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Politics and Economic Reform in Malaysia

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Abstract:
Malaysia's admirable economic growth is often attributed to liberal, open economic policies. Aggregate measures of openness, however, often veil the way coalitional politics drove illiberal government intervention in the economy to correct ethnically based economic inequality, create national heavy industries, and favor politically well-connected entrepreneurs. A more nuanced analysis reveals a complex mix of liberal and illiberal economic policies designed to balance competing coalitional interests. These policies created a "dual economy" that successfully replaced growing political and social instability with rapid economic growth sufficient to support redistributive politics. Yet this same dual economy also slowed further reform and retarded technological development, leaving Malaysia mired in mediocrity: neither price competitive with China nor technologically competitive with Singapore, the East Asian NICs, or the OECD countries.

Introduction[1]

Among all of the developing countries in the world, Malaysia is often held up as one of the few countries whose economic policies might be worth emulating.[2] As the story goes, economic policy decisions on the part of Malaysia's ruling elite spurred foreign direct investment, drove technological deepening, sidestepped resource abundance traps, and facilitated specialization, comparative advantage, and overall growth.[3] These policy decisions have in the aggregate maintained an open, liberal economy in which existing economic assets have been successfully *restructured and reallocated* into new combinations of labor, capital, and technology in ways that at least did not derail and most likely facilitated FDI-led growth.[4]

But the aggregate measures of growth and openness associated with this story veil the way coalitional politics drove illiberal government intervention in the economy to correct ethnically based economic inequality, create national heavy industries, and favor politically well-connected entrepreneurs. Equally important, they conflate outcomes of economic growth, or raw wealth creation, with economic upgrading, the process of moving to ever-higher levels of innovation and value-added in the production process.[5] A more nuanced analysis reveals that a complex mix of liberal and illiberal economic policies led to both beneficial and not so beneficial economic outcomes. On the positive side, growing political and social instability and volatility were replaced with a solid foundation upon which the economy could grow. Equally important, these

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[1] I would like to thank Allen Hicken, Linda Lim, Gayl Ness, and the participant of the Economic Reform Seminar at the William Davidson Institute, University of Michigan for comments on an earlier draft. Errors that remain are mine.

[2] See for example Smogyi 1991.

[3] Cf. Felker 2003; Hobday 2000; and Sachs and Warner 1995a.

[4] Lall 1999; Sachs and Warner 1995b.

[5] Several recent studies point to the importance of transitioning from structural change to industrial upgrading and increased value-added to local products in order to sustain economic development. These include Doner, Ritchie, and Slater 2003, Kim and Nelson 2000, Waldner 1999, Romer 1986:1002-37; 1994: 3-22, Grossman and Helpman 1991.

policies created an economic system in which growth was the key engine of redistributive politics.

On the negative side, policies and their legacies have slowed further reform and retarded technological development, leaving Malaysia mired in mediocrity: neither price competitive with China nor technologically competitive with Singapore, the East Asian NICs, or the OECD countries. Malaysia's dual economy, in which efficient, multinational corporations manufacture for export in tariff-free export processing zones along side protected, less competitive and government-subsidized local firms producing for the domestic market, led to an impressive physical infrastructure, capable macro-economic management, and a broad foreign-led manufacturing industrialization. But it has done little to *create new* stocks of knowledge and skills among the labor force; bases of research, development, and design within local corporations; or connective linkages between government, business, labor, and academia critical for the information exchange, monitoring, enforcement, and evaluation tasks needed for upgrading. Thus, although Malaysia has progressed far beyond many other developing nations, it has yet to overcome the "micro-level rigidities" that keep it from achieving the same developmental level of the East Asian NICs.[6]

Nor has simply returning to a path of economic reform after 1990 resolved the upgrading challenge.[7] Although growth has continued, albeit in spurts and stops since the Asian Financial Crisis, the formal and informal institutional remnants of earlier policy decisions continue to deter technological upgrading. Incentives attached to earlier redistributive policies encouraged firms to remain small, making the "Kaldorian" technological progress associated with economies of scale difficult (as opposed to Korea); limited the ability of the government to acquire technology on

[6] See World Bank 2003 (Malaysia brief); Waldner 1999 and Kaldor 1972.
[7] Over time, economic reform has become synonymous with liberalization. On this point see Landa and Kapstein 2001 and Sachs and Warner 1995.

behalf of smaller firms (as opposed to Taiwan); reduced incentives for productive linkages between local firms and the government (as opposed to Japan); created competitive and isolated bureaucratic agencies (as opposed to Singapore); and restricted the linkages between upstream and downstream producers (which were fostered by Japan and all the NICs).

In the end, then, Malaysia does appear to be a critical case, but not as the shining star of openness, growth, and development, but rather as a country trying to reconcile path dependent institutional legacies with the changing demands of technological upgrading in an increasingly global world economy. As economic tasks change, previously neutral or beneficial configurations of institutions can become problematic, leading countries to "grow into trouble." Whether Malaysia can resolve these institutional legacies and continue on the path of economic reform *and* upgrade technologically depends critically on the political incentives of its changing coalitional politics, which, with Mahathir stepping down after more than 30 years in power, are in as much flux as at any time since independence.

My analysis, then, focuses on how ruling elites introduced economic policies to maximize coalitional support for their own political interests. Since coalitional politics is not the only variable that matters, my arguments are necessarily probabilistic,[8] but not in any minor sense: coalitional politics have been and continue to be a primary driver of the Malaysian political economy. Importantly, I define coalitional politics not just within the narrow interplay of communal preferences, but extending to all actors who receive benefits in return for political support.[9]

In the rest of this essay I first explore briefly the origins of coalitional politics in Malaysia. Subsequent sections then explicate how coalitional politics impacted economic policy change

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[8] See Mohoney 2000.
[9] See Doner, Ritchie, and Slater 2003.

and reform during the implementation of the New Economic Policy (NEP) from 1970-71 until roughly 1986; the decline of the NEP in the late 1980s and implementation of the New Development Policy (NDP), which spawned a period of liberalization and privatization lasting roughly until 1996; and the Asian financial crisis period from 1997 to the present. As part of the discussion in each section I evaluate patterns of economic reform and intervention and how institutions created in response to economic policy shaped economic outcomes, especially technological development, in current and later periods.

