.9.[2]

The imposition of capital controls and the political unrest following the ousting of Anwar raise the need for a fresh look at two questions that have usually been answered optimistically:

1. What is the short- and medium-term outlook for Malaysia's economic growth?
2. What is the underlying international competitiveness of Malaysia's economy at present, and how is it likely to evolve in the future?

To answer these questions adequately, it is necessary to keep in mind that nearly three decades ago, Malaysia's political leaders took a large gamble. The gamble was that the nation could simultaneously restructure its economy to increase the ownership share of Malays in the industrial and modern service sectors, and continue to enjoy rapid increases in per capita income for all. By any reasonable standard, this gamble paid off. The economy achieved a large degree of restructuring, and growth continued at an annual average per capita rate of between 4 and 5 percent per year over two and a half decades. If per capita GNP (measured in purchasing power parity) in Malaysia continues to grow at 4 percent per year, by the year 2020 Malaysia will have a per capita GNP nearly equal to that of the United States in 1993.

Success in the past, however, does not guarantee success in the future. The achievements of 1970–96 were partly due to effective national leadership, but there was also luck involved. Malaysia had an unusually rich natural resource base on which it could rely as it began its restructuring. Just as the restructuring got underway, that resource base got

2. There is, of course, no simple negative relationship between the interest rate and the stock market index: factors such as political instability and expectations of the future also matter. For example, the stock market index fell to 294.6 on September 2, 1998, the day that Anwar was sacked, even though the short-term interest rate on that day was 9.5 percent, lower than on June 10.

even richer with the development of the offshore extraction of petroleum and natural gas. With petroleum and timber channeling large funds into government and private coffers, Malaysia could make mistakes and still do well. As it turned out, Malaysia did not make that many mistakes so it did very well. Natural resources, however, will not carry the Malaysian economy into the future, because its share of total output and exports has shown a clear downward trend in the last 15 years.

To identify Malaysia's prospects for economic growth and worldwide competitiveness, we turn to examine the economic policies, business organizations, and business leaders that contributed to Malaysia's successes.[3]

11.1 State Ownership from the Race-Based Economic Policies of the 1970s and 1980s

In many ways, the breakthrough from import-substituting industries to the export of manufactures occurred with the establishment of free trade zones, first in Penang in 1970 and then around Kuala Lumpur in 1971.[4] The subsequent arrival of many Japanese and American firms was not so much the result of actions taken by the Malaysian government as it was of external factors. Japanese and American firms could no longer stay competitive in much of their electronic assembly work if they continued to rely on high-cost labor at home. The issue was not whether to go abroad but where to go. Malaysia was an attractive choice: it was stable politically, foreigners could live there comfortably, and the Malaysian government welcomed foreign investment (unlike Taiwan or South Korea).

The other major development of the first half of the 1970s in the industrial sphere was the discovery and development of petroleum. Petroleum, like electronics, was another new industry developed for the most part with foreign investment and technology.

In the context of this booming economy Malaysia began to implement policies to achieve 30-percent bumiputra ownership of modern sector assets. Up to the mid-1970s, the path chosen to raise the bumiputra ownership share was the creation of state-owned enterprises. These efforts, however, had only a limited impact.

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3. A more detailed historical analysis of Malaysia's policies that were aimed at changing the racial distribution of corporate ownership is presented in Perkins (1998).
4. In a free trade zone, exporters can bring in inputs without paying duty, provided that such imports are re-exported as finished products.

To accelerate the rise in bumiputra ownership, in 1995 the government introduced the Industrial Coordination Act (ICA). The ICA required that all enterprises with equity over a certain limit had to sell 30 percent of their shares to bumiputras. There were loopholes. The most important one was that firms that exported over 80 percent of their output were not subject to the bumiputra ownership requirement. None of the Kuala Lumpur and Penang electronics firms, therefore, felt any impact from the ICA. The Chinese-Malaysian and foreign businesses complained vociferously about the ICA from the outset. These complaints gradually led to modifications in the legislation, mainly the raising of the asset limit and the lowering of the export requirement.[5]

Table 11.4 presents data on ownership of modern sector firms in Malaysia in 1974 and 1993, and it shows that the ethnic makeup of the Malaysian-owned companies has changed dramatically in two decades.

While half of the share capital of the top 80 firms in 1974 was in the hands of foreigners (excluding Singaporeans from the "foreigner" category), foreigners owned only 10.7 percent of the shares of the top 100 firms on the Kuala Lumpur Stock Exchange (KLSE) in 1993. In the mid-1970s, the private local ownership was mostly Chinese. By the early 1990s, Chinese-Malaysians controlled only 13.9 percent of the top 100 company shares, and Indian-Malaysians owned a minuscule 0.1 percent. Bumiputra direct ownership in 1993 was 6.3 percent, but the unit trusts, which were primarily designed to provide bumiputras with share ownership, accounted for another 17.6 percent, bringing the bumiputra total to 23.9 percent in 1993. The Malaysian government directly controlled 40.5 percent of the market capitalization of these firms in the 1990s, in contrast to only 6.3 percent in 1974. The race-based economic policies had caused the Malaysian government to dominate "the commanding heights of the economy"—an economic ownership pattern that is similar to that of state socialism! [6]

5. In 1975 the asset limit was initially set at MR250 thousand, a level that included all but the smallest non-bumiputra enterprises. It has been creeping upward since; e.g., the limit was MR2.5 million in 1986, but this was still low enough to include most enterprises above the level of a single proprietor with one or two dozen employees. The export requirement was changed so that firms exporting 50 to 80 percent of their output could have foreign ownership of over 50 percent, but the bumiputra share still had to be 30 percent. In effect, if exports constituted over 50 percent of output, a foreign firm could reduce the non-bumiputra local ownership share.

6. The state-owned capital should be included in the bumiputra ownership totals, since the government was staffed mainly by bumiputras and these companies had hiring policies that gave strong preferences to bumiputras. In addition, government companies relied heavily on bumiputra suppliers and vendors.

