Natural Resources and Economic Diversification:
A Case of Malaysia

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Abstract
This paper explains that Malaysia’s ability to diversify its economy and overcome dependence on natural resources is driven by two factors. First, the path dependent nature of Malaysia’s economic arrangement has made it possible for Malaysia to continue its diversification strategy. The paper will demonstrate that the late entry of commercial oil production and the prior existence of a thriving private sector had made it easy for Malaysia to diversify its economy and avoid overdependence on natural resources. Second, the paper will argue that the path dependent nature of Malaysia’s consociational politics inadvertently limits its economic policy option so much so that Malaysia has little choice but to continue to adopt a diversification strategy to allow for an expanding economy.

Keywords: Historical institutionalism, Path dependence, Economics of Diversification

Introduction
There is a general agreement that states with abundant natural resources tend to fare poorly economically when compared to non-resource rich states. Many attribute this so called “resource curse” to several reasons. First, state’s reliance on natural resources leads to economic distortions that retard growth. For instance, surge in natural resource exports would drive up real exchange rate and hence makes it difficult for states to develop other sectors like manufacturing and services. Second, receipts from natural exports tend to make state invest in unproductive non-traded sector given the tendency for states to concede to public demands to distribute earnings. Third, abundant natural resources may induce competition between governing elites for control these resources to champion sectional interests which ultimately leads to less than optimal welfare policies. Finally, natural resource rich states tend to have a large bureaucracy. A dominant state could retard the growth of the private sector and

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result in an extractive or predatory bureaucracy. In sum, states with abundant natural resources tend to have an underdeveloped private sector, lack financial depth, suffer from low domestic and foreign investment and are more prone to corruption. (Gylfason 2004)

The literature has come up with two broad solutions for states to avoid the “resource curse”. The first requires states to undertake administrative reforms by putting in place mechanisms that limit opportunities for rent-seeking and allowing for greater accountability and transparency. One way to do this is to privatize the resource sector or distribute receipts from natural resources directly to the public. This is an attractive proposition but comes with a major obstacle; it may not be in the state’s interest - especially authoritarian ones - to improve transparency and accountability. State institutions are resilient to change and easy access to resource rents makes state institutions more unwilling to institute change. Indeed, state elites have good reasons to resist reforms. Revenue from high commodity prices and the need to dispense patronage to maintain regime legitimacy are strong reasons to resist reforms and continue to rely on natural resources. Even if there are public claims to distribute wealth, state can employ methods that might not involve improvements in transparency and accountability. To meet public expectations, the state could for instance transfer part of the income generated by resource rent to the public in the form of lower taxes or no taxation. The state could also mute public demand for accountability by distributing natural resource receipts in the form of direct transfer or subsidies in key areas like education, food and transportation.

One other solution for states to avoid the resource curse is to diversify the economy. This is indeed a more sustainable solution. Diversifying revenue streams and generating multiple economic capacities are sure ways to avoid or remedy economic distortions and help buffer the economy against external shocks. Attractive as this may be, natural resource-rich states often struggle to diversify. The literature is patchy on state’s success in economic diversification and generally agrees that if there is a successful economic diversification strategy, there is no one-size-fits-all solution. State’s failure to diversify could be due to its idiosyncratic institutional quality - a product of the state’s political, social and economic qualities. Any policy prescription to diversify the economy must be contextual in nature, one that takes into account state’s political and economic structures. (Malik and Temple 2009)
When it comes to state’s performance at economic diversification, Malaysia is often been singled out as a success story. Indeed, Malaysia has successfully transformed its economy since gaining independence in 1957. Despite being endowed with tin and oil and gas, Malaysia has developed into a multi-sector economy driven by high technology and capital intensive industries. The oil and gas sector in fact contributed only 19% of Malaysia’s GDP in 2009(Pemandu 2010). In 2011, Malaysia’s exports included electronics (34.5%), petroleum related products (9.9%), palm oil (9.3%) and chemical products (6.9%). Malaysia also counts among the world’s 20 largest trading nations and its economic performance was ranked seven out of fifty nine countries in 2011. The World Competitiveness report 2011 also ranks Malaysia as among the top five most competitive nations in Asia Pacific.