Coalitional Politics in Malaysia

Largely in response to economic incentives, large numbers of Indians and Chinese immigrated to Malaya between the end of the 19th and beginning of the 20th century, resulting in a multi-communal, but highly segregated society. It was within this ethnic patchwork that the Malaysian state began to consolidate and take shape amid a complex blend of conflict and cooperation. With the conclusion of the Second World War, Britain began the process of independence for many of its commonwealth colonies.[10] In Malaysia, bargaining over the form and implementation of an independent government reflected the inchoate ethnic communalism and disjointed polity spawned by the colonial political economy.[11] Working together through the United Malay National Organization (UMNO), Malays successfully negotiated a "special position" in the political system. Nevertheless, the British did not drop their criterion for independence that all ethnic groups in Malaysia participate in and be represented by the political system. As a result, in 1952 UMNO incorporated the Malaysian Chinese Association (MCA) and

[10] Much of the information on independence, if not cited otherwise, comes form Jomo (1986).
[11] Jomo 1986, notes that "The particular circumstances of colonialism in Malaya, as in many other places, set the stage for the emergence of a post-colonial governing group, economically, socially, culturally, and otherwise poorly integrated with the local bourgeoisie" (p.247).

the Malaysian Indian Congress (MIC) into a multi-party coalition called "The Alliance".[12] Both the MCA and MIC primarily represented (at least eventually) the narrow interests of business elites who were willing to trade economic favors for special Malay privileges.[13] The bulk of the Chinese-educated and the working-class gravitated to the left-leaning Labor Party of Malaya or affiliated with the communist insurgency, which did not end until 1962. The result was Chinese working-class electoral constituencies, which arguably further exacerbated ethnic fragmentation.[14]

The truth was that the seemingly broad-based coalition upon which the constitution rested was in fact a good bit narrower than it seemed. Labor was not included because of its radical and national elements.[15] Interestingly, neither were mainstream Chinese business owners; the elite Chinese economic class did have a seat at the table, but their interests were closely bound up with the elite Malay political class. The average Chinese businessman found himself on the political fringe despite owning the bulk of the country's economic assets.[16] Thus, despite its early mass-based beginnings, UMNO developed a scalene connection between labor and business that has often made it difficult to balance the preferences of its Malay base with those of its elite, non-Malay coalition partners. Although later coalitional shifts de-emphasized communal priorities in favor of particularistic relationships among economic elites of all races, these early cleavages along race lines led to social confrontation that gave birth to Malaysia's first major illiberal economic intervention.

[12] See Bedlington, 1978; Parmer, 1966.
[13] Article 153 of the constitution gave special privileges to the Malays for education, positions in public service, and the issuance of business permits and licenses. Agreement was also reached on dividing bureaucratic territories and ministries and on allowing ethnic education (Parmer 1966).
[14] Personal communication with Linda Lim, March 14, 2003.
[15] Government occasionally tried to act as a neutral arbiter, although the state's favor of capital over labor was reflected in various amendments to the labor laws or the government's role in industrial relations.
[16] Jomo (1986:243) notes that from its creation in 1940 the MCA "has tended to reflect the interests of big Chinese businessmen; hence limiting its following among other classes in the Chinese community from the outset."

Coalitional Imperatives and Eroding Liberalism: 1970-1986

Immediately after independence, Malaysia began aggressively pursuing an import substitution industrialization strategy to supplement its already-vibrant commodity export industries.[17] In 1957 the government enacted the Pioneer Industrial Ordinance,[18] which provided investment incentives for labor-intensive manufacturing for the domestic market. At the same time the government imposed import tariffs to protect these nascent industries.[19] The combination resulted in brisk, although uneven, economic growth throughout the post-independence decade Narayanan 1996, 869-881. Significant strides were also made in technological upgrading within several primary commodity industries, notably rubber and palm oil.[20]

Some time after the 1964 elections but before the 1969 elections, ethnic dissatisfaction with the growing asymmetrical distribution of economic assets began to emerge.[21] Although some progress towards equality was being made in certain sectors,[22] a little more than a decade of independence had resulted in Malays owning only 1.5% of all equity in companies in Peninsular Malaysia. In comparison, Chinese owned 22.8% and Indians 0.9%. Foreign interests accounted for 62.1% and other interests the remaining 10.1%.[23] The issue quickly became a political one as opposition parties charged "that the UMNO leadership was working hand-in-

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[17] See Ness 1967.
[18] There seems to be some debate as to the date of this ordinance. Felker and Jomo 2003, identify it as the PIO of 1958 while Parmer (1966) identifies it as occurring in 1957.
[19] See Lim, 1992. Because government did not discriminate against majority-owned foreign ventures, foreign firms gleaned the lion's share of the benefits (Felker and Jomo 2003).
[20] Malaysia continues to lead in rubber research, both with synthetics and natural latex. Recently a Malaysian inventor patented a process to transform old tires into the equivalent of virgin latex. See Drabble 1973, 2000 for an in depth analysis of the Malaysian rubber industry.
[21] I owe this point to Gayl Ness.
[22] Malay ownership of tin dredging companies expanded faster than any other ethnic group and that Malay investors had "some, though not many, interests in the pioneer industries of the 1960s" (Jomo 1986: 254).
[23] Jomo 1986: 254.

globe with wealthy Chinese to exploit [peasant Malays]."[24] In 1969 ethnic unrest seethed into bloody riots.

Coalitional Politics and The New Economic Policy

In response to this social upheaval, the government launched the New Economic Policy (NEP) in 1971.[25] The NEP attempted to radically restructure society through economic policy in two ways. Its first objective was to eliminate poverty regardless of race. The second was to eliminate the identification of race with economic and social class. It was the latter, however, that received the most emphasis on implementation.[26]

Decoupling race and economic function demanded that 1) the number of Malays in the ranks of both capital and urban wage-labor rise,[27] and that 2) the incomes of the remaining mass of rural Malay peasants increase.

The government took several general steps to accomplish these tasks. To encourage the growth of an educated urban proletariat, the government made Malay the official language of education, expanded education facilities and programs to the Malay population, and invested heavily in vocational and technical education and training, especially through MARA, the government Malay promotion ministry.[28] It artificially created demand for Malay workers through ethnic employment quotas, which effectively reduced the unemployment rate for Malays below that of the economy as a whole and encouraged the rise of Malay supervisors and

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[24] Parmer 1966: 115.

[25] That the NEP was implemented in response to internal crisis and not external factors is clear from the condition of the macro economic indicators in the country. As David Lim (1992) notes, "These changes took place in an economy where monetary policies kept the rate of inflation well below that in most other countries, where fiscal policies resulted in a sound balance between government spending and income, and where the balance of payments remained healthy" (p. 110). Each of these indicators deteriorated substantially after the NEP.

[26] Jomo 1986:152.

[27] I am indebted to Linda Lim for her insights on the subtle balancing act required to meet both capital and labor requirements. Personal communication, March 2003.

[28] See Ritchie 2001.

managers.[29]

The government also restructured industry ownership in two ways. First, it established large public enterprises protected from outside competition through tariffs. Initially most of these enterprises were fiducial investment trusts representing "Malay (especially rural) interests."[30] Second, in 1975, it passed the Industrial Coordination Act (ICA), which required companies larger than 250,000 RM in paid up capital to register with the government for industrial licenses, distribute 30% of their assets to Bumiputera (Malay) interests, and assume a similar proportion of Bumiputera managers.[31] "Expecting that existing indigenous Chinese businesses would initially be reluctant to cooperate with the state in creating business opportunities and a stake in equity-ownership for the Malays, the government fostered an alliance with foreign capital."[32] This did not mean, however, that MNCs were immune to the NEP's redistributive reach. Although NEP capital redistribution requirements did not apply to foreign MNCs, labor quotas did, since foreign firms were most likely to employ Malay workers outside of the plantations. Moreover, efforts were made to dispossess and weaken foreign capital (through legal means) in labor-poor primary commodity and service sectors while simultaneously seeking to enhance foreign investment in labor-intensive, export-manufacturing industries.