Table 11.4
Market capitalization of the top KLSE companies by ownership category

Nationality or ethnicity	Percent share (1974)	Percent share (1993)
Foreign-controlled companies [a]	49.11	10.7
Malaysian-controlled companies		
Government A[b]	6.3	40.5
Government C	17.7	
Chinese (private local)[c]	27.0	13.9
Bumiputra (private local)		6.3
Indian (private local)		0.1
Institutions		10.4
Unit trusts	–	17.6
Nominees	–	0.7
Total	100.0	100.0

a. Foreign-controlled companies in 1974 do not include Singapore-controlled companies. If Singapore companies were included, the foreign share would be 61.1 percent of a larger total. Singapore companies were excluded because of complications connected with the way Singapore (and Malaysian) companies were cross-listed in the early years in both Singapore and Kuala Lumpur.
b. Government A companies were those under government control in 1974. Government C companies were those under foreign control in 1974 but were taken over by the government by 1977.
c. Private local ownership in 1974 was mostly Chinese.
Sources: The 1974 data were derived from Tan (1982). Ms. Veena Loh constructed the 1993 data under the supervision of Tan Tat Wai.

A major question from the outset was how to distribute the bumiputra shares. Few bumiputras had experience with corporate shares, and most lacked the money to buy them. The initial approach was for the Ministry of Trade and Industry to draw up a list of names to whom the shares should be distributed. The chosen individuals typically bought the bumiputra shares at a significant discount from the other shares in the same company. Share allocation, therefore, became a vehicle for political patronage.

However, if the favored bumiputras were to realize their profits quickly by turning around and selling off the discounted shares that they had just received (an action engaged in by many), then the 30-percent target of bumiputra ownership would be very difficult to achieve. So, over time, a large part of the discounted bumiputra corporate shares were given to the unit trusts set up by Permodalan Nasional Berhad (National Equity Corporation or PNB). PNB formed its first unit trust, Sekim Amanah Saham Nasional (ASN), in 1981. The ASN unit trust was a quick success because it had a number of special features. PNB, using funds allocated to it by the government, guaranteed each share of MR10 a bonus of MR90, but the MR90 could not be withdrawn until regular earnings had accumulated to an equivalent amount. A rate of return of 10 percent was guaranteed, plus there were bonuses if investments did better than that. As things turned out, ASN paid an average annual rate of return of 18 percent.

By the early 1980s Malaysia was well into the process of restructuring the race ownership of the modern sector of the economy. The commodity price boom of the late 1970s not only ameliorated the disincentive effects of ownership restructuring, it also helped lay the groundwork for a government-led effort in the 1980s to change Malaysia's industrial structure by establishing a number of heavy industries. The core of the plan was the construction of a new cement plant (Kedah Cement), a new steel mill (Perwaja Steel), and an automobile plant (Proton Saga). These heavy industry projects were financed to a large degree by a new state-owned corporation, HICOM, which undertook massive external borrowing to do so.

11.2 Privatization in the 1990s

By the 1990s large numbers of Malaysians, including many government leaders, had become increasingly disillusioned with state-owned enterprises as vehicles for achieving growth and social goals. Many of the state-owned enterprises made sustained losses, even though private enterprises in the same lines of business were doing well. Government oversight of the state-owned firms was so weak that the government itself did not even know how many firms there were!

The first step toward changing the ownership structure of many of the large state-owned enterprises was corporatization, which started in the mid-1980s with the listing of Malaysian International Shipping (MISC) and Malaysian Airlines (MAS), but did not get underway on a broader basis until the 1990s.

The second step was the privatization of new infrastructure projects (e.g., the North-South highway and cellular phone projects) through a process that awarded the contract on what was called an invited bid or involuntary bid, which usually meant that the contract went to the first proposal. The awarding of these contracts has been controversial from the outset. The ethnic makeup of those who won the contracts was reasonably balanced; however, the process was not transparent, only a limited number of firms was involved, and the terms of the contracts were widely perceived as being overly generous. For example, Renong Berhad, which used to be the main investment vehicle for UMNO and now is controlled by Halim Saad, won eight of the thirteen large national projects that Malaysia has awarded since 1992.

The third step was the outright privatization of existing large state firms. The scope of the effort was broad, and by 1993 even HICOM was sold. Privatization in Malaysia, however, has involved objectives not found in similar efforts elsewhere, such as in Great Britain under Margaret Thatcher. Privatization in Malaysia was only partly driven by considerations of efficiency. In an important respect, privatization was the continuation of UMNO's social redistribution policies in another form, and was a means of strengthening bumiputra loyalty to UMNO. Since most of these companies were already corporatized, share prices were already determined by market forces, and so the price at which shares were sold was not a major issue. On the other hand, the government did issue a controlling block of shares to favored individuals, generally allocating 32 percent or less of the total number of shares, because under the law any higher percentage required a general offer.

The entrepreneurs who received these shares, such as Tan Sri Yahya Ahmad, who took control of HICOM, and Tan Sri Tajuddin, who took control of MAS, were mainly bumiputras and members of UMNO. Realistically speaking, given the political background of many of these firms, it is doubtful whether anyone other than a bumiputra entrepreneur could have done the vigorous cost cutting that was required, and which did occur after privatization in the cases just cited. Who else could have cut the bloated staffs (mostly bumiputras) of these companies or removed inefficient bumiputra vendors from their lists?

While the acquisition of assets by UMNO members strengthened their allegiance to the top ministers, it also rendered their support of the existing UMNO leadership to be disproportionately influenced by the state of the economy in general, and by the state of the stock market in particular. This second implication of the massive asset redistribution program, we shall see, lies at the root of the two extraordinary economic and political events mentioned at the beginning of this paper.