Malaysia’s success in diversifying its industrial output stands in contrasts with the experience of Ghana. At the time of independence both Ghana and Malaysia had almost similar political and economic structure(Auty 2000; Auty 2001). Both countries gained independence from Britain in 1957. Both states inherit British institutions like a democratic political arrangement, an effective civil service and an education system that were relatively high among their immediate peers. In the years after independence, the two economies began to diverge. In 1957, Ghana’s export made up almost 30 percent of its GDP, whilst Malaysia’s export made up almost 50 percent of the GDP. In 1995, Ghana’s export shrank to about 25 percent of its GDP, whereas Malaysia’s export took up almost 95 percent of its GDP. Malaysia’s agricultural sector – which in 1957 took up 36 percent of GDP - generated 14 percent of Malaysia’s GDP in 1995. To make up for the drop in agricultural output, manufacturing became Malaysia’s main industrial output accounting for almost 33 percent of GDP. It is a different case for Ghana. Ghana’s agricultural sector remains the state’s main output. In fact, Ghana’s agricultural output took up almost 46 percent of the country’s GDP in 1995. Ghana’s manufacturing output in fact shrank to make up only 6 percent of the GDP. (Auty 2000)

Malaysia’s ability to diversify its economy invites obvious questions: How can one explain Malaysia’s ability to develop multiple sector economy? How is it possible that Malaysia is able to rely less on natural resources as a source of growth and stay away from over-indulging in unproductive non-traded sector of the economy?

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2 Economic Transformation Programme Handbook, Chapter 6
The above questions are not entirely novel. Islam and Chowdury (1997) for instance believe that Malaysia’s success in avoiding the resource curse is due to its ability to manage consensual democracy in a highly plural society. They argue that Malaysia’s economic success is the result of a tacit agreement between Malaysia’s politically dominant Malay actors and economically dominant Chinese actors. Under such an agreement the state (being Malay dominated) agrees not to over indulge in productive activities (Chinese domain) and in return the state is allowed to disburse resources to invest in the economic and human capital of the Malay majority. In another argument, Paul Collier (2006) gives a number of reasons to Malaysia’s ability to move away from the “resource curse”; Malaysia’s ability to get its macroeconomic right, the state’s consistency in pursuing liberal market ideas and Malaysia’s competence in handling conflict in the post-colonial period. (Collier 2006)

Islam and Chowdury’s functionalist explanation as well as Colliers’ liberal argument bears some truth. There is little doubt that Malaysia’s ability to diversify its economy is largely due to its nature of its consociational democracy and its ability to adopt appropriate macroeconomic policies. But the explanations need to be expanded. This paper believes that Malaysia’s successful adoption of a diversification strategy is best understood when one adopts a historical institutional analysis. This paper argues that Malaysia’s successful economic diversification strategy is the result of the state’s institutional character and a product of the historical process. The paper will discuss two factors that contribute to Malaysia’s success in diversifying its economy. It will first demonstrate that the path dependent nature of Malaysia’s economic policy (colonial as well as post-colonial periods) and the increasing returns nature of economic diversification have made the oil and gas sector only as an add-on to Malaysia’s already varied economic production structure. In arguing this, the paper makes the case that the Malaysian economy was already diversified with major revenues coming from primary products like tin, rubber and palm oil before oil and gas production became commercially viable. The paper will also explain that Malaysia’s success in diversifying its economy is also due to the character of the Malaysian political economy. It will argue that the path dependent nature of Malaysia’s political economy demands that Malaysia adheres to a consociational arrangement that inadvertently limits Malaysia’s economic policy option. It will demonstrate that despite the affirmative nature of Malaysia’s New Economic Policy(NEP), the NEP, ironically, gives the state little choice but to continue to adopt economic diversification strategy.
The paper is divided into several parts. The first part will discuss, in brief, historical institutionalism and its attendant concept of path dependence. The second will describe the Malaysian economy and how a diversified economy has paved the way for relying less on natural resources. The subsequent part of the paper will describe the NEP and how it forces the state to expand, hence to continue to diversify the economy. The final part will describe Malaysia’s response to its economic crisis in the 1980s, 1990s and in the year 2008. The paper highlights Malaysia’s response to the crises for two reasons. First, the crises demonstrate Malaysia’s resolve in keeping to a liberal and expansive economy, encouraged of course by a thriving private sector and the increasing returns from a diversified economy. Second, the crises demonstrate that the state understands that the NEP can only hold political and economic relevance with an expanding Malaysian economy. This is evident when, time and again, the state was prepared to change some of the terms in the NEP in order to allow for greater economic growth.