While fostering the growth of foreign capital, these policies slowed the technological development of smaller, usually Chinese-owned firms. The state support that proved so critical to help small local manufacturing capital attract and acquire new technologies in the NICs was largely absent in Malaysia.[33] ICA requirements encouraged local entrepreneurs to diversify their

[29] Jomo 1986.
[30] Jomo (1986) notes that this trusteeship form of ownership resulted in projections that by 1990 Malay interests would account for ¾s of the 30% while Malay individuals would own the remaining ¼.
[31] Felker and Jomo, 2003.
[32] Narayanan, 1996:870.
[33] ibid:880. See Kim 1997 for a discussion of state support of local technology acquisition and assimilation in Taiwan, Korea, and Japan.

holdings, always flying just below the government's redistributive radar. But smaller firms were less likely to see technological progress as a result of economies of scale.[34] Smaller firms were less likely to pursue opportunities in more technologically demanding industries, preferring trading to manufacturing. To be sure, local entrepreneurs often evaded ICA requirements altogether through ingenious "Ali Baba" arrangements in which Malay sleeping partners provided access to trade protection, preferential terms of trade, government projects, and rapidly growing new sectors of the economy.[35] But avoiding onerous economic policies has deadweight costs and is not the same as benefiting from far-sighted policies characterized by reciprocity.[36] To illustrate, the resulting dualism in the Malaysian economy fostered high levels of rent seeking, little pressure on firms to seek out exports, an industrialization limited to final producer goods, and the majority of import substitution industries being foreign-owned.[37] Furthermore, institutionalized patterns of corporate evasion made future reform efforts difficult, regardless of their potential short-term benefit.

Finally, the government implemented fertilizer and guaranteed price supports for rural farmers, which propped up incomes without taxing business.[38] Nevertheless, the government took steps to bias the trade regime against primary commodity products in order to promote manufactured exports.[39] The Federal Land Development Agency (FELDA) also implemented land reform. But despite the agency's relative technocratic efficiency, land reform stopped far short of the redistributive kind found in Korea or Taiwan. Intra-coalitional preference for large shareholders and plantation owners over small farmers as well as a reluctance to scare foreign

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[34] On this point see Kaldor 1972.
[35] I am indebted to Linda Lim for this point.
[36] See Amsden 1989 and Schneider and Maxfield 1997.
[37] Jomo and Edwards 1999.
[38] Jomo 1986.
[39] Lim 1992.

capital with aggressive appropriation of property rights certainly helped shape FELDA's policy preference for opening new plantation lands optimal for oil palm cultivation and production.[40]

To remain palatable, these pro-Malay affirmative action policies had to be accompanied by brisk economic growth. Since it was politically difficult to rely on the largely Chinese domestic capital class to generate economic growth, the government turned to foreign capital.[41] Thus, NEP policies had to balance targeted protection for domestic industries with liberalizing foreign investment, especially in export manufacturing. A key mechanism for doing so was the creation in the early 1970s of 10 free trade zones (FTZs), which improved Malaysia's desirability as a host for low-cost assembly and re-export of electronics and other products. FTZs also provided advantages of tax free operation, elimination of import and export duties, and exemptions from many NEP and ICA requirements.[42]

This combination of liberal and illiberal policies led to tremendous economic growth throughout the 1970s, driven by foreign investment and development in primary commodities and labor-intensive assembly manufacturing. Growth, however, led to little indigenous heavy industry or higher technology manufacturing. Moreover, prioritizing growth and investment through foreign MNCs and government-owned investment trusts kept the Malay entrepreneurial class small.

To both deepen the industrial structure and extend the economic role of Malays into high-value industries, a dynamic young minister of trade and industry, Dr. Mahathir Mohammad, formed HICOM, a series of heavy and chemical firms in sectors such as steel, cement, automobiles, chemicals, and paper and pulp. A combination of Mahathir's extreme pro-Malay

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[40] See Barlow 1978 for more details on FELDA's impact on rubber and palm oil plantations. Also important were Malaysia's federal structure, which limits the federal government's control over state-owned land; Islamic inheritance rules; and the availability of vast, unsettled forest lands.
[41] See Jesudeson 1989.
[42] Rasiah, 1993.

position and his nationalist “Look East” policy propelled an interventionist economic strategy that increasingly ignored market forces. The effort was not cheap, and was supported with a combination of government subsidies and increasing tariff protection, underwritten by rising income from petroleum sales and expanding exports from foreign multinationals.[43] HICOM was designed to drive growth by facilitating forward and backward industrial linkages and expanding the capital goods sector.[44] From a political perspective it furthered economic nationalism by expanding the base of ethnic Malay entrepreneurs into investment intensive industries. But unlike many mecantalist strategies, HICOM was also a pragmatic partnership with foreign—usually Japanese or Korean—firms.

HICOM’s success was clearly important to Mahathir’s political career as well as the economic prospects of Malaysia. Mahathir had the project transferred to the Prime Minister’s office soon after taking power in 1981. But despite this personal oversight, the program suffered several costly failures and the jury is still out on several of the ventures that remain.[45] On the positive side, the program has forced bureaucrats and businessmen alike to become more technologically savvy to rigorously screen and negotiate over technological content with their foreign partners.[46]

The interplay of international economic crises of the late 1970s and early 1980s, stagnating foreign capital flows, growing reliance on foreign MNCs, and HiCom’s growing financial problems created pressures for multi-dimensional reform in trade, investment, and finance. To encourage new forms of investment capital, the government radically liberalized and deregulated trade for the export sector, reducing local ownership and content requirements and providing

[43] Crouch 1996:220.
[44] Ibid.
[45] Felker and Jomo 2003.
[46] ibid: 97-98.

calculated initiatives to woo increased foreign investment, especially in manufacturing. The government began a systematic privatization of state-owned enterprises (or at least portions of them) and reduced capital controls and redirected government spending.[47] All of these changes implicitly or explicitly relaxed application of NEP policies, especially for foreign investors.

Yet it would be a mistake to argue that all or even the majority were pro-market reforms. Privatization, for example, was a straightforward transfer of state-controlled assets previously acquired "in trust" for the Bumiputra population into the hands of a few government-chosen entrepreneurs. In addition, investment reform did not extend to local firms to the same extent as MNCs. Despite efforts of many local businesses to lobby the government to repeal NEP policies, the government "made no effort…to motivate the private sector, partly in fear…of appearing to reverse the NEP momentum."[48]

Financial sector reform was also less aggressive. NEP fiscal policy was designed primarily to soften economic downturns with counter-cyclical spending and to guard Malay economic assets in state-owned enterprises.[49] Although the strategy worked well throughout the 1970s, the severity of the debt-induced fiscal crisis and accompanying recession of the early 1980s provided incentives for reform. Yet when the government announced it would reduce spending by 30%, coalitional pressure made it difficult to back track on previous and now politically entrenched counter cyclical patterns. Dramatic reductions would constrain the massive directed bank lending to cronies and state-owned enterprises. As a result, reductions were limited reductions to 10%,

[47] See Felker & Jomo, 2003; Leigh, 1992; Narayanan, 1996; Rasiah, 1996.
[48] Narayanan, 1996: 872.
[49] From 109 enterprises and 33% of the total development budget in 1971, the number of SOEs rose to 656 and 47% in 1980 and to 1,014 and 56% by 1985. Much of this growth was sustained through foreign borrowing, which reached 42% of GNP in 1986. But 1986 marks the high water mark for both number of firms and fraction of development budget. Foreign debt also began to diminish in favor of FDI for the remainder of the decade and into the next (see Narayanan 1996). Efforts to privatize existing SOEs began in small amounts in 1983, and began to reach critical mass after Daim Zanuddin assumed the role of Finance Minister in 1987.

putting further pressure on levels of national debt as a percent of GDP.[50]

In sum, the NEP's odd combination of redistributive, liberal, and nationalist economic policies intensified Malaysia's dualistic economy[51] but also balanced the interests of rural Malays, foreign capital, and large Chinese capital through rapid overall growth. Local Chinese capital, while marginalized, learned to prosper "under the radar."