11.3 Enhanced Vulnerability to Financial Panics and High Interest Rates

It turns out that the headlong plunge to accelerate bumiputra ownership of the corporate sector made the bumiputra business community particularly vulnerable to financial downturns. The financial vulnerability was created by the government's lax regulations on collateral-based loans and by the government's directions to the state banks to extend investment loans to bumiputras. The generous flow of bank loans enabled the bumiputra community to buy the discounted shares and to invest in the more profitable unit trusts, and made it possible for the politically connected bumiputra entrepreneurs to buy controlling shares in state companies. The newly purchased assets, in turn, constituted a large proportion of the value of the collateral that the bumiputra borrowers pledged for their bank loans.

The high economic growth of the 1990s, supplemented by large foreign capital inflows, caused the stock market to boom. The Kuala Lumpur Stock Exchange Composite Index went from 506 in 1990 to 1238 in 1996. The rise in share prices allowed Malaysians to borrow more from the banks to acquire more assets. The outcome was that the domestic debt/GDP ratio in Malaysia in mid-1997 stood at 170 percent, which is among the highest in the world.

The reversal of foreign capital flows in mid-1997, and its acceleration at the end of 1997, exacerbated the decline of the Malaysian stock market that had started at the end of 1996.[7] Besides crashing the stock market, the capital outflow also depreciated the ringgit significantly against the U.S. dollar, from MR2.5/US$ in 1997:2Q to MR3.9/US$ in 1997:4Q, and then to MR4.2/US$ in 1998:2Q.

Anwar, who was in charge of economic affairs up to almost the end of June 1998, reacted to the acceleration in capital flight in the final months of 1997 by implementing an IMF-style high interest rate policy to stabilize the exchange rate. The annualized growth rate of reserve money went from over 25 percent in all four quarters of 1997 to –6 percent in 1998:1Q and then to –15 percent in 1998:2Q. As a result of the significant tightening of credit in early 1998, the lending rate, which had been inching up since the start of the Asian financial crisis in July 1997 from 8.9 percent in 1996:4Q to 10.0 percent in 1997:4Q, jumped to 12.2 percent in 1998:2Q. The high interest rate policy could not halt the

7. The Kuala Lumpur Composite Index had fallen from 1238 in 1996:4Q to 1077 in 1997:2Q.

decline of the ringgit, however. Worse yet, it reduced investment spending further and contributed to the downslide of the stock market index to 455 in 1998:2Q from 1238 in 1996:4Q.

In Anwar's defense, it could be argued that the efficacy of his high interest rate policy was undermined by Mahathir's occasional excoriation of conspiratorial speculation by foreigners. The ringgit fell sharply after each outburst by Mahathir, possibly because jittery investors interpreted his strong condemnation as the prelude to the imposition of capital controls. One should note, however, that similar high interest rate policies in Indonesia, Thailand, Korea and Russia had also failed to stop their currencies from falling further after an initial sharp devaluation, despite the absence in these countries of denunciations of foreign speculators by high government officials.

The collapses in the domestic stock market and the foreign exchange market were also accompanied by a large decline in aggregate demand. Private consumption and private investment, especially housing investment, plunged because of the abrupt withdrawal of foreign funds, the high interest rates, and the pessimism about quick economic recovery in East Asia. Furthermore, the positive effects from the depreciation of the ringgit were more than offset by the depressed demand conditions in the region, making exports in the first half of 1998 (US$35 billion) lower than in the first half of 1997 (US$39 billion).

The fall in profits and in share prices rendered many large bumiputra conglomerates financially illiquid or insolvent. The decline in their share prices reduced the value of the collateral pledged against their bank loans, and the drop in profits caused by the economic slowdown made them unable to service their bank loans.

Possibly, the most well-known rescue attempt of a politically connected conglomerate in 1997 was the November 17 announcement by United Engineers Berhad that it had just used borrowed funds to acquire 32.6 percent of the shares of its parent company, Renong Berhad. United Engineers had done this without consulting its minority shareholders. Furthermore, the government had to issue a waiver to exempt United Engineers from having to make a general offer for Renong shares that it did not own. Because United Engineers' move was widely seen as bailing out the indebted majority shareholders of Renong to the detriment of minority shareholders in both companies, the share prices of both companies plummeted after the announcement of the acquisition.[8]

The continued general downslide in profits and share prices led to a second bailout of Renong. In October 1998 Renong defaulted on its debts, and the government paid off MR10.5 billion of Renong's short- and medium-term bank debt by issuing an equivalent amount of long-term bonds. Renong promised to repay the government from its future earnings.

Most large bumiputra conglomerates shared Renong's financial difficulties over the last year. Quite a few of them, especially the politically connected ones, also received state assistance to weather the financial storm. The difficulties that Malaysia's conglomerates (both bumiputra-owned and non-bumiputra-owned) had in servicing their large bank debts severely damaged the balance sheets of Malaysia's banks. Bank Bumiputra, a state bank, was pushed into bankruptcy for the third time since its establishment in 1966. The government had to put in at least MR2 billion as capital in order for Bank Bumiputra to meet the minimum risk-weighted capital adequacy ratio. Sime Bank and RHB Bank, two banks with strong ties to UMNO members, merged in mid-1998 and received an infusion of MR1.5 billion from Danamodal, a state company recently established to recapitalize troubled banks.

An estimate by Lehman Brothers in October 1998 put Malaysia's problem loans at the median of key Asian market economies experiencing banking crises. The proportion of problem loans in total bank loans was 13 percent for Japan, 33 percent for Malaysia and South Korea, 48 percent for Thailand and 61 percent for Indonesia.[9] Standard & Poor estimated that the amount of funds required to recapitalize Malaysian banks would exceed 40 percent of GDP.