**Historical Institutionalism and Path Dependence**

Works on historical institutionalism place premium on context, historical moments and processes in order to understand policy outcomes. A historical institutional analyst believes that institutional processes can best be understood if they are studied over time. A historical institutional analysis seeks to explain large outcomes, asks “big” questions and believes that “detailed investigation” of carefully chosen case studies can provide a “powerful tool for uncovering the sources of change.” Understandably, an integral part of any historical institutional work is process tracing. Indeed process tracing – along with concepts like path dependence, timing and sequence – helps ensure that historical episodes be linked in a meaningful way before they can offer explanation of a particular case.

Central to historical institutionalism is the concept of path dependence. Path dependence is thrown to various definitions. Sewell(1996) defines path dependence as “what happened at an earlier point in time will affect the possible outcomes of a sequence of events occurring at a later point in time.” Mahoney (2000) sees path dependence as “specifically those historical sequences in which contingent events set into motion institutional patterns or event chains that have deterministic properties.” Levi (1997) perhaps provides a more lucid description of path dependence when she describes that once a
state "has started down a track, the costs of reversals are very high." Path dependence, she says, entrenches certain institutional arrangements that effectively "obstruct an easy reversal of the initial choice."  

The above definitions suggest that path dependence involves two things. First, making that initial choice is important. Second, once a choice is made, self-reinforcing mechanism sets in where “each step in a particular direction makes it more difficult to reverse course.”  

It is not that taking a reverse course is impossible. Rather, the choice of reversal is increasingly difficult because the cost of reversal increases over time given actors' investment on resources.

What brings about path dependence and why do social, political and economic processes get stuck in a path dependent mode? Perhaps two most important works that deconstruct the logic of path dependence are those carried out by economic historians Paul David(1985) and Brian Arthur(1994). Arthur suggests that path dependence is due to self-reinforcing mechanisms. He describes four self-reinforcing mechanisms that encourage path dependence. They are: large set up costs; learning effects, coordination effects and adaptive expectations.  

To put simply, the initial choice gets hard wired within an institutional setting and thus makes it harder for existing institutions to adopt alternative technology.

David’s and Arthur’s works have been extensively borrowed by social scientists. One of the best efforts at incorporating David’s and Arthur’s works to public policy is the one carried out by Paul Pierson(2004). Pierson argues that the source of path dependence and self-reinforcing mechanism lies in the nature of public good. He explains that the non-excludable and non-rivalrous nature of public good give rise to collective action problem, opacity in political decisions and the development of institutional density that encourage self-reinforcing mechanisms. To put briefly here, policy makers are always confronted with collective action problem when making policy decisions and that due to opacity in assessing policy outcomes, policy decisions are often made with less than perfect information. These factors when combined with the existence of a dense network of institutions most always means that
policy changes (in the short term) are usually incremental or small in nature but produce large outcome over the long term.\textsuperscript{13}

Although path dependence gives the impression that the state is limited by the type of institutions it inherits, it does not necessarily mean that states are caught in institutional stasis. Institutional change exists, but in most cases, change is incremental in nature; change is usually ‘transformational’ when viewed over the long term. There is a growing literature that accounts for such institutional change. Streeck and Thelen (2005) for instance do not see change as drastic but describe that "rather than abrupt and discontinuous, transformative change often result from an accumulation of gradual and incremental changes." Change happens when there are inherent ambiguities and gaps that exist by design or one that emerges over time between formal institutions and actual implementation" (Streeck and Thelen, 2005: 19).

The historical institutional narrative as well as Pierson’s work fit this paper’s explanation on Malaysia’s success at diversifying its economy. Malaysia’s economic diversification efforts are a function of timing, sequence and path dependence. Malaysia’s success in diversifying its economy rests on the timing of the state’s discovery of oil and and the path dependent nature of Malaysia’s economy that encouraged a diversification strategy. Malaysia’s brand of political economy also facilitated the diversification process. When we apply the concepts of path dependence and institutions, Malaysia’s power sharing arrangement - which is a product of Malaysia’s historical process – in fact imposes limits on Malaysia’s policy options. Different terms have been used to describe Malaysia’s power sharing arrangement but Arendt Lijphart’s use of the term consociationalism provides a more comprehensive description of Malaysia power sharing arrangement. Lijphart’s (1996) consociationalism refers to the presence of multiple ethnic groups of equal proportion of political power that are prepared to come together in a political arrangement despite retaining their identities through agreements reached between leaders of these groups who have support of their ethnic communities. Consociationalism works when governing elites understand the perils of political, social and economic fragmentation and hence work on maintaining cohesion and stability among its political constituents (Lijphart 1996).\textsuperscript{3}

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In sum, institutions, tend to make policy actors invest in specialised skills, create mental maps over social and political realities which encourages actors to adopt small, incremental policy changes that use existing policies as barometer (David 1985; North 1990; Pierson 2004). The article will argue that the path dependent nature of Malaysia’s economic structure and Malaysia’s consociational institutional legacy has made it possible for the state to embark on a diversification strategy and hence avoid the so called “resource curse.” We look briefly now at the Malaysian economy.

