

# MALAYSIA INTERNATIONAL TRADE, GROWTH, POVERTY AND HUMAN REDUCTION AND HUMAN DEVELOPMENT



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# MALAYSIA INTERNATIONAL TRADE, GROWTH, POVERTY AND HUMAN REDUCTION DEVELOPMENT

Published by the  
United Nations Development Programme (UNDP), Malaysia.

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First published June 2006.

ISBN 983-40995-6-8

United Nations Development Programme  
Wisma UN, Block C, Kompleks Pejabat Damansara,  
Jalan Dungun, Damansara Heights, 50490 Kuala Lumpur, Malaysia.  
[www.undp.org.my](http://www.undp.org.my)

A catalogue record for this book is available from the library of UNDP.

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Design : A Del Design & Craft

Printed in Malaysia

## FOREWORD

**G**lobalization is a process that has been going on since colonial times and that emerged as a major phenomenon during the era of British imperial free trade. Nineteenth-century globalization involved large-scale movements of population in many parts of the world, as governments, trading companies, and individuals sought to exploit new economic opportunities. The states that now constitute Malaysia were part of this trend and by the early twentieth century, shipments of primary commodities, comprising mainly rubber and tin, were leaving busy ports, such as Penang, for destinations in the more developed world.

The agricultural and mining products on which this trade was based relied heavily on foreign labour and foreign capital. The migrant labour came mainly from southern China and south India, and these populations, together with the indigenous Malays, comprised a significant market for manufactured consumer goods from abroad. Foreign capital, or foreign direct investment (FDI) as it is now known, had also become well established, mainly through investments by the large trading houses and other investors in the agricultural and mining sectors, particularly in large rubber plantations and tin mines.

Modern Malaysia continues to be part of contemporary globalization, but patterns of production and trade at the beginning of the twenty-first century have changed radically. The production of technologically advanced and high-end manufactures, as well as of services, has superseded the dominance of agricultural commodities in Malaysia's export trade. And the benign neglect of human development that characterized the colonial era has been replaced by a concerted government policy of development, equity, and empowerment for all the communities of the country's diverse population.

This publication documents the changing patterns and structure of Malaysia's international trade, and shows how sustained trade-led growth has contributed to a massive reduction in poverty rates, as well as leading to high human development. It begins by reviewing the literature on the international experience which shows that industry-

based import substitution has not been a sustainable long-term strategy for promoting economic growth. Trade liberalization is shown to promote economic growth, and more open economies tend to attract FDI, especially in the context of political stability. And since economic growth raises average incomes, so poverty can be expected eventually to fall in countries with good growth records.

Malaysian development has followed the East Asian model. Its openness to international trade has led to three and a half decades of rapid economic growth and a spectacular decline in poverty rates. An open trade policy, coupled with pro-poor growth and equity strategies, has been the key factor that contributed towards poverty reduction. The Millennium Development Goal (MDG) target to reduce the proportion of the population living below the poverty line by 50 per cent between 1990 and 2015 was achieved in 1999 when Malaysia's poverty rate fell from 16.5 per cent in 1990 to just 7.5 per cent in 1999—the level has fallen even further since. Taking a longer span of time between 1970 and 2004, income inequality in Malaysia has also been reduced.

Key to Malaysia's successful export-led economic growth has been the growth of manufactured exports, especially electronics, such that Malaysia is now one of the world's leading exporters of semi-conductors and electronic components. FDI, attracted by, inter alia, Malaysia's infrastructure, human resources, and government incentives, contributed markedly to the development of export-oriented industries. The exchange rate was relatively stable and the Malaysian ringgit was not overvalued. The growth of manufacturing was generally beneficial to the empowerment of Malaysian women through modern sector employment opportunities.

Though the evidence suggests long-run economic gains for all from trade liberalization, there will be short-term winners and losers. Compensatory policies are needed to help the poor deal with the transition costs of adjustment and benefit from open trading regimes. Trade liberalization in Malaysia was thus accompanied by pragmatic social and macroeconomic management as well as investments in human capital, especially health, education, and women's empowerment.

For the future, the challenge for Malaysia is to continue on the growth path in a context of increasing globalization and regionalization, characterized by systems of production that take place in international networks. In particular, this will entail expanding trading agreements and greater investments in human capital development, as envisaged in the Ninth Malaysia Plan, 2006–2010, with an emphasis on knowledge, innovation, and ideas.

This publication has been produced to coincide with the launch in June 2006 of UNDP's Asia-Pacific Regional Human Development Report 2006, *Trade on Human Terms: Transforming Trade for Human Development in Asia and the Pacific*. I would like to thank Dr Hafiz Pasha, UNDP Assistant Administrator and Director of the Regional Bureau for Asia and the Pacific, for inspiring it. I would also like to thank all the members of the Report Team (listed on page vi) for their good efforts and professionalism in putting this publication together. Special appreciation is extended to the Economic Planning Unit (EPU), Prime Minister's Department, and to the Ministry of International Trade and Industry (MITI) for providing helpful comments on an earlier draft report. I hope that it will provide a useful case study to support human development in other countries.