11.4 Reflating the Economy

It was clear by the end of June 1998 that the forecast of 2.5 percent growth in 1998 released in May by the IMF was too high. Salomon Smith Barney predicted in June that 1998 growth would be –3 percent,

8. Later, in February 1998, the Kuala Lumpur Stock Exchange reprimanded United Engineers for not reporting accurately that the shares had actually been purchased over a period of time up to November 17, 1997, rather than on November 17 itself. This is probably the major reason why the Renong shares were bought at MR3.24 per share, about 12 percent higher than the closing price of MR2.90 on 17 November. A fine of MR100,000 was levied on United Engineers for inaccurate reporting.

9. "Little Help in Sight," *Far Eastern Economic Review*, October 15, 1998.

while the Economist Intelligence Unit (EIU) predicted 0.8 percent growth in its 1998:2Q issue. It was in this atmosphere of deepened pessimism, and after Mahathir's political leadership was indirectly challenged by Anwar at the annual UMNO meeting in June, that Mahathir appointed Daim Zainuddin to formulate an alternative to Anwar's high interest rate policy.

Reflation through lower interest rates in July 1998 was a risky policy however, because the unsettled global financial markets made the outcome uncertain. There was a chance that a significant lowering of interest rates would stimulate aggregate demand to rise substantially to raise output, restore corporate profits, and renew confidence in the underlying strength of Malaysia's economy. The culmination of this positive scenario would be the repatriation by domestic investors of their overseas holdings to undertake capacity expansion, the return of foreign capital to the stock market, and the stabilization of the ringgit.

On the other hand, there was also a chance that lowering interest rates considerably would worsen the July 1998 situation. Instead of stimulating private spending, the lower interest rates would end up stimulating capital flight. Speculators would borrow ringgit at the lower rates, and buy foreign currencies to bet against a further depreciation of the ringgit. A massive substantial injection of money would thence set the ringgit on a downward spiral, which would bankrupt even more Malaysian banks and businesses that had foreign debt.

Given the uncertainty of the outcome from lowering interest rates, and the ongoing capital flight from the region, a "wait-and-see" policy emerged by default, along with a small reduction in interest rates. The short-term interest rate on August 26, 1998 (one week before implementation of capital controls) was 10.0 percent, down from 11.1 percent on July 1, 1998. Output, the stock market, and the ringgit continued to fall in July and August. It soon became clear that GDP had fallen an annualized 6.8 percent in the second quarter of 1998, and that the decline in the third quarter would be even greater. Incremental adjustments on the policy front were no longer acceptable, either politically or economically.

Malaysia put on capital controls on September 1, fixed the exchange rate at MR3.8/US$, started reducing interest rates substantially, and announced an expansionary government budget on October 23, 1998. Infrastructure spending was increased to raise the general government budget deficit to 4.2 percent of GDP in 1999, a major reversal of the budget surplus tradition, which had produced surpluses of 4 percent in

1997 and 0.7 percent in 1998.[10] The non-financial public enterprises became an important vehicle of the reflation effort. The state oil company, Petronas, kept financially precarious firms operating by acquiring them, e.g., the country's largest shipper (Malaysian International Shipping Corporation) and the national car company (Petronas). The deficit spending of the non-financial public enterprises caused the budget surplus of the consolidated public sector to go from 4 percent in 1996 and 6.3 percent in 1997 to –1 percent in 1998, –5.4 percent in 1999, and (expected) –4.5 percent in 2000.

Mahathir and Daim also announced that bailouts of troubled firms would increase, and they urged banks to boost their lending. Two new state agencies, Danaharta and Danamodal, were established to restore the banking sector to financial solvency so that bank lending would resume. Danaharta would take over the bad bank loans, and Danamodal would recapitalize the banks. The central bank even imposed a mandatory target of 8 percent growth for bank loans in 1998.[11] In February 2000, the central bank introduced a MR300 million subsidized loan program targeted at small and medium-sized firms owned by bumiputras.

The injection of liquidity, with leakage minimized by capital controls, lowered the short-term interest rate steadily from 11.1 percent on July 1, 1998—after Daim just took over the economic portfolio—to 6.6 percent on December 9, 1998, and then to 3.17 percent on December 21, 1999. The stock market index rose steadily from 471 on July 1, 1998 to 522 on December 9, 1998, and then to 791.2 on December 21, 1999.[12]

The pegging of the ringgit at MR3.8 per US$ since September 1998 has rendered it undervalued vis-à-vis the other major currencies in the region. The results were a surge in Malaysian exports from US$72 million in 1998 to US$82 million in 1999, and a surge in foreign investment in the semiconductor industry. Foreign direct investment was also

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10. General government comprises federal, state and local governments. The budget balance as a percent of GDP was calculated from estimates in pages 6, 7 and 23 in the 1999:4Q issue of the Economist Intelligence Unit report on Malaysia. Nominal GDP in 1999 and 2000 was calculated by assuming a nominal growth rate that equaled the real growth rate plus the CPI inflation rate minus 1.
11. The 1998 target was rescinded in early December, when it became clear that it would not be reached because the deep slump had reduced the demand for credit too much. This 8 percent target is mandatory for 1999.
12. The short-term interest rate in early February 2000 is very much below the interest rate on July 2, 1997 when the Thai crisis began: 3.2 percent and 7.5 percent, respectively. However, the stock market index in early February 2000 (about 943) is still way below the pre-crisis level of 1085.

helped by the exemption of new foreign-owned firms from bumiputra ownership requirements, regardless of the export orientation of the new foreign-owned firms.

The reflation measures, together with the natural bounce-back from the regional financial panic, gave Malaysia a 4.7 percent growth rate in 1999; this was higher than the 3.9 percent growth in Thailand but lower than the 9.4 percent growth in Korea.[13] The success of the reflation program would have been predicted by any standard macroeconomic model, because the output decline in 1998 was caused by a reduction in aggregate demand and not by a loss in production capacity.