The Malaysian Economy

Malaysia’s economy has stayed diversified not only because it has embarked on the right policies but also due to a confluence of events that has allowed Malaysia to have a varied economic production. Historically, the Malaysian economy has never been dependent on a single source of economic production for sustenance. During the colonial administration, the Malayan economy was one the most laissez-faire economies and is still among the world’s freest trading economies. In the past, the Malaysian economy has been dominated by exports of primary products, like tin, rubber and palm oil. Tin, perhaps, came close to dominating Malaysia (then called Malaya) economic output. The ore was found as far back as the 17th century, but it was only during the last quarter of the nineteenth century when the Malay States came under British colonial administration did tin become Malaya’s dominant economic output. Towards the end of the nineteenth century, Malaya became one of the world’s largest exporters of tin. In the early twentieth century Malaya’s tin output contributed to more than half of world’s tin production. Even as late as 1979, Malaysia accounted for 31% of the world’s output producing 63,000 tonnes of tin ores. However by 1994, the economy’s reliance on tin dropped to a low of 6,500 tonnes. The drop in production was due to due to the exhaustion of tin deposits, low tin prices and the high operating costs. Currently, Malaysia hardly exports its tin; tin are now used for domestic electronic and tinplating industries. (Drabble 2000)

In late twentieth century, the Malaysian economy was not only dependent on tin, rubber and oil palm for trade receipts it increasingly relied on manufacturing for economic returns. At the time of independence, Malaysia’s manufacturing sector contributed 11 percent of GDP. By the late 1960s,
manufacturing began to emerge as Malaysia’s main industrial output. The early 1970s also saw Malaysia aggressively targeting foreign manufacturing firms when it set up 5 export-processing zones in an effort to reduce production costs and enhance production network. The period also saw the state reducing its tariffs and non-tariff measures. Malaysia’s determination to keep an open economy is reflected in the country’s effective rates of protection (ERPs) where ERPs against imported manufactured goods stood at between 35-40 percent which was far less than in most developing economies. In fact Malaysia’s ERP on manufacturing declined to 23 percent in 1982 and dropped further to 17 percent in 1987 (Ghee and Woon 1994; Auty 2000). Malaysia’s efforts at improving its industrial output bore results. If the 1960s saw Malaysia’s industrial output making up a mere 6.3 percent of the GDP, by the 1980 the country’s industrial activities rose to about one fifth of total GDP. In fact, by 1990 manufacturing made up almost 60 percent of Malaysian exports as opposed to only 12 percent in 1970. (Drabble 2000)

Given the path dependent nature of Malaysia’s diversified economic structure it is little surprise that Malaysia has the flexibility and room to be less reliant on a single natural resources, especially oil and gas in the later years. It helps that oil and natural gas industry was a late entrant to Malaysia’s industrial output. Even when oil was discovered in Sarawak (Sarawak only became a member state of Malaysia in 1963) in 1911, output from oil and gas only became significant in the second half of 1970. Before 1974, oil and gas industry’s experts saw little in Malaysia’s ability to produce significant oil and gas production. One senior official of a continental oil company remarked, “on the basis of the discoveries so far it would appear that we do not have another Middle east, or even another North Sea, but an area where relatively small discoveries are the norm” (Gale 1981). Such pessimistic view on Malaysia’s oil reserves was also aided by the lack of technological capabilities and low oil prices that deterred further any interest in Malaysia’s oil deposits. It was only when oil was struck in large quantities off the east coast of Malaysia – when two oil companies were given the right to start exploration in two offshore concession areas - that Malaysia began to map a comprehensive oil management strategy. In 1974, Malaysia introduced the Petroleum Development Act which gave birth to Malaysia’s Petroleum Nasional Berhad or PETRONAS. Under the act, PETRONAS was given custodial rights to Malaysia’s petroleum resources. Petronas would retain ownership and management control in exploration, development and production of oil resources.

4 Drabble (2000)p.189
The important point is that the late entrant of the oil and gas industry plus the existence of a diversified private sector prior to the presence of oil and gas allowed the Malaysian economy to continue its diversification momentum. The increasing returns from earlier diversification efforts have made it costly, unproductive and perhaps impossible for Malaysia to unwind its diversification effort. As it is revenues from the exports of rubber, tin, palm oil and increasingly manufacturing were providing Malaysia with good balance of payment outcome. Needless to say, the multiple sources of industrial revenue gave Malaysia no urgent need to aggressively pursue and rely on oil and gas reserves.