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## ABBREVIATIONS

|        |   |
|--------|---|
| ACFTA  | ASEAN–China Free Trade Agreement                            |
| ADB    | Asian Development Bank                                      |
| AFTA   | ASEAN Free Trade Agreement                                  |
| AIA    | ASEAN Investment Area                                       |
| AIM    | Amanah Ikhtiar Malaysia                                     |
| AJCEP  | ASEAN–Japan Comprehensive Economic Partnership              |
| APEC   | Asia-Pacific Economic Cooperation                           |
| ASEAN  | Association of South-East Asian Nations                     |
| ASEM   | Asia–Europe Meeting   |
| BEC    | broad economic categories                                   |
| CEC    | closer economic cooperation                                 |
| CEP    | closer economic partnership                                 |
| CEPT   | common effective preferential tariff                        |
| CGE    | computable general equilibrium                              |
| D8     | Group of Developing Eight                                   |
| DOS    | Department of Statistics, Malaysia                          |
| EC     | European Economic Community                                 |
| EFTA   | European Free Trade Association                             |
| EPA    | Economic Partnership Agreement                              |
| EPU    | Economic Planning Unit (in the Prime Minister’s Department) |
| EPZ    | export processing zone                                      |
| EU     | European Union  |
| FAMA   | Federal Agricultural Marketing Authority                    |
| FCZ    | free commercial zone  |
| FDI    | foreign direct investment                                   |
| FELCRA | Federal Land Consolidation and Rehabilitation Authority     |
| FELDA  | Federal Land Development Authority                          |
| FIZ    | free industrial zone  |
| FTA    | Free Trade Agreement  |
| FTZ    | free trade zone   |
| GDP    | gross domestic product                                      |
| GLC    | government-linked company                                   |
| GMP    | guaranteed minimum price                                    |
| GSTP   | Global System of Trade Preferences                          |
| HDI    | human development index                                     |
| ICA    | Industrial Coordination Act                                 |
| ICT    | information and communications technology                   |

|          |  |
|----------|--|
| IMP      | Industrial Master Plan   |
| ISIS     | Institute of Strategic and International Studies                       |
| IT       | information technology   |
| LFPR     | labour force participation rate  |
| M&A      | mergers and acquisitions   |
| MDG      | Millennium Development Goal  |
| MIDA     | Malaysian Industrial Development Authority                             |
| MIER     | Malaysian Institute of Economic Research                               |
| MITI     | Ministry of International Trade and Industry                           |
| MNC      | multinational corporation  |
| MPOB     | Malaysian Palm Oil Board   |
| MPOPC    | Malaysian Palm Oil Promotion Council                                   |
| MSC      | Multimedia Super Corridor  |
| NAE      | non-agricultural employment  |
| NAFTA    | North American Free Trade Agreement                                    |
| NDP      | New Development Policy   |
| NEP      | New Economic Policy  |
| NIC      | newly industrializing country  |
| NVP      | National Vision Policy   |
| OECD     | Organisation for Economic Co-operation and Development                 |
| OEM      | original equipment manufacture   |
| OPP      | Outline Perspective Plan   |
| Petronas | Petroleum Nasional Berhad  |
| PLI      | poverty line income  |
| PORIM    | Palm Oil Research Institute of Malaysia                                |
| PORLA    | Palm Oil Registration and Licensing Authority                          |
| PTA      | Preferential Trading Arrangement                                       |
| RDA      | regional development authority   |
| RISDA    | Rubber Industry Smallholders' Development Authority                    |
| SME      | small and medium enterprise  |
| SMI      | small and medium industry  |
| TFP      | total factor productivity  |
| TNC      | transnational corporation  |
| TPS-OIC  | Trade Preferential System Among Organization of the Islamic Conference |
| UN       | United Nations   |
| UNCT     | United Nations Country Team (Malaysia)                                 |
| UNCTAD   | United Nations Conference on Trade and Development                     |
| UNDP     | United Nations Development Programme                                   |
| WB       | World Bank   |
| WTO      | World Trade Organization   |



# INTERNATIONAL TRADE, GROWTH, AND POVERTY REDUCTION

The relationship between trade liberalization and development is the central theme of current trade talks. In his address to the World Trade Organization (WTO) meeting in Hong Kong (December 2005), the United Nations (UN) Secretary-General, Mr Kofi Annan, directly linked trade reform to world poverty. 'The lack of major gains here', he warned, 'would be a severe disappointment for poor people around the world yearning to lift themselves out of poverty.'

Yet there is a view, often advanced by the 'anti-globalization' lobby, that greater economic integration in the world economy is harmful to the poor. A recent book published by the International Forum on Globalization asks, in its title, 'Does globalization help the poor?' Its answer is an emphatic 'No'. 'Globalization policies', it claims, 'have contributed to increased poverty, increased inequality between and within nations.' (Mander et al. 2001)

Bhalla (2002) asks a similar question, 'Who has gained from globalization?' But his answer is an equally emphatic 'The Poor'. Between these polar positions, most economists and development experts see an important, but not exclusive, role for trade liberalization in policies aimed at helping the world's poor. Our purpose in this opening chapter is to examine the evidence in support of this emerging consensus as a backdrop to an in-depth review of the Malaysian experience.