There is, however, a very important issue concerning the use of bailouts in the reflation. If the bailouts were mostly for bumiputra firms that were rendered illiquid by the financial panic (e.g., companies that were unable to roll over their short-term debt), then the underlying growth of the economy will be unaffected. But if the bailouts covered mostly bumiputra firms that had their insolvency hastened by the high interest rates and lower aggregate demand, then the survival of these low-growth potential firms will lower the trend growth rate. Furthermore, these inefficient firms are likely to weaken the future fiscal situation by requiring more subsidies, and to raise the costs for downstream firms by obtaining increased import protection in the future.

In conclusion, the government's reflation policies did reduce the output loss inflicted by the Asian financial crisis. However, the sustainability of the present recovery will hinge crucially on the Mahathir-Anwar political conflict not escalating to either dampen private spending or reduce foreign investment. Furthermore, the long-term benefits from the reflation program will depend crucially on whether it was accompanied by a restructuring of the industrial and financial sectors to weed out the less efficient firms. If no such weeding occurred, then the short-run reflation program might have lowered the long-run growth rate.

11.5 Capital Controls and Future Growth

Since the primary reason for the imposition of the capital controls was to prevent funds from rushing out in response to the anticipated demonstrations by Anwar supporters, it was only natural that the capital controls were reduced as the political protests became less frequent.[14]

13. Estimates are from HSBC, *Asia Economic Weekly*, January 24, 2000.
14. See Mahani (forthcoming) for a fuller discussion.

On February 15, 1999, the government divided foreign capital into two categories: (a) funds that had entered before that date and (b) funds that would come in after that date. For the first category, the repatriated principal would be taxed if it had been in residence less than a year; and for the second category, only the profits would be taxed. In effect, the government was exempting new capital flows from exchange controls.

Finally, on September 21, 1999, the above two-tier system was replaced by a flat tax rate of 10 percent on repatriated profits. Repatriated principal is now neither taxed nor subject to legal impediments; thus, Malaysia has abandoned the practice, if not the rhetoric, of capital controls.

Relatively little outflow of foreign capital has occurred since the easing of capital controls in February 1999: less than US$350 million flowed out between mid-February and the end of September. This is not surprising because the Malaysian stock market had rebounded substantially; the output recovery was fairly robust; and Morgan Stanley Capital International had announced on August 12, 1999, that Malaysia would be re-included in its Emerging Markets Free Index and the All Country Free Index. The last development is especially noteworthy, because it confirms international recognition that capital controls are no longer binding in Malaysia.

The important question for Malaysia is whether its temporary use of capital controls has permanently turned a large proportion of foreign investors away from Malaysia toward the many developing countries that are now welcoming foreign capital as never before. Given how dependent Malaysian growth and competitiveness have been on foreign direct investment in the past, the continued high inflow of foreign capital (and hence technology) will be necessary to maintain the high trend growth rate of the last two decades. We think that the extensive Latin American experiences with capital controls provide grounds to be optimistic that foreign capital will return over time to Malaysia, albeit possibly with a higher risk premium being paid by Malaysia for several years. Of course, the return of foreign capital is fundamentally conditional on the underlying social stability in Malaysia not being affected by the current Mahathir-Anwar political fight.

Table 11.5
Malaysia: Tracking economic developments

	1997:Q1	1997:Q2	1997:Q3	1997:Q4	1998:Q1	1998:Q2	1998:Q3	1998:Q4	1999:Q1	1999:Q2
Growth rate of real GDP (%)	9.2	8.4	7.5	6.0	–2.8	–6.8	–10.9	–10.3	–1.3	4.1
Exchange rate (against US$)	2.5	2.5	3.2	3.9	3.6	4.2	3.8	3.8	3.8	3.8
Real exchange rate (1990 = 100, WPI based)	71.4	73.9	90.9	106.1	93.9	104.7	96.8	102.3	97.6	96.8
International reserves minus gold (US$ million)	27,709.9	26,586.3	22,159.3	20,788.2	19,803.9	19,701.6	20,702.4	25,559.4	27,139.8	30,571.3
Reserve money growth (%)	28.7	25.7	25.6	27.8	–6.3	–15.0	–39.6	–38.6	6.2	24.6
Narrow money growth rate (%)	23.4	20.3	15.1	8.7	–14.2	–18.9	–30.6	–29.4	–17.3	–3.7
Broad money growth rate (%)	22.6	23.0	21.6	17.5	8.9	3.1	2.8	–1.4	3.6	13.2
CPI growth rate (YOY%)	3.2	2.5	2.3	2.7	4.3	5.7	5.7	5.4	4.0	2.6
Nominal lending rate (%)	9.2	9.3	9.6	10.0	11.2	12.2	10.9	8.2	8.0	7.4
Nominal deposit rate (%)	7.2	7.3	7.7	8.9	9.4	10.0	8.7	5.9	5.6	3.8
Export value (US$ million)	19,696.9	19,698.8	20,443.2	19,064.9	17,579.3	17,914.8	19,292.1	20,000.8	18,225.5	20,490.5
Import value (US$ million)	18,882.6	21,606.6	19,955.7	18,601.0	15,345.2	14,472.2	585.0	549.4	550.3	616.8
DS stock market index ($)	629.8	543.0	321.8	197.4	241.6	136.5	121.6	168.8	167.5	303.1
DS stock market index (national currency)	649.7	570.2	434.0	319.7	365.9	235.6	192.3	381.5	331.1	532.3
Kuala Lumpur Composite Index	1,203.1	1,077.3	814.6	594.4	719.5	455.6	373.5	586.1	502.8	811.1

11.6 International Competitiveness

We now turn to the microeconomic level to examine the international competitiveness of each sector of Malaysia's economy. We group Malaysian industries into four categories: manufactured export industries, manufactured import-substituting light industries, heavy industries and modern service industries.