In fact, the late entry of the oil and gas industry and the increasing returns and dividends from a diversified economy have given Malaysian policy makers greater impetus to continue to upgrade Malaysia’s industrialization strategy and avoid relying on oil and gas production. Such policy attitude (not to rely on oil and gas to dominate state’s revenue) allowed Malaysia the ability to map a sustainable oil management strategy from early on. In 1980, the state introduced the National Depletion Policy, the purpose of which was to manage oil production given experts’ view of limited oil reserves. Under the policy oil production, at the time, was limited to no more than 270,000 barrels per day.

To conclude it is little surprise that the path dependent nature of Malaysia’s economy saw the state continuing its economic diversification pathway in the years after independence. Malaysia’s developed and profitable non-oil based economic production has evidently made it less attractive, in fact costly, for the economy to reverse economic production. The increasing returns and dividends from a multi-sector economic base are an attraction on their own that made relying on oil production less urgent. Oil and gas revenue was a luxury that Malaysia could bank on but not a necessity. (see figure 2).

We turn now to an aspect of Malaysia’s political economy that further facilitates Malaysia’s economic diversification. Though the introduction of the New Economic Policy is seen by many as a step back to Malaysia’s economic growth, the introduction of the NEP, ironically, imposed further discipline to Malaysia’s economic diversification effort. We turn to this next.

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5 In fact, in the 1980s, official views held that Malaysian oil reserves could be exhausted in 13 years if the state maintained oil production at 200,000 barrels per day
The New Economic Policy

Any appraisal of Malaysia’s economy in the post-colonial period will not be complete without the mention of the New Economic Policy (NEP). The NEP was implemented in 1971 as a result of negotiations between Malaysia’s different ethnic communities, following the bloody racial riot on 13 May 1969. The state put the blame of the riot to the huge income disparity between the Malays (bumiputeras) and the non-Malays. Many also saw the riot as a consequence of the stark identification of race with economic function that fermented envy and animosities between ethnic groups.

The NEP\(^6\) is an economic document that serves not only economic but Malaysia’s political and social objectives. Implemented in 1970, the NEP had two objectives. The first was to restructure the economy and society and eliminate the identification of economic function with a particular ethnic group and the second, to eradicate poverty irrespective of race. The NEP set the target that come 1990, equity distribution among the *bumiputera*(Malays), *non-bumiputera*(non-Malays) and foreigners must be in the ratio of 30:40:30 respectively. This target is in sharp contrasts to the equity distribution in the 1970, one in which *bumiputera* (Malays), *non-bumiputera* (non-Malays) and foreigners held assets in the ratio of 1.9: 23.5:60.7 respectively.

Is the NEP distortionary in character? Why didn’t the affirmative action nature of the NEP compromise Malaysia’s liberal economic arrangement? How could it be possible that Malaysia continue to employ relatively liberal economic arrangement and diversify its economy in spite of the NEP?

It is indeed true that the NEP is an affirmative action policy bent on providing *bumiputera* with a sizeable stake in the economy through active state intervention. There is also no doubt that state intervention have led to a less than optimum allocation of economic and political resources. In fact, we are not short of Malaysian literatures that detail the distortionary capacity of the NEP (Gomez and Jomo 1997; Lee 2010). However it is also hard to disagree that in spite of the highly interventionist character of the NEP the Malaysian economy has continued to stay liberal and diversified. This is best judged by Malaysia’s economic performance post 1970. Malaysia, despite the NEP, has continued to attract investments, maintain an open trading regime and stay diversified.

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\(^6\) The NEP was replaced with another document the New Development Policy (NDP). But analysts tend to use the two terms interchangeably.
The best answer to the conundrum is that the NEP – despite its distortionary nature- also limits Malaysia’s economic option. To serve the NEP’s objectives it is in the state interest that Malaysia continues to employ liberal economic policies and to have a diversified economic production. The distributive nature of the NEP means that the NEP is only sustainable with an expanding economic cake. For the NEP to hold relevance the state must continuously maintain social and political peace and this can only come with a growing economy.

The argument means that the NEP further entrench Malaysia’s diversified economy. To be relevant, the NEP cannot be an outright robbing of the rich to give to the poor. Only with an expanding economic cake and a diversified economy can the state not invite intense rivalry between Malaysia’s different political constituents. One must also add that the path dependent nature of Malaysia’s economic production structure also made it easy for the Malaysian economy to stay on the diversified course.