The UN Millennium Development Goal (MDG) is to halve the 1990 'US Dollar a day' poverty rate by 2015. It has been estimated that this goal will be achieved on time (World Bank 2000), or even ahead of time (Ravallion 2003) if current trends are maintained. Whilst the UN Millennium Project report in 2004 primarily showed the need for 'Marshall Plan' development assistance to achieve the MDGs, it also sees international trade as playing an important role in lifting the world's poor out of poverty:

*For its part, international trade can be a powerful driver of economic growth, which in turn is indispensable to reduce poverty. Trade, however, is not a silver bullet for achieving development. Trade openness should be combined with increased public investments, a sound business environment and macroeconomic stability, if the benefits of development are to be fully realized. Yet there is no doubt that if developed countries open their markets significantly more to developing countries, and if developing countries reciprocate with open trade policies on their part, and if trade liberalization is accompanied by complementary investments and policies, then economic growth and poverty reduction will accelerate. (UN 2004)*

The last quarter of the twentieth century witnessed an unprecedented growth in world trade and the incidence of world poverty declined significantly over the same period. The poverty rate, based on the money metric international poverty line of \$1.08 per day, almost halved in the last twenty years of the last century: from 40.4 per cent in 1981 to 21.1 per cent in 2001. The drop is less dramatic, yet still significant, if China is omitted—from 31.7 per cent to 22.5 per cent. The Chinese case is particularly revealing. Amongst other reforms, China began to dismantle its many barriers to trade in 1979, and much more rapidly after 1988. The substantial growth in the share of its gross domestic product (GDP) accounted for by trade was accompanied by significant reductions in poverty: from 63.8 per cent in 1981 to 16.6 per cent in 2001.

There is then, in the world headline figures and in the remarkable example of China, good cause to view trade as being pro-poor. Before examining the more formal evidence, it is illuminating to consider a development model that recommended exactly the reverse—import substitution through protection of domestic industries.

## Import-Substitution Policies

When many developing countries achieved their independence after World War II, emphasis was initially placed on import-substitution industrialization. Local industries were protected against foreign competition by tariff barriers. It was hoped that these barriers would eventually be removed when the 'infant industries' reached maturity. Advocates of such policies could point to historical examples of successful

inward-looking policies: the United States imposed high duties on imported manufactures over the latter part of the nineteenth century, as did France, Germany, and Japan (the last after 1900). Import substitution was further justified by the arguments of Raul Prebisch, the founder and Secretary-General of the United Nations Conference on Trade and Development (UNCTAD). He applied the 'infant industry' argument to all manufacturing rather than to specific industries.<sup>1</sup>

Although import substitution had some initial successes, industries generally remained in infancy and growth rates of inward-looking economies began to falter. Proponents of import substitution failed to anticipate the full implications of their policies. In particular, they failed to anticipate the effects on export performance and foreign exchange earnings. In some cases, however, import substitution was strengthened by providing trained manpower, technology, infrastructure, trade facilitation and knowledge.

Exporters were faced with increasing costs of imported intermediate and capital goods. In many countries, government revenue failed to keep pace with expenditure, and budget deficits were increasingly financed by money creation with inevitable inflationary consequences. Indeed, as Baldwin (2003) observed, 'it was the macroeconomic crises associated with unsustainable import deficits for central banks, unmanageable government budget deficits, runaway inflation, and so on that had the greater effect in finally turning most countries away from import substitution policies than a realization of the serious resource misallocation effects of these policies'.

The switch to outward-looking development began in East Asia: Hong Kong, which had long adopted outward-looking policies, was joined by Taiwan Province of China, Singapore, and the Republic of Korea. By the late 1960s, many of the restrictions on trade had been dismantled.<sup>2</sup> The move towards outward-looking development took

<sup>1</sup> Prebisch was later to emphasize the role of a more equitable income distribution in national economies as a key ingredient in ensuring that domestic markets are large enough for industrial deepening (Bianchi 2006).

<sup>2</sup> In the Republic of Korea, effective rates of protection remained high into the 1970s but were mitigated to a large extent by export subsidies and exemptions.

longer elsewhere. The debt crises of the 1980s persuaded many developing countries to change direction (even those countries that had applied import substitution most enthusiastically, such as Argentina, Chile, Mexico, Turkey, and Ghana). But it was the remarkable growth performance of the East Asian pioneers that lay behind the change in policy orientation, together with the gradual shift in thinking of economists and development experts. A consensus emerged that the import-substitution approach was not successful in promoting appreciably higher growth rates in the long run. Countries that have persisted in import-substitution policies, such as Myanmar, Pakistan, and Zimbabwe, have tended to experience relatively slower growth.

## Trade, Economic Growth, and Poverty Linkages

Whilst most studies consider the effects of trade on growth, and growth on poverty, where the causation runs one-way, there may be important relationships running in the reverse direction. For example, high poverty rates can be an impediment to growth when the high dependency ratios and low levels of savings that they imply limit capital accumulation and growth.