Manufactured Export Industries

Malaysia's manufactured export industries have shared two characteristics that are important to achieving international competitiveness. First, ethnicity-oriented ownership policies have played only a minor role in these industries because most have been exempted from the ownership requirements of the ICA. Second, the great majority of firms in this sector are foreign-owned, either wholly or in controlling part. The ICA ownership policies played little role because the government recognized early on that there are few rents to redistribute in the export of manufactures. International competition largely eliminates rents in this sector, and profits thus reflect returns on business skill and entrepreneurship. Any effort to divert a substantial share of these profits to those not contributing to their creation kills the incentive to develop the business in the first place. Where foreign ownership is involved, it is a simple matter for the owner to decide to set up business in some other country.

Malaysia's electronics sector, by far the most important manufactured export sector in the country, illustrates how Malaysia's manufactured exports have developed to date. The electronics sector is two distinct groups of industries, both of which sell most of what they produce outside of Malaysia. Large American firms such as Intel and Hewlett-Packard dominate the semiconductor, computer and peripherals industries. These firms are not listed on the Kuala Lumpur Stock Exchange, so the precise size of their Malaysian operations is not public information; however, several firms, notably Intel, have investments in Malaysia that exceed US$1 billion. What started as highly mobile firms employing cheap labor have become enterprises participating in a wider range of activities in Malaysia. Furthermore, management and the technical staff of these plants are now largely drawn from the local population. Ownership, on the other hand, is entirely foreign.

The other part of the electronics sector produces consumer electronics, such as television sets, VCRs, air conditioners and refrigerators. Brand names matter with these products, and most of the firms in this sector are wholly owned by large Japanese conglomerates such as Matsushita, Sony, Hitachi and Sanyo. Japanese firms differ from those of the Americans and Europeans in that top management in Malaysia is usually staffed by Japanese who rotate in and out from their home offices in Japan. These plants cannot be easily relocated to other countries because they involve substantial investments and have been in Malaysia a long time, but they are less firmly rooted than the semiconductor manufacturers. However, one should not overstate how firmly rooted are the semiconductor firms, given the rapid pace of technological change in the industry.

If Malaysia's future is like its past, future manufactured export growth will depend on the following actions:

- retaining foreign exporting firms already in the country,
- continuing to attract new foreign direct investment (FDI), and
- avoiding actions that would discourage existing foreign firms from branching out into new and more advanced areas of business as their existing lines become obsolete or uncompetitive.

But can foreign direct investment alone carry an economy that is no longer generating much growth from its rich natural resource sector? Singapore and Hong Kong have experienced FDI-led growth for long periods, but they are much smaller countries or territories than Malaysia and have an unusually strong financial and commercial infrastructure. Malaysia is more comparable in size and infrastructure to Taiwan, but Taiwan's manufactured export industries were led by Taiwanese, with FDI playing only a small role. Thus, there is a plausible basis for concern that foreign direct investment alone will not be able to carry Malaysian manufacturing to ever higher levels of production and exports sufficient to sustain rapid GDP growth.

Manufactured Import-Substituting Light Industries

Most of the firms in this category are small or medium-sized. Three companies in this category are listed in the top fifty on the Kuala Lumpur Stock Exchange. Two are foreign-owned (Nestle and Rothman) and one is local, Perlis Plantations (of the Robert Kuok group), which includes sugar manufacturing among its diversified activities. In the next fifty firms listed by size, there are only six more in this category and most of them are foreign (R.J. Reynolds, Guinness and Carlsberg) or local franchises of foreign operations (Kentucky Fried Chicken). The exception is Federal Flour, also part of the Robert Kuok group.

Chinese-Malaysians own the great majority of the firms in this category. Some of these firms will no doubt grow enough to become suppliers to more than the Malaysian domestic market, but few firms outside of the textile industry played such a role in the mid-1990s. As they grow larger, however, they become subject to the rules of the Industrial Coordination Act, and if they do not become larger, they are not likely to be able to export. But if many of these local light industry firms do not grow up to international status, which firms will?

The incentive structure rooted in the ownership legislation thus inhibits the development of an export capacity among import-substituting light manufacturers. This situation is common to many developing countries, particularly in the Philippines. Very small firms often prosper and grow out of sight of government regulatory and tax authorities until they reach a certain size, when they are suddenly faced with a raft of government interventions. Those firms with foresight often avoid this problem by staying small.

In short, light manufactures currently in the import-substituting sector do not appear to be promising sources for the export-oriented entrepreneurs of Malaysia's future, and this is in part because the ICA discourages non-bumiputra-owned firms from expanding the scale of their operations.

Heavy Industries

Oil and gas

Malaysia currently has oil and gas reserves plus the realistic prospect of future discoveries of new fields that will allow the country to extract substantial rents from this source for several more decades. The sector, however, is not a dynamic source of future growth either in domestic value-added terms or in terms of exports. If domestic demand for petroleum and gas continues growing at current rates, Malaysia will eventually become a net importer of these products.

Petrochemicals

The petrochemical sector is dominated by Petronas, the state company that controls all the oil and gas fields and receives most of the rents from them. In the mid-1990s, worldwide profit margins in petrochemicals were extremely low. Petronas's downstream efforts may also have had low or no profits, but there is no way for an outsider to know because profits from downstream activities are not separated out publicly from the profits (and rents) to the company as a whole. The Malaysian situation is further complicated by being next to Singapore, which entered the industry early and made itself the petroleum and petrochemical center for all of Southeast Asia. In addition, Singapore has defended that position with vigorous price cutting and similar measures to prevent or cripple the rise of potential competitors.

Cement

Cement is an industry in which transport costs provide significant natural protection for what, in most countries, is an industry oriented toward the domestic market. Scale economies can be achieved at one or two million tons of output per year, and the Malaysian market in 1996 was already around 12 million tons, more than big enough for Malaysia's six major producers. The largest producer is APMC, a joint venture between the MUI group of Khoo Kay Peng and the Blue Circle Group of the U.K. Most of the other cement firms have close ties to the government.