Unlike local capital, labor was less able to flourish through neglect. Although real wages grew significantly in the 1970s and pockets of labor shortages began to appear in some industries, labor was not afforded a seat at the coalitional table. Nor were any of the NEP policies designed to enhance labor's position. Instead, repressive labor policies were the norm.[52]

Reform, FDI, and Structural Change (1986-1996)

The deepening financial and capital crisis of the early 1980s further bifurcated the Malaysian economy. A combination of dwindling foreign loans and the sudden expansion of available investment capital due to the Plaza Accord yen revaluation pressured the government to intensify earlier reform to encourage FDI. Virtually overnight the government relaxed all restrictions on capital flows and ownership that might impede the inflow of FDI, resulting in a tremendous upsurge of incoming FDI into Malaysia (see Table 3). Yet although growing FDI shifted coalitional priorities and generated dramatic social and economic transformation, entrenched institutional legacies and coalitional preferences impeded more comprehensive economic reform.

Encourage FDI was initially designed to generate employment to relieve recessional pressures spawned by global financial downturns. But as FDI grew rapidly, priorities changed. In

[50] ibid: 881.
[51] For more on dualism in the Malaysian economy see Felker 2001a and 2001b, Edwards 1990, and Rasiah1995.
[52] See Jomo, 1989 and Jomo & Todd, 1994.

1992 Mahathir unveiled "vision 2020," a plan to transition Malaysia into a developed economy by the year 2020. In addition to growth, innovation and technological development were now needed to create the capacity for sustainable, long-term upgrading. The challenge, however, is that compared to structural change, upgrading places much heavier demands on coalitions, especially on participation. Thus, *how* coalitional actors participated in economic reform began to be as important as who participated. The problem was that while existing institutions effectively created broad, passive coalitional support, they had little capacity to facilitate intensive and active participation from these same and other groups when it became needed to accomplish more complex tasks associated with upgrading.

FDI and changing coalitional priorities

In an endogenous cycle, burgeoning FDI shaped the coalitional structure in a number of ways. First, as might be expected, international business began to play a stronger and more influential role. "It was pressure from foreign rather than domestic business that was instrumental in drastically limiting application of the ICA."[53] Second, growing FDI reduced government's need to rely on commodity exports as a means to generate foreign exchange or fund counter cyclical (or just plain patronage) spending to secure support from the rural sector.

Third, by the end of the decade, rapidly growing FDI and a return to aggregate economic growth relieved earlier pressure on the government to resolve escalating labor unrest. Rather than resolve tensions, the government jailed labor leaders involved in strike actions, limited union rights, and promoted in-house unions subordinate to management (often foreign).[54] In 1987 the finance minister called for "voluntary" wage freezes for three years. However, there was no concomitant promise to freeze prices, nor was there any effort to explain why a wage freeze was

[53] Leigh, 1992: 117.
[54] Jomo, 1989 and 1993b.

necessary. If the "voluntary" freeze did not happen, he promised the government would implement it by force. Falling wages as a result of the post-1985 depreciation of the ringgit and the ramping up of internationally competitive export-manufacturing industries kept government from acting on their promise.[55]

Finally, growing reliance on FDI made it possible to further marginalize Chinese capital, especially in manufacturing. Repressing Chinese business interests, or at least doing nothing to promote them, while building Malay assets through privatization and fiducial trusts, even if only narrowly, reflected coalitional priorities. Ironically, however, the very success of the export sector allowed government to relax its stance toward local capital over time, extending most of the trade and investment benefits earmarked for MNCs to all firms by the late 1980s and early 1990s. Even so, support to local firms has "tended to favor larger business interests rather than small companies."[56] For example, although government systematically privatized many SOEs, the motivation for doing so was not to benefit rank and file Malays, but to promote a few well-connected elite Malays.[57]

FDI, policy change, and economic transformation

By the mid 1980s, the Malaysian government had become fully committed to a strategy of development based on MNC-led export-oriented manufacturing.[58] The change itself was less remarkable than its extent. Virtually every country in Southeast Asia underwent significant transformation during this period from commodity (primarily agricultural) production to embracing FDI and manufactured exports. But no country has been more successful in attracting FDI into higher technology manufactured exports, especially electronics, except perhaps

[55] Jomo, 1993b.
[56] Gomez & Jomo, 1997: 49.
[57] ibid: 26.
[58] On this point see Jomo and Felker, eds. 1999, Jomo, et. al. eds. 1999, Felker and Jomo 2003, Leigh 1992, and Lim 1992.

Singapore. Certainly among the ASEAN-4 "Malaysia was the most active…in reshaping its investment regime to capitalize on the regional boom in manufacturing FDI during the 80s and 90s.[59]

Many of the new policy initiatives built on earlier investment liberalization. In 1986 the government restructured the investment regime by all but eliminating the application of NEP or ICA requirements for any company exporting the bulk of its production as well as for domestic firms with less than RM 1 million shareholder capital. In the same year the Malaysian Industrial Development Authority (MIDA) was overhauled as a one-stop investment shop where new and potential investors could go to resolve all of their problems and concerns. A new industrial master plan was written with exports at its strategic center.[60] The tax code was liberalized and rewritten. But perhaps most important, in July 1985 the government significantly liberalized ownership restrictions, and not just for firms exporting all of their production, but also for those producing for the local market.[61]

Growth continued unabated, averaging over 6.4% between 1980 and 1992.[62] By 1991, however, growth had created labor shortages, full employment being reached in 1993.[63] Tight labor markets put upward pressure on wages disproportionate to the historical rise in productivity.[64] Recognizing the threat of pricing themselves out of the global market, the government replaced the NEP with the New Development Policy (NDP) in an effort to shift out

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[59] Felker and Jomo 2003: 96.
[60] Lim 1992.
[61] See Felker, 2003 and Narayanan, 1996. Foreign equity participation up to 100% was allowed in export-oriented projects. For domestic companies equity participation up to 51% was allowed. The fact that most other countries in the region waited much longer to liberalize ownership restrictions reflects both the difficulty of the change and Malaysia's government capacity. It is not until 1994 that Indonesia abolishes restrictions on foreign ownership see Pangestu 1997, xiii, 311. The Philippines and Thailand completely liberalized their investment regimes in 19?? and 1990 respectively Alburo and Gochoco-Bautista 1997, xiii, 311; Pasuk and Baker 2002.
[62] World Bank Development Indicators 1999.
[63] Lucas & Verry, 1999.
[64] Bank Negara reports that labor productivity rose 6.6% from 1982-1990, but –1.6% in 1990.

of labor-intensive to more capital- and technology-intensive manufacturing. Although the NDP retained many of the same components of the NEP, it made the application of the requirements more flexible and contingent on performance, particularly in export manufacturing. Put another way, the redistributive priorities of the NEP gave way to more developmental priorities under the NDP, which included efforts (albeit with differing emphasis) to simultaneously 1) increase the labor supply, 2) boost the level of skills in the local work force, 3) advance the level of technology in both foreign and domestic firms, and 4) increase the amount of local content in foreign-owned export manufacturing.