The effects of trade liberalization on income inequality and poverty are normally analysed in two steps:

- the effects of trade on economic growth
- the effects of economic growth on poverty.

To anticipate the main conclusions of this chapter, international trade is thought to substantially promote economic growth, and economic growth in turn is believed to be essential for poverty reduction. The consensus appears to be that, other than its influence through economic growth, the direct effects of trade on poverty are of second order. As we will see in the evidence surveyed in this chapter, there is no presumption that more trade or more growth or both are poverty-reducing. The achievement that Malaysia can rightly point to is that it was able to demonstrate that with complementary policies greater trade and more rapid poverty reduction can be accomplished simultaneously.

## *Trade and Growth*

Countries which are open to international trade are likely to gain in two ways. First, they reap the static benefits of comparative advantage. Economists have long recognized that there are considerable gains from moving from autarky (self-sufficiency) to international trade. Each trading partner specializes in the production of goods for which it has a comparative advantage and trading economies will all enjoy higher levels of income. Although these are labelled 'static' gains, they may take some years to be fully exploited and it will inevitably take some time to reallocate resources (of capital and labour) to those industries with the comparative advantage. In the short-run adjustment period, there will inevitably be gainers and losers, and, as we shall see, poorer communities may well be drawn from either or both groups.

Secondly, modern 'endogenous growth' theories suggest that there may be additional dynamic benefits from trade. Endogenous growth theories explain growth in a number of different ways. For example, some stress the gains from having a variety of inputs into the production process and international trade acts to increase this variety. Others stress the knowledge spillovers from trade. For example, trade creates opportunities to copy the products and production technologies of foreign producers. The importance of such knowledge spillovers is illustrated by Coe et al. (1997), who find that total factor productivity (TFP)—i.e. output as a ratio of all production inputs—of 71 developing countries is significantly related to the research and development carried out by their trading partners. Because of effects like these, endogenous growth theories generally predict slower growth when trade is restricted.

## *Trade's Effects on Poverty*

There are a number of channels through which trade can be expected to affect poverty directly. In broad terms, trade liberalization will change the prices of the goods that the poor buy and those of the goods and labour services that they sell. In the short run at least, the net effect of these two will determine whether the poor gain or lose from trade. For example, trade reform will invariably lower import prices, and this will raise the real incomes of poorer households who buy imported goods, especially food. However, if poor farming households are net suppliers of

the goods whose prices have fallen, the same trade liberalization programme could well lower their real incomes.

Trade reform may also reduce or remove export taxes. If the poor are net producers of exported goods, they will gain as they will receive a larger share of the world price. So by changing the prices of the goods that the poor buy and sell, trade reform will affect the welfare of the poor: in some circumstances, they will benefit; in others, they will lose.

Where the poor are wage earners, a similar picture emerges. They will gain in the short run if, as a result of trade reform, their wages rise relative to the prices of the goods they consume. Trade reform can be expected to raise some real wages, but lower others.<sup>3</sup> Agénor (2004) has suggested that in some countries, trade liberalization would lead to reduced demand for unskilled labour, lowering their real wages in the short run. The resulting reductions in household income might well lead to higher poverty rates. In other contexts, trade reform might well increase the demand for unskilled labour. The opening up of agricultural markets in the developed world, especially the USA and the European Union (EU), will inevitably raise the demand for unskilled agricultural labour in developing countries, benefiting poor households.

It is therefore not possible in theory to determine whether poor communities will gain or lose from the direct effects of trade liberalization in the short run. Indeed, we can expect there to be winners and losers from any trade reform, and both can be expected to include poor households.

In the long run, losers from trade may yet benefit if they take the opportunity to change their economic activity—turning to the production of goods and services made more profitable by reform. In this way, short-run losers may become long-run winners. Because poor individuals find it harder to cope with short-run income loss—they may find it difficult to borrow in hard times—income support, micro-credit facilities, and retraining programmes are clearly important. As Bannister and Thugge (2001) argue, there is a need to develop 'diagnostic tools that can help policymakers identify who the losers from trade

<sup>3</sup> There may be nominal rigidities in labour markets, especially in urban areas and, because of this, trade reform may well lead to short-term job losses and unemployment.

liberalization might be. Based on this analysis, compensatory policies can be designed to help the poor to deal with the transition costs of adjustment and to benefit from the new, open trade regime.'

There are other, less direct, effects of trade reform on poverty. For example, trade liberalization may reduce government revenue from tariffs and export taxes, and thereby affect the government's ability to fund education, health, and other welfare programmes from which the poor directly benefit. In this way, the consequences for the welfare of poor communities will extend beyond the effects trade reform has on market wages and prices.

Because there are mechanisms by which openness can, in theory, both benefit and harm the poor, Agénor (2004) concludes that 'determining whether globalization is (on net) "good" or "bad" for the poor is—as is often the case in economics—an empirical issue, not a matter of faith'.