Because infrastructure and concrete products (as inputs) affect the cost of export products only in a small and indirect way, the question of whether local Malaysian-produced cement is fully competitive with imported cement only becomes an issue if the domestic plants are extremely inefficient, and Malaysia's are not. Malaysia, in fact, might well become an exporter of cement, particularly to Singapore, which regularly imports several million tons a year. However, the export market for cement is neither large nor growing rapidly, in part because it is a favorite target for the import-substituting industrial policies of many developing countries.

Steel

The steel manufacturing industry is very different from the cement industry. The technology is more complex; scale economies are important in the case of some products; and steel is both a potential export product and a major input into other actual and potential exports, notably automobiles. The Malaysian government has tried to help develop a modern steel sector, but it has experienced decidedly mixed results. Malayawata was the government's first attempt. The government's second try (Perwaja Steel) resulted in large financial losses. The 30-percent tariff rate on steel products has produced two prosperous private steel mills, ASM and Southern Steel.

Automobile manufacturing

The case of the car manufacturer Proton Saga is complex. Proton has a large advantage in the Malaysian market in that, unlike its domestic competitors, Proton does not have to pay either the excise tax or the 40-percent duty on the import of completely-knocked-down kits. Informed guesses put the Proton price at about 20 percent above that of comparable automobiles on the unprotected world market, which is not a particularly high percentage as developing country auto production costs go, but is not an internationally competitive price either.

If one takes a longer view, to the year 2020, the case for Proton may prove to be stronger. All late-developing automobile sectors, including that of the Japanese, take a long time to become competitive. If Proton's costs do not come down, the consoling thought is that expensive cars do not generally raise the costs to other manufacturers the way expensive intermediate inputs do. Nonetheless, an uncompetitive car industry would be a drag on overall economic performance.

The engineering firms connected with the automobile sector are not yet capable of standing on their own as exporters of auto components, as is the case, for example, of many auto parts manufacturers in Taiwan.

On the whole, even an optimist would agree that it will be several years before Malaysia's heavy industries can realize their potential to be internationally competitive.

The Modern Service Sector

Malaysia's service sector has a long way to go before it will be capable of playing a leadership role in the economy and becoming a major source of foreign exchange earnings. Malaysia's banking sector is a clear case in point. The large-scale banking sector, if one excludes the foreign-owned banks, is owned by either the government or large bumiputra interests with close ties to government. The private Chinese-Malaysian banks are small and getting smaller. Their decline did not come about because of government coercion. For the most part, mismanagement by the banks' founders got the banks into trouble, and the central bank was forced to step in. Once the government intervened, however, the eventual result was often the sale of the banks' assets to bumiputra interests. Restrictions on the opening of new branches by existing smaller banks have had a similar effect.

Among the bumiputra banks, there are strong institutions such as the Arab Malaysian Bank of Tan Sri Azman Hashim. Others are considerably less successful, notably Bank Bumiputra. The problem with banks with close ties to government, such as Bank Bumiputra, is that the competitiveness of these banks is undermined from two directions. On the one hand, they are expected to lend to government-supported enterprises even when those enterprises are in deep trouble, as was the case with Perwaja Steel. On the other hand, these banks have good reason to believe that, because of their close ties to government, they will be rescued if they make mistakes. Banks with this set of constraints and incentives are never likely to be internationally competitive.

The service sector in Malaysia also includes tourism, hotels, gambling and related services. Malaysia is already a major international presence in the hotel business, with such notable international chains as Shangri La and Equatorial (even if the headquarters of the former has now moved to Hong Kong). Malaysia does not have the historical sights of Bali or Thailand, but it has other major tourist assets and it is well along in developing them.

Some portions of Malaysia's service sector have the potential to become internationally competitive, but a service sector capable of supporting broad and sustained growth of the economy and of foreign exchange earnings has yet to be developed.

11.7 Conclusion

We have reviewed the evolution of Malaysia's industrial policy and industrial structure as part of an effort to identify sources of future competitiveness and growth in the manufacturing and service sectors. We found that the internationally competitive parts of the manufacturing sector are mostly dominated by foreign-owned and foreign-controlled firms. A few domestically owned and controlled firms also have become successful exporters of manufactures and even a few services, and their numbers increased modestly in the mid-1990s. Most manufactures and services are oriented toward the domestic market, and many still require some protection from international competition.

The size of the Malaysian domestic market is not particularly large, however, so firms whose growth is based solely on that market will not be able to take advantage of many economies of scale. Furthermore, industries that depend indefinitely on protection from foreign competition tend to work more at maintaining that protection than at raising their own productivity. Import-substituting growth, therefore, is likely to be slow growth over the long haul. If Malaysia is to enjoy continued rapid GDP growth, many of these import-substituting firms will have to become exporters of goods and services.

There is nothing really unusual about this future challenge, except for two special features of the Malaysian economy. The first special feature is the important role of Malaysia's rich natural resource base. This natural resource base has made a major contribution to Malaysia's growth in the past and has played a central role in helping fund some of the country's industrial and social experiments. But Malaysia's natural resources are a steadily declining share of GDP, of exports, and of government revenue, and will soon play a minor part in the Malaysian growth story, much as tin and rubber have become relatively minor sectors of the overall economy.

The second special feature of Malaysian industrial and service sector development is the emphasis on ownership restructuring and income redistribution. In the view of Malaysia's leaders, and even from the perspective of many who had to help pay for this restructuring and redistribution, the change was necessary to ensure a stable society in which benefits are widely shared and occupations are not identified with ethnicity. By any reasonable standard, ownership restructuring has been highly successful. By the mid-1990s it was not possible to identify many large sectors of the economy as belonging to any one ethnic group.

However, ownership restructuring was not without its costs. Malaysia's internationally competitive manufacturing sectors are precisely those sectors that have been exempted from the ownership requirements and are dominated by direct foreign investors. Local Malaysian firms, as is usually the case in most countries, have started by concentrating on the domestic market; hence they have been subject to ownership restructuring throughout their history. Some have grown and prospered under the requirements of laws such as the ICA, but the number of these firms that have grown to be truly international is not large.