NDP reforms were difficult to implement for at least five reasons. First, economic reforms to create technological capacity take time to bear fruit.[65] Second, whereas actors targeted to receive the benefits can easily appropriate investment incentives and spending policies, the same is not true for skills creation and research and development (R&D). Newly trained employees easily leave for rival firms and the profits from new discoveries are often dissipated through the market before initial investments can be recovered, resulting in a series of potential collective dilemmas. Third, creating new resources with a comparative advantage in a technically complex global economy requires quantitative and qualitative improvements in acquiring, absorbing, and transferring information. Often the skills and knowledge needed for these tasks do not exist in the local economy. In an endogenous and paradoxical fashion, information is necessary to determine which skills and knowledge are needed; where best to obtain them; how best to teach, transfer, or create them; and how best to disseminate them throughout the local economy. These three considerations lead to a fourth challenge: the need for participation from more actors and the institutions to manage that participation. Finally, as the numbers of actors increase, so do

[65] Admittedly NEP reform was also long-term in its vision. However, many of the steps taken began to impact the economy almost immediately.

potential distributional pressures.

Lacking the ability to address these "developmental" challenges under "greenhouse" protection from the brumal global economy, Malaysia naturally adopted a "technoglobalist" strategy of leveraging technological assets of foreign MNCs to propel the technological development of its local firms.[66] Government addressed labor shortages and rising wages[67] by liberalizing labor laws. To encourage an increase in female labor, especially in the MNC-dominated electronics industry the government removed the paternalistic "night work" provisions making it easier for women to work the night shifts in the export factories of the MNCs. Yet other policies equally critical to facilitate the entrance of females into the work force, such as childcare provisions, were not addressed.[68] To increase foreign labor the government allowed red-card holders to work in any sector of the economy without applying for work permits.[69] Illegal immigrants were given amnesty so that their working status might be legalized. Yet these steps were in no way proportionate to demand.[70]

Upward pressure on wages encouraged firms to begin a gradual shift away from low-tech, labor-intensive industries.[71] Ironically, however, moving from labor-intensive to more capital- and knowledge-intensive industries was hindered by a shortage of skilled labor. Therefore, in 1993 the government created the Human Resource Development Corporation (HRDC) to facilitate firm-level training through the human resource development fund (HRDF).

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[66] See Samuels 1994, , Keller and Samuels 2003, , and Doner and Ritchie 2003, for more on the difference between the institutional demands of technonationalist and technoglobalist strategies and their differential implementation in Northeast and Southeast Asia.
[67] Between 1987 and 1991 wages in the electronics industry rose 12% for unskilled labor and 20% for skilled labor Goh 1999. Within the manufacturing sector as a whole wages rose 6 percent in 1991, 9.6 percent in 1992, and 15.1 percent in 1993 Ismail 1999.
[68] Personal communication, Linda Lim.
[69] By 1996 there were over 2 million foreign workers Rasiah 2001. In states in which agriculture is the dominant industry up to 70% of workers are foreign. Lucas and Verry (1999) report that in the construction industry 1 in 7 workers is from abroad (p36).
[70] See Lucas and Verry 1999.
[71] Wah & Narayanan, 1999.

Firms meeting NEP thresholds are levied 1% of their employee's salaries, which is deposited in firm-specific accounts available for government-approved training.[72] As with earlier investment policies, training reform has proven to be tremendously successful from a structural perspective. By 1997 committed training places had climbed to 533,227, with over RM144 million collected and RM99 million dispersed.[73] At least five line ministries have developed comprehensive vocational and industrial training, each with its own physical infrastructure, curricula, and teaching staff. In addition multiple departments, committees, and governmental units are involved in promoting, planning, and/or supervising the education and training effort in the country.

But creating a larger supply of skills addresses only half of the challenge. Growing the technological capacity of the country also requires that firms upgrade the technological content of their products and processes. To improve the quantity and quality of local firms capable of supplying MNCs, the took steps to improve the linkages between foreign and local firms. Up until the early 1990s, MIDA had used tax incentives to encourage both R&D and education and training. Since most large firms had complete tax immunity anyway, the utilization rate of incentives based on tax relief was low. Thus, the government changed the investment structure to allow 60% tax exemptions for pioneer firms for 3-6 years instead of 100% for the previous 10. Full exemptions for longer periods of time could now be reserved for those that met more stringent requirements for technology content and sharing.[74] By 1995 new investments also had to have more capital investment per employee, at least RM 55,000; R&D expenditures of 1% of

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[72] Edwards, 1999.

[73] See Doner & Ritchie, 2003; Malaysian Human Resource Development Fund, 1999.

[74] Felker and Jomo 2003, identify the following four criteria applied to new investment: "value added of 30-50 per cent, local content levels of 20 to 50 per cent, depth of technology (as measured by the proportion of managerial and technical staff), and linkage effects (largely a qualitative assessment of how the project complements Malaysia's industrial structure)" (p 100).

sales within three years of beginning operations; and 7% of employees with certificates or diplomas in technical fields.[75] Certain activities were promoted as "high technology," which would receive the full 10-year tax holiday, have greater access to foreign skilled labor, and full access to foreign exchange accounts in local banks (ibid, p.101).

Efforts were also made to improve developmental linkages between foreign and local firms. In 1993 MIDA launched its Vendor Development Program (VDP) in which more technologically advanced firms, usually foreign MNCs, were given incentives to mentor upgrading processes in local vendors, which they facilitated through guaranteed contracts, a free interchange of engineers and product specifications, loans with preferential terms from local banks, and ongoing technical assistance from public research institutes. From a small start of 7 MNCs in 1993 the program grew to 45 MNCs and 9 large Malaysian corporations, which had established mentoring relationships with 59 vendors. In 1995 the government launched the Small and Medium-Scale Industries Development Corporation (SMIDEC) to function as a point agency to coordinate all incentives and assistance for the technological development of local firms.[76]

In addition to linkages between foreign and local firms, government sought also to create and strengthen linkages between itself and industry. In 1993 the government created the Malaysian Business Council (MBC), the Malaysian Industry-Government Group for High Technology (MIGHT), and the Malaysian Technology Development Corporation (MTDC) to promote public-private cooperation for upgrading. Both the MBC and MIGHT brought most of the important business leaders and key government administrators and directors together in regular consultative meetings. The MTDC was initially constructed as a financial mechanism to spin public research into the private domain and provide zero and first-stage seed financing. In

[75] Felker & Jomo, 2003.
[76] ibid.

the same year Khazanah Holdings was formed to invest in new high-tech ventures.

In addition, public research institutes, such as the Malaysian Institute of Microelectronic Systems (MIMOS) and the Standards and Industrial Research Institute of Malaysia (SIRIM), were created to promote basic and early-stage research and development in budding technology sectors and to supply development assistance to local firms. SIRIM has succeeded remarkably well in promulgating ISO9000 series certifications within the country.[77] In addition to commercial pursuits in computers and telecommunications technology, MIMOS has partnered with several other firms and government organizations to develop a new wafer fabrication facility in the Kulim high technology park, which is adjacent to Penang.[78]

The most comprehensive and ambitious upgrading initiative, however, has been the Multi-media Development Corporation (MDC), tasked with creating and managing the Multi-media Super-corridor (MSC). Created in 1996, the MDC has developed an impressive physical infrastructure. At first glance the MSC appears to be an extensive high-tech industrial park, hewn out the plantations of palm oil trees south of the capital. But it is actually much more. The MDC is also a venture capital fund, runs the Multimedia University, the flagship educational institution in the corridor, and manages the investment incentives for foreign firms locating within the corridor. At last count the MDC had certified over 300 firms.