## Empirical Evidence

This section begins by reviewing evidence on the direct effects of trade liberalization on poverty. It then examines the effects of trade on poverty in two steps: first, the effect of trade reform on economic growth and secondly, the effects of economic growth on poverty.

### *Trade and Poverty*

Three approaches have been used to examine the effects of trade on poverty: (a) country case studies, (b) computable general equilibrium models (CGE), and (c) cross-country regressions.

#### **(a) Country case studies**

As one would expect, the evidence from country case studies is mixed. Winters (2000) reports on a joint Oxfam–Institute of Development Studies study of liberalization of the cotton market in Zimbabwe during the late 1980s and 1990s that illustrates the potential beneficial effects of trade liberalization on the poor. Before liberalization, the government was a

monopsony buyer (a sole buyer facing many sellers) of cotton from farmers and used low producer prices to subsidize inputs into the textile industry, thereby reducing the incomes of small, poor farmers. Liberalization included elimination of price controls and the privatization of the marketing board. The results were higher prices and greater competition among an increased number of buyers, not only in terms of price but also in providing extension and input services to small landholders.

In a contrasting example, Winters reports that in Zambia, liberalization of the maize market had the opposite effect. Before liberalization, maize producers enjoyed cross-subsidies, financed by the mining sector, that considerably lowered the cost of inputs. In addition, small producers in remote areas were implicitly subsidized by prices, set by a parastatal firm (one funded by the government without formally being a part of it) serving as a monopsony buyer, that were uniform for all seasons and throughout the country. When the subsidies were removed and the parastatal was privatized, larger farmers close to national markets saw no effective change in market conditions while small farmers, and especially those in remote areas, were severely affected by price fluctuations. In addition, owing to a sharp deterioration in transportation infrastructure, remote rural markets for corn completely disappeared, leaving poor farmers without formal incomes.

As Winters pointed out, in Zimbabwe trade liberalization resulted in the creation of markets in which the poor could participate and an improvement in market performance, while in Zambia it resulted in the disappearance of functioning markets for the poor's produce. These examples serve to illustrate that trade reforms can be pro- or anti-poor in the short run.

#### *The Chinese Case*

As noted earlier, since 1980, China has experienced remarkable reductions in the incidence of poverty: from 63.8 per cent in 1981 to 16.6 per cent in 2001, using the US\$1.08 a day poverty line. It has been suggested that China's greater openness to external trade since Deng Xiaoping's 'Open-Door Policy' of the early 1980s was the key to its subsequent success against poverty (Dollar 2004). Indeed, Ravallion

(2004) reports that the simple correlation coefficient between China's trade share and its headcount poverty rate over the period of trade liberalization (1981–2001) was  $-0.7$ .

However, Ravallion points out that the major reductions in China's poverty rate occurred in the early 1980s<sup>4</sup> when trade liberalization was quite modest. The bulk of the trade reforms came later, with the extension of the special economic zone principle to the whole country (in 1986) and from the mid-1990s, in the lead-up to China's accession to the WTO. Ravallion concludes that 'a closer look at the time series evidence for China casts doubt on the view that greater openness to external trade has been the driving force in poverty reduction' and attributes China's pro-poor growth largely to the agrarian reforms initiated in the late 1970s.

#### (b) CGE models

CGE models provide a useful 'laboratory' for investigating the short- and medium-term effects of trade liberalization on poverty. They attempt to capture key product and factor market interactions and they can be used to simulate the impact of trade liberalization on household incomes and hence poverty. For example, using the CGE approach, Chen and Ravallion (2004) analysed the impact of China's accession to the WTO in 2001. They simulated the behaviour of the Chinese economy under the assumption that WTO accession did not take place and compared the outcome with simulations that took into account the effects of accession. Their model generated a set of price and wage changes that embodied both the direct price effects of the trade policy change and the 'second-round' indirect effects on the prices of non-traded goods and on factor returns, including effects that operate through the government's budget constraint.

Their simulations revealed that, in aggregate, accession had only marginal effects on poverty, slightly reducing it in the lead-up period and slightly raising it in the post-accession period.<sup>5</sup> However, these aggregate results mask significant variations at the microeconomic level. For example, the model simulates that, because of accession, three-quarters of rural households lost real income in the period 2001–7 but this was

<sup>4</sup> Rural poverty rates fell from 76 per cent in 1980 to 23 per cent in 1985.

<sup>5</sup> This result was consistent with Ravallion's (2004) interpretation of Chinese time-series evidence referred to earlier.

true for only 1 in 10 urban households. Farm income was predicted to fall due to the drop in the wholesale prices of most farm products plus higher prices for education and health care. And more than 90 per cent of farmers in the north-east provinces of Heilongjiang and Jilin were predicted to experience a net loss in income. Chen and Ravallion (2004) argue that the winners and losers from trade reform may cancel each other on aggregation, so it is important to analyse the effects of trade liberalization on poverty using what they call a 'micro lens'.