The peculiar nature of the NEP in disciplining Malaysia’s economic diversification process is understood by Malaysian policy makers. The state understands that Malaysia’s growth rests on it being an open economy that does not place excessive restrictions on non- bumiputeras and foreign investors. Despite continuing to provide institutional support to bumiputeras, the state has maintained the fact the NEP must be built on fairness; a policy that is meant to alleviate poverty and improve the living standards of all Malaysians, not just the bumiputeras.

In fact, when the NEP was introduced in 1970, the state reassured the investing community that the NEP was an attempt at empowering local capacities not an outright nationalization strategy. This is of course evident because the NEP only targeted 30 percent bumiputeras ownership with the rest of the 70 percent of total assets being held by non- bumiputeras and foreigners. In fact, there were numerous occasions when the state amended terms of the NEP just to make room for economic expansion. On these occasions Malaysia has given greater priority to economic expansion at the expense of allocating priority to the bumiputeras; the state understands that only by expanding the economy can the NEP’s larger interest be served. This policy posture is evident in Malaysia’s handling of the economic crisis in the 1980s, 1990s and the year 2008. The crises tested Malaysia’s commitment between keeping to terms in the NEP or seeking creative ways to expand and diversify the economy. In all the crises, Malaysia has shown greater commitment to expanding the economy even if it means tweaking
conditions in the NEP. This is done so that an expanding economy can serve the NEP’s long term objectives.

We look now at three economic episodes to highlight two important things; first, the crises demonstrate Malaysia’s resolve in keeping to a liberal, hence expansive economy, encouraged of course by a thriving private sector and the increasing returns from a diversified economy and second the crises demonstrate that the Malaysian state is prepared to changes to the original terms of the NEP to allow for greater economic growth because the state understands that only with an expanding Malaysian economy can it justify the NEP’s relevance.

The 1980s

The recession in the 1980s tested Malaysia’s resolve at keeping to a liberal and diversified economy. It threatened, for the first time, the relevance of the NEP and Malaysia’s commitment to the NEP’s redistributive character. The Malaysian economy contracted by 1 percent in 1985 hurt by falling commodity prices of tin, petroleum and rubber (Doraisami 2012). In 1986, growth was a mere 1.2 percent with unemployment hitting a high of 8.1 percent. And in that year, Malaysia’s debt stood at 112 percent of its GDP.

The economic woes during this period saw the state revisiting existing economic policies including the NEP. The review of the NEP invoked strong political reactions which saw bitter fights between members of the dominant ruling Malay party UMNO. UMNO was split between two camps. The first camp advocated the ‘pro-growth’ strategy that called for less state intervention and a review of some aspects of the NEP. The second camp was ‘pro-distribution’ and called for preservation of Malaysia’s economic restructuring process. In the end, the ‘pro-growth’ team, under the then Prime Minister Mahathir Mohamed won the political contest.

Under the pro-growth strategy, Mahathir made changes to the NEP to restore economic growth. The Mahathir administration modified the highly unpopular Industrial Coordination Act (1975) – an act that required small Malaysian firms to provide for thirty percent bumiputera (Malay) ownership and foreign
firms to have no more than 30 percent equity. Under a new act, smaller firms were relieved from such quota imposition. Mahathir also introduced the Promotion of Investment Act in 1986 which gave further incentives to foreign investment by excluding foreign investors from NEP quotas. Foreign firms were also exempted from providing for 30 percent bumiputera equity ownership on condition that 50 percent of its output was exported or sold to companies in the newly established Free Trade Zone (FTZs)(Leete 2007).

The changes made by the Mahathir regime brought desired results. Relaxation of the NEP rules saw Malaysia attracting many manufacturing companies which continued to be the main driver of the economy contributing substantially to employment, export and overall industrial output. Exemptions from the NEP rules drew industries in electrical and electronics, metals, chemical and petroleum(Leete 2007). By the end of the 1980s, Malaysia had established some 10 Free Trade Zones (FTZs) and most of the companies that operated from the FTZs were foreign-owned companies - mainly Japanese and American companies.

The 1980s saw further diversification in the Malaysian economy. This period saw Malaysia riding on the privatization wave that was sweeping most parts of the world. By early 1990s, thirteen state enterprises were privatized, involving companies from telecommunications, television, utilities to airlines. The privatization effort gave further boost to the stock market raising some 201 billion ringgit in market capitalization. So strong was the expansion of the private sector that credit to the private sector was 160 percent of GDP. By 1996, total market capitalization in KLSE was 16 times that in 1987 (Doraisami 2012).