Yet this seeming progress is hollow. Few of the firms in the MSC do significant R&D. Poor planning and insufficient attention to human capital, especially technical skills, has hampered technological deepening in the corridor. Similar caveats apply to Malaysia's growth in general: colossal physical transformation has been attended by only small portions of upgrading,

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[77] It should be noted that ISO certification is not a technology certification but rather a process certification. Firms can be technologically abysmal, but if they are consistently abysmal they can receive ISO9000 certification.

[78] The government now has two high-tech parks, the first, Technology Park Malaysia, is located just outside of Kuala Lumpur. Kulim park, the second, is located in the north of the country. Both have testing facilities, laboratories, and training centers.

the vast bulk of which has been in process improvement.[79] Upgrading in formal R&D and product improvement, including management, has been much slower (see Table 2). Comparative evidence across sectors seems to bear out this observation, whether in semiconductors, automobiles, or telecommunications.[80] The problems hindering technological development include an inability to completely address appropriation dilemmas within firms; agencies that lack monitoring and enforcement capacity; disconnected information flows between foreign and local economic sectors; poor absorptive capacity; tariff protection that creates obstacles between exporters and importers, upstream and downstream industries, and MNCs and local vendors; and weak linkages and/or competition between the government and local firms.[81]

Table 1: Technology Indicators

	R&D (% of GDP)	High-tech exports as a percent of manufactured exports (1999)	Scientists Engineers and Technicians per million capita (1996-1998)	Tertiary Science and Engineering students (% of population)
Hong Kong	0.49 (1999)	21.08		
Korea	2.71 (1995)	32.20	2511	1.34
Taiwan	2.05 (1999)		2980	1.09
Japan	2.96 (1995)	26.69	5736	
Singapore	1.13 (1995)	60.90	2619	0.56
Thailand	0.1 (1997)	32.40	142	0.32
Indonesia	0.1 (1994)	10.38	206	0.13

79 Hobday, 1995; Hobday, 2000; Lall, 1999.
80 See Goh, 1999, Leutert & Sudhoff, 1999, and Lall, 2000.
81 Ali, 1993; Felker & Jomo, 2003; Ritchie, 2001a.

Malaysia	0.22 (1996)	58.95	125	0.15
Philippines	0.2 (1999)	58.69	179	

Source: www.taiwan; www.info.gov.hk.; Taiwanese Ministry of Economic Affairs Indicators, 2000; World Bank Development Indicators, 2002; MASTIC, 1998; Thai National Research Council, 1998; UNESCO yearly report, various years.

Similarly, despite remarkable gains in the size of the education and training effort, outcomes in terms of quality have been less spectacular. Earlier failures to invest in primary and secondary education and a misguided loyalty to Malay as the language of instruction hampered gains in mainstream education, especially in math, science, and English. Gains made in education and training have not been distributed evenly, but rather concentrated among a small group of elite Malays.[82] Malaysia's large education and training system is extremely fragmented and disconnected, reducing gains from scale economies that might otherwise have been generated.[83] Tertiary education, including vocational training, is poorly coordinated with labor market demand. At the end of the 1980s only 10% of tertiary students were studying science and engineering. A decade later the number had climbed to 28%, still 14 percentage points below where Singapore was 10 years earlier.[84] Almost a full quarter of tertiary students go abroad for advanced education and training, most of these non-Malays. Fewer opportunities at home to use skills and knowledge acquired abroad means that many of these students choose not to return. Finally, the very structure of the system does little to encourage firms to use their full allotment of training resources (see Table 2).

[82] Lucas & Verry, 1999.
[83] Ritchie, 2001b.
[84] Author interviews, Singapore, Malaysia 1998, 1999, 2000, 2001.

Table 2: HRDF Levies and Grants

Year	Collection (RM)	Payment (RM)
1993	55,524,081	-
1994	73,632,751	16,084,154
1995	100,985,156	56,006,776
1996	126,788,239	85,865,476
1997	144,548,973	99,234,027
1998	61,000,356	88,166,080
Total	562,479,556	345,356,513

Source HRDF 1998 Report

When compared to investment and education, little attention has been given to financial policy change, liberal or otherwise. In spite of an overheating economy in the early 1990s, Anwar seemed oblivious to any need for change in either the tax laws or fiscal policy in general.[85] Instead, he maintained the fiscal line developed by his predecessor, Daim Zanuddin, which was to spend extensively on infrastructural development. Financial oversight focused on maintaining exchange rate stability in the face of massive FDI inflows. Other than Bank Negara beginning to use interest rates as a monetary lever in the early 1990s, reform was limited.[86]

Why was so little attention given to finance? One explanation is that Anwar really had little power to implement reform since Mahathir had moved much of the oversight of financial policy to the Economic Planning Unit, which was under the direction of his office. But even if Anwar did have the power, would he have preferred to use it? Certainly continued government

[85] Narayanan, 1996.
[86] Jomo & Hamilton-Hart, 2001.

spending, especially on rural development projects, benefited the general Malay population, even if indirectly through economic stimulus. But continued spending also disproportionately benefited a narrow stratum of well-connected Malay and Chinese businessmen. Thus, even though the economy did not need any further spending stimulus, the government allowed public development spending to increase by double-digit percentages between 1988 and 1992.[87]

From the foregoing discussion it seems clear that while ethnic elements and priorities within the coalition were still important in shaping policy decisions of ruling elites, new coalitional priorities were shifting to big business, regardless of race or ownership. Communal politics help explain why immigration policies were not changed to encourage an increased inflow of foreign labor. Up to this point Malaysia had been very successful in generating at least a semblance of cultural and national unity in spite of the communal divisions underlying its political economy. Thus, the government was "especially wary of creating social dislocations as a result of having to absorb new waves of migrant populations."[88] Communal politics also shaped the implementation of skills training, where quotas ensured that the vast majority of vocational students were Malay.[89]

Yet despite the continuing influence of ethnicity on coalitional politics, relationships between wealthy Chinese entrepreneurs and Malay politicians were growing more intimate and MNCs and big business were playing an increasingly important role in both politics and economics. SMIs, however, remained outside the coalition, often by choice.[90] Government also

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[87] Narayanan, 1996.
[88] Lucas & Verry, 1999: 45. Martin 1994, reported that over a year and half period between 1992 and 1993 over 4,400 requests were made by firms for 431,000 expatriate laborers. The Ministry of Human resources approved 41% of these.
[89] See Malaysian Human Resource Development Fund, 1999.
[90] The Hong Piow, the major owner of Public Bank chose not to become embroiled with the NEP and the political leadership. Instead he learned the guidelines and limited diversification into other sectors, presumably also took steps to limit his exposure to the NEP, and steered clear of controversy. Interestingly, Natasha Hamilton-Hart

continued to ignore labor. Although skills development was viewed as a way to address the employment/wage dilemma, labor was neither involved in crafting nor implementing change.[91] Lucas and Verry report that wage negotiations continued to be set using the 1967 Industrial Relations Act, which allowed collective bargains to be struck for three years. However, these rights only extended to about 10% of the labor force and even then the length of the agreements made wages inflexible in relation to productivity growth.[92] As a further slap, legislation in 1989 eliminated bonuses, overtime, employee provident fund, and holiday pay from the negotiations and sought to reduce holiday and overtime pay in an effort to lower wages overall (ibid).