Ravallion and Lokshin (2004) report on a similar CGE assessment of the impact of cereal de-protection in Morocco. As in the Chinese case, the study found a negligible aggregate impact of de-protection on the poverty rate; for example, with a tariff cut on imported cereals of 30 per cent, the headcount index was predicted to rise marginally from 19.6 per cent to 20.3 per cent. However, as in the Chinese case, the small aggregate impact masked important heterogeneity at the regional level. Their simulations suggested that rural families tended to lose from the Moroccan liberalization programme and urban households tended to gain.

CGE experiments are likely to lead to quite different conclusions depending on the precise trade reform measures being considered and the specific country application. A good example is the series of CGE models on trade and poverty in the Philippines (Cororation et al. 2005; Cororation and Cockburn 2005). Cororation and Cockburn (2005) find that the current Doha agreement is likely to slightly increase poverty in the Philippines, but more extensive trade reform will reduce it.<sup>6</sup> Cororation et al. (2005) find that the tariff cuts implemented between 1994 and 2000 were generally poverty-reducing, primarily through the substantial reduction in consumer prices they engendered. These two studies illustrate the possibility that, in the short run, trade reform can affect poverty either way.<sup>7</sup>

One major problem with the CGE approach is its failure to allow

<sup>6</sup> This is a similar conclusion to that reached by Agénor (2004) from his non-linear cross-country regressions noted above.

<sup>7</sup> Agénor (2005) argues that many recent attempts to develop applied (CGE) macro models for poverty analysis are failures because they 'recycle' models that were built for a very different purpose and fail to capture the key interconnections required to model poverty. Agénor promotes his own series of applied models (Agénor 2003) claiming that they do capture the salient interconnections.

for the longer-term benefits of trade on economic growth, and through growth on poverty. The dynamic gains from trade stressed by the endogenous growth literature have yet to be incorporated into the CGE approach.

### (c) Cross-country studies

There have been relatively few cross-country studies of the effects of trade on poverty (as opposed to their effects via growth).<sup>8</sup> In a recent study, Ravallion (2004) compared changes in poverty rates between income surveys in a number of countries with the changes in trade volume, matched as closely as possible to the survey dates. His sample consisted of 178 such 'spells' in 75 countries. He found that the correlation between the changes in poverty and the change in trade to be 0.09, statistically insignificant. He concludes that his data 'cast doubt on any generalization that greater trade openness necessarily means lower poverty in developing countries'. He adds the caveat that his data cannot capture the longer-term benefits of trade on poverty.

Another recent cross-country example is Agénor (2004), who argues that the relationship between trade openness and poverty may not be linear. Using data from 16 low- and middle-income countries, he finds that, starting from a position of autarky, openness initially makes poverty worse, but as economies become increasingly open, poverty declines. The lesson to be learned from this non-linear relationship is an interesting one: 'globalization may hurt the poor in some countries not because it went too far but rather because it did not go far enough'. However, his is a relatively small sample and his results have not been subject to the same critical scrutiny as the cross-country studies of the effects of trade on economic growth, which are examined below.

## *Trade and Growth*

<sup>8</sup> There have been a number of studies on the effects of trade on income inequality. For example, Dollar and Kraay (2004) find little or no effect of trade on income inequality. Lundberg and Squire (2003) find evidence that trade openness tends to increase inequality.

The effects of trade reform on economic growth have been analysed mainly through the use of cross-country data. The group of developing countries identified by Dollar and Kraay (2001) as 'globalizers' had population-weighted growth of 5 per cent per capita in the 1990s, compared with 2 per cent for the rich countries, and -1 per cent for the rest of the developing world.

By comparing different countries' 'openness' with their growth performance, the approach attempts to capture the long-run impact of trade on economic growth, and hence poverty. There are many technical problems to overcome. The first is the definition of openness. The following are examples: the ratio of the sum of imports and exports to GDP, tariff receipts relative to exports, a measure of tariff and non-tariff barriers to trade. The last-mentioned is a measure of trade policy, whereas the first two are measures of the effects of policy. The second concerns the likely endogeneity of openness. For example, a faster-growing country is likely to import more and this will lead to a rise in the first measure in our list. Causality may run from growth to openness, not the other way round. And a common problem in all studies is the questionable accuracy of the data, especially those for developing countries.

In a recent 'meta-study' of cross-country growth regressions, Sala-i-Martin et al. (2004) report that trade volume is statistically significant in two-thirds of the regressions, though it is not amongst their subset of 18 robust predictors of economic growth.

Three widely cited studies that find that openness is associated with faster growth are Dollar (1992), Sachs and Warner (1995), and Frankel and Romer (1999). A more recent study by the World Bank (2002) also finds that the countries that have opened themselves the most to trade in the last two decades (the 'new globalizers') have, on average, grown the fastest. These countries reduced import tariffs, on average, by 34 percentage points since 1980, compared with 11 percentage points for those developing countries that, on average, saw no growth in per capita incomes over the period.