The 1980s also saw Malaysia embarking on heavy and chemical industries. This was part of the state’s effort to broaden the economic base and to emulate the economic success of developmental states like Korea and Japan. Under its “look east policy”, Malaysia introduced heavy industries like auto making,

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7 Under the ICA of 1975, firms with over $100,000 in shareholders’ fund and more than 25 workers must obtain a licence where they have to reserve at least 30 percent equity for bumiputeras. Under the revised scheme, only firms with over $2.5 million shareholders’ fund and more than 75 workers would have to reserve 30 percent bumiputera equity.
steel manufacturing, cement, machinery and equipment and petrochemical industries. The state also set up the Heavy Industry Corporation of Malaysia (HICOM) which allowed the flow of foreign funds, specifically from Mitsubishi and Honda, to spearhead the new industrialization drive.

Even though Malaysia’s decision to move into heavy industries generated heavy criticisms, one cannot also take away the fact that the development of this sector - unproductive as it may be - has added depth and width to the Malaysian economy. Indeed, in time to come embarking on high industries would hold Malaysia in good stead as such industries involved the acquisition of high technology, injection of huge capital investment and the development of skilled labour - factors that would give Malaysia comparative advantage especially in heavy industries. (Lall 1995)

The tweaking of the NEP and the introduction of new economic structure in the 1980s bore intended results. After recording sluggish growth of just 1.2 percent in 1986, the coming years saw Malaysia posting impressive growth. Between the years 1988 – 1990 the economy grew at the impressive rates of 8.9, 8.8 and 9.8 percent respectively. Malaysia’s response to its economic condition in the 1980s was not an exception. The 1990s would also see the state tweaking further the economic structure just so to grow and diversify the economy as well as keep the legitimacy of the NEP.8

The 1990s and Malaysia’s response

The Asian financial crisis which began in late 1997 threatened to undo Malaysia’s promising growth posted in the early 1990s. The early 1990s saw the Malaysian economy revving at an impressive average annual growth rate of 8 percent. Between the years 1990-1995, Malaysia’s manufacturing exports grew at an annual rate of 20 percent. Unemployment was also at its lowest. In 1995 Malaysia’s unemployment rate stood at 3.1 percent, the lowest since independence.9 (Leete 2007)

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8 By the year 1990, the NEP was replaced by the New Development Policy (NDP). Commentators however still refer the NDP as the NEP, mainly because the NDP still retains the essence of the NEP.
The Asian crisis again tested Malaysia’s commitment to maintaining a liberal economy. The crisis also threatened the relevance of the NEP (now called the New Development Policy, NDP) as it prompted reactions that Malaysia’s economic malaise was the result of years of political patronage, cronyism and corruption brought on by the highly interventionist NEP. The Malaysian economy began to fall apart in the summer of 1997. In 1998, Malaysia’s real GDP fell by 7.5 percent. By the middle of 1998, its stock market lost more than 50 percent of its value with the Malaysian ringgit falling to its lowest points against major currencies. By the middle of 1998, the ringgit depreciated some 40 percent to the US dollar. (Leete 2007)

Malaysia’s initial reaction was to increase interest rate and limit access to credit. The increase in rates was to improve credit ratings and to stem further weakening of the ringgit, curb inflation and prevent outflow of capital outflow. Malaysia’s move however was short of the IMF’s full prescription. It did so, because Mahathir Mohamad, then prime minister, feared that a full IMF solution would seriously threaten not only the economy but would also tear at Malaysia’s social and political fabric and put the state’s defence of the NEP increasingly tenuous. (Mahathir 2000).

Instead of taking the IMF’s prescription pill, Malaysia took its own initiative. In the summer of 1998, it introduced the highly unpopular capital control which made the trading of the ringgit offshore to be illegal. In a bid to stabilize the domestic economy and make the quickest of recovery, Malaysia set up two state asset and credit managing companies - Danaharta and Danamodal. Both companies were tasked to do a corporate rescue of local firms and financial houses, both bumiputeras or non-bumiputera owned, to provide liquidity and stabilize domestic companies’ credit positions.