Interestingly, one state in Malaysia's federal structure seemed to be immune to the challenges plaguing the rest of the country. Penang responded to the crises of the late 1970s and early 1980s and the opportunities of the 1990s with different policy initiatives that correlate strongly with coalitional differences. Penang's coalitional differences, in turn, arose from two factors: its unique structural conditions and its ethnic composition.

Penang is a small island state without significant natural resources, the majority of its citizens are Chinese, and, along with Malacca and Singapore, historically relied primarily on an entrepôt trade economy that left it highly vulnerable to swings in the national and international economy. But the ultimate challenge came when the federal government moved Malaysia's main port facilities from Penang to Klaang, just outside of Kuala Lumpur.

Penang had successfully petitioned the government to become an export-processing zone

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reported that this course allowed him to sail through the 1997 currency crisis relatively unscathed Hamilton-Hart 2002, .

[91] The process was completely different in Singapore, where although the NTUC is essentially a government-sponsored labor representative, power over the formation and implementation of skills development policies was extended by the government to organized labor. This power did not extend in any way to wage negotiations, but even here the government had at least made efforts in the past to move wages upward. Once it became clear that the country's survival depended on wage rates following productivity gains, some input into the skills development process was the best labor could hope for.

[92] 1999.

(EPZ) as early as 1970 and had successfully convinced several large MNCs to locate labor-intensive production on the island. But with the closing of the port, the state moved into high gear to attract more FDI and, more importantly, to create a local manufacturing base capable of supplying foreign MNCs. The first step was to create the Penang Development Corporation (PDC). The PDC facilitated cooperation between the purchasing agents of the foreign multinational companies and local companies, especially machine tool manufacturers.[93] The linkages formed between local and foreign firms often extended to finance, technical training and help, specifications, and equipment.[94] To further expand the pool of knowledgeable workers, the PDC founded the Penang Sklls Development Center (PSDC) in cooperation with multiple MNCs and the University Sains Malaysia.

The ability of the PDC to facilitate linkages among local entrepreneurs, foreign MNCs, academic institutions, and labor (although to a much smaller extent and confined almost entirely to skills training) was the result of different coalitional pressures. Unlike federal Malaysia as a whole, Penang was not hamstrung by preferences to maintain the NEP. As the stringency of the NEPs requirements for implementation waned, so did the efforts of the various actors to implement it at all, especially since most of the firms involved were located in the EPZs and manufacturing for export.[95] Also, unlike in the rest of Malaysia, a large portion of the state's economic policies were geared to helping local capital, since promoting SMI growth and development would not upset delicate communal balances. Nor did the PDC pursue local industrial upgrading without the broad participation of multiple actors. Labor, academia, government, and local and foreign business all participated in tasks such as increasing R&D, developing new skills and knowledge in the work force, and forging linkages between foreign

[93] Rasiah, 1996.
[94] McKendrick, Doner, & Haggard, 2000.
[95] Rasiah, 1993.

and local firms.

The success of economic reform in Penang has been striking. By 1987, Penang boasted the large majority of FTZ development in Malaysia, including number of firms, employment, developed area, and firms' fixed assets.[96] Neither did Penang's development remain at the technologically shallow end of assembly, as it has in most of Malaysia. Strong linkages between local and foreign firms have resulted in significant upgrading and technological deepening (Rasiah, 1988, 1994, 1996, and 1999). The obvious and important counterfactual question is whether this upgrading was in some way the result of special considerations extracted from the federal government in response to Penang's special vulnerabilities? The answer is that although the federal government allowed early implementation of FTZ status for Penang, no other compensation or special help was forthcoming. The high degree of flexibility on the part of the PDC to create linkages between local firms, MNCs and a development infrastructure of skills development, early stage financing, and investment promotion might also have been achieved by other Malaysian states had they not suffered from different coalitional constraints.

The Asian Financial Crisis (1997-)

Continuing rapid growth and FDI expansion between 1990 and 1996 muted pressures for upgrading until the bottom fell out of the economy in late 1996 and early 1997. The twin pressures of falling GDP and stagnating technological progress led Mahathir to implement a new round of economic policy change, which, as before, was a complex combination of liberal reform and nationalist controls. Importantly, prior policies and institutions both spawned post-crisis reform while limited its ultimate scope and effectiveness. Moreover, Malaysia's post-crisis policy overhaul reflected and caused further coalitional shifts, often working against previously

[96] ibid.

central coalitional constituents.

Consider first the corporate sector. Forced restructuring and consolidation, reduced government support, and efforts to increase shareholder rights and transparency in corporate governance bode well for liberal reform. Yet re-nationalizing key industries, selectively bailing out some “crony” owned firms while withdrawing support for others, and continuing stimulus spending signified continuing illiberal nationalist intervention, political retribution, and fiscal profligacy.

Similar trends are evident in fiscal policy change. Soon after the crisis began, the government opted against “liberal” IMF intervention, choosing instead to implement selective currency controls. For the first year after implementation, the controls extended to all outgoing capital, although controls were subsequently reduced to apply primarily to “hot” money, i.e., assets capable of being liquefied and moved quickly in and out of the country. But since the bulk of the capital that was going to leave had already done so by the time of the initial ban, the government ended up punishing those investors who had shown the most loyalty.[97] The complete ban on capital outflows was lifted in 1999 although an exit tax remained for a short period.

Although currency controls allowed the government to reduce interest rates while maintaining the peg of 3.8 RM to the dollar, they may have masked the need for reform in the banking sector, where “fragility remains a serious problem.”[98] Also problematic, the growth of International Off-shore Financial Centers (IOFCs) made foreign borrowing easier without a concomitant rise in regulations managing the growth of this ‘private banking.’ Without constraints, vested interests captured the retained wealth in the economy and invested it in the protected import-substituting sector. Over time, this sector became heavily indebted. Rising

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[97] Jomo, 2001.
[98] Jomo & Hamilton-Hart, 2001: 67.

interest rates from 1997 exacerbated debt loads for these highly leveraged companies.[99]

Those changes that were made in the banking industry again reflected liberal and interventionist preferences, often politically motivated. Reform efforts extended to consolidating banks and nationalizing asset management and liquidation. These tasks were overseen by two government-owned corporations, Danaharta, which assumed non-performing loans and Danamoda, which re-capitalized the banks. Even so, banks have not moved quickly to take advantage of this window of opportunity, although there have been some mergers to reduce insolvent or weak financial institutions. Much of the hesitancy may be as much the fault of government sending mixed signals to the market, especially with respect to the amount of foreign ownership it will allow.[100]

In addition, the government renationalized significant private-sector debt, reassuming majority shares in Malaysian Airlines (MAS), United Engineering Malaysia (UEM) and Celcom. Doing so has hastened the downfall of previously coddled tycoons such as Tajudin Ramli. Nor has the purge been limited to economic cronies. In addition to Anwar's sacking, Mahathir has also cut Daim Zenuddin and his economic empire loose from the UMNO stable, which may be a political response to calls for *reformasi* as anything else. And finally, the government has sought to increase private equity ownership as a means of reducing firm debt. To facilitate private investment the government created a new bourse in 1997, the MESDAQ, modeled after the high-tech heavy NASDAQ in the U.S. However, listings have been limited and little money invested despite the small capital requirements.