Probably the least successful strategy of the ownership restructuring was the reliance on state ownership to implement social objectives. The government itself realized some years ago that state firms tended to be inefficient, and undertook privatization of most of them. Privatization, however, generally meant sale to bumiputras, not sale to the highest bidders, in order to create a group of bumiputra billionaires. The goal of creating bumiputra billionaires is being achieved in part by giving selected individuals exclusive licenses to build key elements of Malaysia's infrastructure. In some cases, the license has mainly generated rents for the license holder. The more this type of situation occurs, the greater the danger that Malaysian costs of doing business will rise to uncompetitive levels. A worrying example is the 1997 increase in electric power rates, which are now at a level that makes Malaysia the second most costly producer of electric power in the region.

The crucial question in the Malaysian context is whether the newly created bumiputra billionaires have acquired the right kind of experience to be able to match the earlier performances of the more successful Korean chaebols. Few of these individuals, for example, came to their tasks with much experience of either manufacturing or exporting. If these new holders of great wealth can make the necessary transition to industrial and international entrepreneurship, Malaysia's future looks bright. If they cannot make this transition, then Malaysia has two (not mutually exclusive) choices. The economy can continue to depend on foreign direct investors to play this role or it can attempt to look elsewhere locally for entrepreneurial talent. For the most part, the incentive structure needed to stimulate foreign direct investors can arguably be said to be in place despite the recent temporary capital controls. The same, however, cannot be said with respect to a mechanism to encourage new sources of local entrepreneurial talent.

There exist fast-acting solutions to the present economic malaise and to the long-run problems of maintaining high growth and increasing international competitiveness, but considerable statesmanship and political skill will be required to overcome resistance to these quick-relief solutions.

The first politically sensitive reform is to relax the ownership restrictions of the ICA to enable the needed recapitalization of the banks and large firms. UMNO must make a credible commitment to the permanence of the ICA reforms if the troubled firms are to succeed in issuing new shares. The ICA reforms will also have the salubrious effect of encouraging the small and moderate (import-substituting) firms owned by non-bumiputras to expand their capacities and eventually become big exporters.

The second politically sensitive reform is to revise the state industrial policies to include expiration dates for state subsidies and import protection. The government must institute a weeding-out process within its infant industry program to prevent high-cost inputs from undermining international competitiveness. This "tough love" approach will help the protected firms to focus on improving productivity.

Our suggestion for the reform of the ICA is actually neither radical nor politically infeasible. The National Economic Recovery Plan unveiled by Daim Zainuddin in July 1998 included just such a proposal. In its essence, the suggested ICA reforms in Daim's plan are similar to the "graduation requirement" we recommended for incorporation into the national industrial policy. The government clearly has succeeded in creating a professional and entrepreneurial bumiputra community that equals the non-bumiputra community in competence and competitiveness. By most indications, Malaysia now has a large, well-educated bumiputra middle class that is actively engaged in nearly all industrial and modern service activities. Furthermore, there is no reason to think that explicit industrial policies, backed by state subsidies and import protection, are needed to guide the investments of well-informed bumiputra entrepreneurs.

Of course, assessments differ as to whether the Malay professional and entrepreneurial classes are now able to compete with non-Malay Malaysians. On the eve of the 1997 elections, in a speech to government officials, Mahathir rejected the arguments for meritocracy advanced by some successful bumiputras:

> [With the implementation of meritocracy] the Malays and the bumiputras will become manual workers and will not be able to hold high positions they are holding today. … Let us not think that we have reached this level because of our own ability.[15]

Although there is disagreement over the readiness of the Malays to compete, there is agreement that the government subsidies retard the progress of Malays toward parity in competitiveness with the non-Malays and, equally important, toward parity in competitiveness with the rest of the developed world. In his advice to the Malay community after the 1999 elections, Deputy Prime Minister Abdullah Ahmad Badawi warned:

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15. The Straits Times Interactive, "Malaysia not ready for merit system: Mahathir," July 30, 1999; http://straitstimes.asia1.com.sg/reg/region.html/.

[Because of the excessive dependence by Malays on government subsidies], for every step taken by Malays, the non-Malays take 10 steps... [Even then] this economic structure is changing and bumiputras must be aware of globalization and its effects on our economy…We must prepare ourselves to compete in a bigger arena… It is time for more bumiputra entrepreneurs and businessmen to attain excellence through their own efforts.[16]

Herein is the Malay dilemma: the government subsidies that promote the socioeconomic mobility of the Malays in the short run may end up harming the long-run competitiveness of this race unless the government can ensure that the Malays do not become addicted to these subsidies. The Malay leadership is caught between short-run political expedience and long-run economic competitiveness. The economic future of the Malays (and of the country) and their relative position in the world economy hinge on how UMNO will react to the significant Malay desertion from UMNO in the 1999 elections. Would UMNO be too weak to take a farsighted view of the interests of the Malay race in a global economy, or would UMNO convert this crisis into an opportunity to implement policy changes that would enable Malay entrepreneurs and professionals to stand on their own feet on the world stage?

These are extraordinary times in Malaysia, and extraordinary political leadership is important. Part of extraordinary leadership is the political courage to assess objectively whether the continuation of the race-based programs and the industrial policies has more to do with ensuring political patronage than with providing "infant industry protection" to "disadvantaged" bumiputra professionals and businesses. If holding onto political power is the real motivation behind these policies, then the economic costs from a rigid ICA are not serving the cause of social justice, which is the defensible motivation behind the race-based policies. It is then time to throw away the crutches that are getting in the way of the economy advancing faster. A fast-growing and fiercely competitive economy will do more to enrich the bumiputra community than state-generated rents can ever hope to do.

16. The Straits Times Interactive, "Abdullah warns of new Malay dilemma," January 31, 2000; http://straitstimes.asia1.com.sg/reg/regional.html/.

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