Despite criticism from the international community, Malaysia’s unorthodox approach worked. In the three years after the crisis, the electronic sectors, petroleum and palm oil sectors recovered. (Lau 2005). Diversification grew apace. By the year 2000 Malaysia’s GDP grew by 9 percent spearheaded by an increase in manufacturing output specifically in electronics. After 1998, Malaysia began to

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10 Leete (2007) p.120
11 See Lau(2005) p. 152
accumulate huge surplus with its external current account making up 13 percent of GNP. Though Malaysia’s handling of the crisis had its fair share of critics, Kaplan and Rodrik (2001) however argue that “Malaysia would have fared even better if they had imposed capital controls sooner.”

We turn now to another episode, the 2008 global financial crisis that entrenched further Malaysia’s diversification strategy.

**The 2008 Global Crisis**

Malaysia’s response to the global financial crisis of 2008 demonstrates yet again its commitment to keep to an open, diversified economy. In the face of yet another crisis, Malaysia continued to be persuaded by the overriding need to keep the growth momentum, knowing well that only with continued expansion of the economy could it justify the relevance of the NEP. The crisis further shows that Malaysia is prepared to make further changes to the NEP so long as the overall objectives of the NEP remain intact.

The global crisis threatened Malaysia’s growth momentum. In 2009, the economy contracted 1.7 percent, a far cry from the average annual growth rate of more than 5 percent in the five years prior to the crisis. The year 2009 also posed added challenge to the ruling Barisan Nasional (BN), whose rule of more than 50 years came under serious threat from Malaysia’s opposition law makers after the opposition pact denied the incumbent BN party of the two-thirds majority in the 2008 election.

The gloomy economic outlook a plus a fragile political scene, saw the government taking every effort to maintain Malaysia’s growth trajectory. In response to the crisis, Malaysia announced two fiscal stimulus packages in 2009. The stimulus budget gave greater attention to construction and infrastructural projects to jump start the economy. Malaysia also introduced several measures to attract foreign investment that saw it tweaking further at existing NEP guidelines. The government for instance announced that foreigners are allowed to buy commercial properties above RM500 000 without approval from the state’s Foreign Investment Committee (FIC). It also further liberalized the services

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12 Kaplan and Rodrik (2001) p. 31
sector, this time allowing 70 percent foreign ownership by 2015. To further stimulate the services sector the government also agreed to remove the 30 percent *bumiputera* equity requirements for 27 services sectors. In addition, the state also set aside some RM 2 billion for private financial initiatives to be made available to private companies in their bid for capacity building projects especially in new growth sectors like biotechnology, healthcare and education.

The economy, thus far, seems to be responding well to the stimulus packages. In 2010, the economy grew at a rate of 7.2 percent before slowing down a little in 2011 when it posted growth of 4 percent. For the full year 2012, the economy grew more than 5 percent. But more importantly, the economy has become more varied spearheaded not only by traditional sector like manufacturing and construction but increasingly by the services sector, specifically finance and insurance. In 2011, for instance, services made up more than half of total GDP with finance and insurance contributing 17 percent.  

**Conclusion**

The above arguments show that the path dependent nature of Malaysia’s economic arrangement made it easy for Malaysia to continue its diversification strategy. In arguing along the historical institutional argument, this paper demonstrates that that the late entry of commercial oil production and the prior existence of a thriving private sector made it easy for Malaysia to diversify its economy. In fact, rewinding a thriving private sector was a non-option.

The path dependent nature of Malaysia’s political arrangement also demands that Malaysia adheres to a consociational arrangement that inadvertently limits Malaysia’s economic policy option so much so that it gives the state little choice but to continue to adopt a diversification strategy. Along similar argument, the NEP (a product of consociationalism) - far from limiting Malaysia’s diversification strategy - only serves to promote it further. The constant need to make the NEP relevant and to conform to Malaysia's consociational arrangement forces the state to ensure that the economy stays expansive and diversified, even if this means tweaking at some of the terms of the NEP. Though a neo-liberal would argue that the NEP is an unnecessary evil given that it fosters distortion, inefficient use of market resources and suboptimal allocation of resources(Gomez and Jomo 1997), it also arguable that the NEP is a necessary

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13 In Malaysia Economic Report 2012/2013, Department of Statistics and Ministry of Finance, Malaysia.
evil because it gives Malaysia no other choice other than to maintain a diversified economy. As Drabble points out, without the NEP and its target of eradicating poverty and tackling income inequality “it is unlikely that Malaysia’s development experience would have been anywhere near as successful as we have seen.” ¹⁴

<table>
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<th>Industry</th>
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Source: Drabble (2000) in p. 188. Selected Years, Ministry of Finance (1990)

¹⁴ See Drabble (2000) p. 290
References


2 Ibid. 596
13 Ibid. 34