However, Rodriguez and Rodrik (1999) have found that some of the

evidence linking trade and economic growth lacks robustness. Their assessment of the Sachs and Warner (1995) study is worth covering in detail. Sachs and Warner constructed a zero-one openness dummy variable for each of the 79 countries in their sample. This variable is zero if any of the following conditions are met over the period 1970–89: (a) average tariff rates are over 40 per cent on capital goods and intermediates; (b) non-tariff barriers cover 40 per cent or more of imports of capital goods and intermediates; (c) the country operates under a socialist economic system; (d) there is a state monopoly of the country's major exports; and (e) the black market premium on its official exchange rate exceeded 20 per cent in the 1980s or 1990s.<sup>9</sup> This measure does not capture varying degrees of openness: indeed a country barely passing the Sachs-Warner measure of openness would be far from fully open. Nevertheless, Berg and Krueger (2003) consider the measure 'a fairly successful effort to measure the overall importance of trade policy restrictions'. Using this composite variable, Sachs and Warner find that openness is positively associated with growth.<sup>10</sup>

Rodriguez and Rodrik (1999) find that, when entered separately as explanatory variables in cross-country regression, neither the measure of tariff levels nor the coverage of non-tariff trade barriers is statistically significant. Growth was mainly affected by the existence of a state monopoly of the country's major exports and a black market foreign exchange premium of more than 20 per cent and this is hardly compelling support for openness in its wider sense.

When empirical researchers find a positive association between their measure of openness and economic growth, they often make statements that imply that simply lowering trade barriers will promote growth. It is clear from the work of Rodriguez and Rodrik that such a claim cannot be supported from existing cross-country studies. The

<sup>9</sup> Malaysia is defined as open by the Sachs-Warner criterion.

<sup>10</sup> Amongst Sachs-Warner open economies, there is what Barro and Sala-i-Martin (1995) call 'absolute convergence': countries with the lowest initial income per capita grow the fastest, implying that their incomes per head will converge to the same level as their richer trading partners. This supports the idea that poor economies will grow faster if they are sufficiently integrated with richer countries. This view is further supported by Ben-David (1993) who found that convergence amongst European countries only became pronounced after the trade liberalization associated with the formation of the European Economic Community (EEC).

multidimensional character of openness and the tendency for its separate components to be correlated in the data make it difficult to determine whether trade liberalization on its own promotes growth. Berg and Krueger (2003), for example, point out that openness is highly correlated with 'institutional quality', broadly defined in terms of the rule of law, effectiveness of government, absence of corruption, and so on, and it is difficult to unravel their separate contributions.

A similar point is made by Baldwin (2003), who argues that 'attempting to isolate the relative importance on growth of a particular component, such as the volume of exports or liberal versus protectionist trade policies, does not seem to make much sense, since there are complex interrelationship among these types of policies that make them highly inter-correlated'. However, Berg and Krueger (2003) are more positive: 'insofar as the data do speak, they tend to single out trade openness as a particularly important reform'. They stress the fact that FDI (which most agree promotes growth) usually follows trade openness.

Winters et al. (2004) conclude their recent literature survey with this summary: 'Despite the econometric difficulties of establishing beyond doubt that openness enhances growth, the weight of experience and evidence seems strongly in that direction.' Similarly, Berg and Krueger (2003) conclude on a positive note: 'To summarize, the cross-country evidence is strong that openness causes higher incomes. This is true when openness is measured in terms of policy, as in the Sachs-Warner variable, and when it is measured as an outcome, in terms of the ratio of exports plus imports to GDP.' And even the more critical Rodriguez and Rodrik (1999) concede that there is no coherent body of evidence that openness is bad for growth.

### *Growth and Poverty*

There is considerable evidence that economic growth reduces poverty. There is nothing to suggest that in rapidly growing economies, income inequality worsens substantially enough to increase poverty. If the pattern of income distribution changes little with growth, absolute poverty is reduced because the entire distribution moves rightward in

line with the average.

Gallup et al. (1998) conclude from a cross-country regression that, on average, the incomes of the lowest quintile increase proportionately with overall average incomes. They recognize that in some countries the poor see less than proportionate growth (sometimes defined as 'anti-poor' growth) but argue that there are as many converse cases in which the poor have fared better than average. Openness—defined using the Sachs-Warner dummy—appears to have roughly the same (beneficial) effect on the growth of the incomes of the poor as on average incomes. Dollar and Kraay (2000) confirmed these results using a larger sample and more sophisticated econometric techniques. They never reject the hypothesis that the mean income of the poor is proportional to the overall mean or, with the exception of inflation, that a variety of other variables affect it only via mean income.

In a large panel of countries, Ghura et al. (2002) find the elasticity of the incomes of the poor with respect to the mean income is 0.94, close to, but in fact statistically less than, unity. Quah (2002) has argued that most of the variation in the incomes of the poor must be the result of changes in average growth, not changes in income distribution, unless the changes in income distribution are of historically unprecedented magnitudes. Quah illustrates this with the case of China. Per capita incomes grew by an average of 3.6 per cent per annum between 1980 and 1992. During this period, China's Gini coefficient rose from 0.32 to 0.38, a large increase by international standards. Despite this rise in inequality, the number of poor (using the \$2 dollar criterion) fell by some 250 million because income growth swamped the effects of rising inequality.