Growing political uncertainty, economic vulnerability, corruption, capital controls, and a weakened legal system have led to a loss of investor confidence. As important, over

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[99] ibid.
[100] Leung, 1998.

concentration in electronics, perceived or real linkages to political Islam, and a failure to improve technical skills and capacities are diminishing Malaysia's competitive attractiveness for FDI. Falling investor confidence and competitiveness has led to sharply falling FDI levels after the crisis, both in absolute terms and when compared to earlier periods (see Table3). Although levels of FDI remain similar to Indonesia and the Philippines, incoming FDI in recent years is much lower than in Thailand or Singapore, let alone China, suggesting more structural causes. Efforts to reverse the trend have been largely ineffective. For example, despite growing numbers of companies in the MDC, the amount of foreign investment declined in both absolute and relative terms. By the latest count the U.S. owns only 5% of the total MSC investment, Europe 9%, and Japan 12%. In comparison, Malaysian firms account for 66%.[101]

Table 3: FDI Inflows (billions of U.S. dollars)

	Indonesia	Malaysia	Philippines	Singapore	Thailand
1990	1.092	2.332	0.530	5.574	2.444
1991	1.482	3.998	0.544	4.887	2.014
1992	1.776	5.183	0.228	2.204	2.112
1993	2.004	5.006	1.238	4.686	1.804
1994	2.108	4.341	1.591	8.550	1.366
1995	4.345	4.178	1.478	7.206	2.068
1996	6.193	5.078	1.516	8.984	2.335
1997	4.677	5.136	1.222	8.085	3.894
1998	-0.356	2.139	2.287	5.492	7.314

[101] See www.mdc.com.my

1999	-2.744	1.552	0.573	6.984	6.213

Spurred by the recognition that the halcyon days of FDI growth may be over, the government is renewing and intensifying efforts to reform training, R&D, investment, and finance to facilitate more knowledge-intensive activities. Yet reform efforts have been stillborn to this point. Education and training is a key case in point. With few business or labor interests involved, the bulk of change has centered on the physical infrastructure. Gleaming new universities and training facilities in Cyberjaya, Kuala Lumpur, and other cities continue to struggle to find qualified instructors and students interested in science and technology. The ability to create linkages with and leverage expertise in the foreign MNCs has been limited to the PSDC and to a much lesser extent the copycat training institutions in Selangor and Jahor.[102] Ongoing controversy between Chinese and Malay parties over vernacular education, quotas, and other institutional legacies of the supposedly defunct NEP thwart meaningful linkages and cooperation necessary for change.

The coalitional structure behind these policy changes has been shifting. Instead of being constructed along communal lines, coalitional factions are developing within and across communities. Conservative Islamists and urban Chinese unite against government corruption. Younger Malays unite against their conservative elders with similar generational gaps evident in the Chinese and Indian populations. Admittedly, the major points of agreement within these relatively broad coalitions often extend only to their disagreements with UMNO, making them potentially ephemeral. Further splits appear evident between rural and urban populations in general, with opposition parties dominating the cities and UMNO returning to its peasant, mass-

[102] See Ritchie 2002, for an in-depth discussion of foreign MNCs and technical education and training in Southeast Asia.

based roots. UMNO has made no effort to incorporate labor. Nor has UMNO been able to co-opt the new middle class created by the NEP and NDP.[103]

Political upheaval is complicating the picture as Mahathir steps down after 30 years in power. A combination of coalitions and crisis has prompted Mahathir to act in ways contrary to the interests of foreign business and well-connected cronies, two constituencies well courted in the past. Clearly neither of these groups has been cut loose, but clearly political survival is dictating new strategies, both economic and political. In many ways Malaysia is a victim of its own economic success. A willingness to alienate labor and small business to facilitate the growth of large MNCs and well-connected local firms has created institutional structures that make flexible adaptation to these new realities difficult. As the partial consociational bargain between UMNO and its elite coalition partners weakens, economic reforms will be more difficult to create and implement without a new support base.

Conclusion

Malaysia has been a remarkable economic success story, worthy in many ways of emulation by other developing countries. This praise, however, is not due to its unwavering commitment to liberal and open trade, investment, and finance. Instead, luck, pragmatism, initial conditions, and *highly interventionist* as well as reform minded government policy combined to balance ethnically motivated demands for a redistributive political economy (a recipe for economic disaster in most other countries) with rapid economic expansion and growth.[104] That the Malaysian government was able to respond to political imperatives and at the same time

[103] Weiss, 1999.
[104] Narayanan argues that "only a fortuitous combination of external factors, personalities, and belated pragmatism ensured eventual success" of the financial system in the 1980s 1996, 869-881: 869. See Doraisami & Rasiah, 2001; Wah & Narayanan, 1999; and Jomo and Hamilton-Hart 2001, on the other points.

"advance Malaysia's position in an evolving regional division of labour"[105] through compromise and arbitration among competing interests, both foreign and domestic, attests to both state capacity and Mahathir's individual leadership.

The complex mix of liberal and illiberal economic policy measures has been driven, to a large extent, by coalitional priorities. Interventionist NEP-era policies were implemented to redistribute assets and create national industries for growth. As long as aggregate economic growth continued, these policies were supported by a broad yet shallow coalition of UMNO political elite, rural Malays, and big business. Rural Malays passively supported the regime while labor was actively suppressed and small and medium-sized businesses ignored. As global economic conditions changed in the 1980s, so did Malaysia's coalitional structure. While communal issues still mattered, FDI and MNCs were thrust to the front of the pack. Massive structural change and growth was increasingly checkered by corruption and cronyism. The resulting economic policies and institutions limited complete liberalization and maintained at least some focus on redistributive priorities.

Institutional and policy legacies reared their heads again during and after the crisis, when the focus of economic policy shifted from macro economic stability to technological development. Whereas the government could meet shifting coalitional priorities without compromising the underlying economic stability necessary for investment accumulation, it was unable to meet coalitional needs and also create knowledge and technological capacity. Prior policy patterns of exclusion, especially of labor and local business, now buttressed by institutional systems, acted to constrain efforts to resolve new and more complex collective dilemmas surrounding information exchange, investment appropriation, monitoring, and enforcement. The result has been an economy slow to transition from the process of

[105] Felker & Jomo, 2003:104.

manufacturing to the more technologically advanced activities of design and creation. The exception that proves this rule is Penang, where dissimilar public-private relationships unencumbered by communal priorities and patterns of small business and labor exclusion has been able to move beyond simple assembly.

Whether Malaysia remains mired in a mediocre skill and value-added equilibrium depends critically on whether the ruling coalition can be reordered to include a broader cross-communal and cross-class set of active participants. Reform that goes beyond structural change to *creating* new stocks of labor and capital, primarily human skills and knowledge, will require the active participation *and* cooperation of government, labor, academia, SMIs, MNCs, and large local firms.

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