## Pro-Poor Liberalization and Complementary Reforms

The cross-country evidence supports the idea that trade liberalization on its own is not enough. Bannister and Thugge (2001) argue that broad-based liberalization is likely to be more pro-poor than a more focused reform, largely because the benefits will be more obvious and the costs of liberalization more widely distributed. Exchange rate flexibility will also help

minimize the effects on poverty when a country liberalizes its trade. It acts to dissipate the effects of reform throughout the economy.

Bannister and Thugge also stress a number of complementary pro-poor reforms. The first is infrastructure development. Better roads and cheaper transportation will give the poor better access to the principal markets for their products and let them benefit from opportunities that might develop as a result of trade liberalization. Encouraging the development of markets involves their deregulation and the removal of monopolies (such as state trading monopolies) that could adversely affect the poor or prevent them from receiving the benefits of trade liberalization. Furthermore, Bannister and Thugge stress the need for reforms to improve labour mobility and training. Rigidities in the labour market make it difficult for the poor to move into other occupations and take advantage of new market opportunities and to minimize the costs of trade liberalization. Worker training and other forms of assistance can help the poor who lose jobs in sectors that suffer from trade liberalization to find jobs in sectors that benefit from it.

According to Winters (2003), 'although a reasonably open trading regime is needed to relieve poverty, other issues are equally important: sound macroeconomic policy, basic health care programmes, adequate infrastructure, education, effective governance, property rights, and so forth. Open trade can help in several of these issues, but it certainly is not sufficient to achieve them.'

## Conclusions

At the conclusion of their recent survey on trade and poverty, Winters et al. (2004) offer the following helpful summary: 'There is a strong presumption that trade liberalization will be poverty alleviating in the long run and on average, and no evidence that it will generally increase poverty or vulnerability. There can be no guarantees however, and we certainly cannot be sure that static and micro-economic effects of liberalization will always be beneficial for the poor. While there are many causes for optimism, the ultimate outcome depends on many factors, and

even within most of the individual causal channels we have identified, the outcome will vary from case to case.'

In summary, trade liberalization promotes economic growth and the incomes of the poor will rise in line with the average. In any trade reform process, there are short-term winners and losers, and it is inevitable that some of the losers will be the poor. The net effect on poverty in the short run can go either way. With appropriate complementary measures, the short-run costs to the poor can be reduced. In the longer term, trade reform and openness are pro-poor, and can also help promote the global partnership for development (MDG 8).



# THE MALAYSIAN EXPERIENCE

This chapter investigates whether the Malaysian experience of trade liberalization, economic growth, and poverty reduction provides a country case study to illustrate the broad lessons from the international experience reviewed in the first chapter. It begins by summarizing the main conclusions to be drawn from the international evidence:

- Import-substitution industrialization was unsustainable.
- Trade liberalization helps promote economic growth.
- More open countries tend to attract foreign direct investment.
- There will be winners and losers from trade liberalization in the short run, so that it is important for policy makers to monitor the short-term effects, especially on poorer communities.
- Economic growth raises average incomes, so poverty can be expected eventually to fall in countries with good growth records.
- Trade liberalization on its own is not sufficient. Other pre-conditions for economic growth include effective governance, human development, especially health care and education, adequate physical infrastructure, and macroeconomic stability.

What has become known as the 'East Asian model' stresses outward-looking development and, within the region, international trade has played a significant role in sustaining growth and reducing poverty. Malaysian development has followed the East Asian model. Its openness to international trade has led to three and a half decades of rapid economic growth, structural transformation, and a spectacular decline in poverty. The details of Malaysia's enviable growth record are the focus of this chapter.

## Setting

Malaysia is an independent nation-state, a parliamentary constitutional monarchy, with a federal government structure. Malaysia was formed in 1963 from the Federation of Malaya, Sarawak and Sabah in East Malaysia, and Singapore, and following the separation of Singapore from the

Federation in 1965, the present nation of Malaysia was in place. Peninsular Malaysia is part of the Asian mainland. Sabah and Sarawak are located on the island of Borneo. Malaysia is part of archipelagic South-East Asia, with Peninsular Malaysia connected to mainland South-East Asia via the long, narrow isthmus of southern Thailand (Map 2.1).

Map 2.1

Malaysia in a Regional Context



### *Population and Socio-Economic Context*

When Malaysia attained independence from the British in 1957, the Federation of Malaya, as it was then known, had a population of just 7.4 million (Leete 1996). Its population has since grown rapidly, such that by 2005 the country had some 26.1 million people. Apart from natural

increase, population growth has been augmented by a continued and steady influx of immigrant labour, primarily from Indonesia, the Philippines, Bangladesh, and Nepal. In 2005, some 63 per cent of Malaysia's population lived in urban areas, compared with a corresponding figure of just 25 per cent in 1957.

Malaysia is a diverse and plural society. Of its three major ethnic groups, the Malays and other indigenous groups, collectively called Bumiputera (sons of the soil), currently account for 65.1 per cent; the Chinese, 26.0 per cent; and the Indians, 7.7 per cent. The population shares reflect major changes over time in favour of the Bumiputera, largely on account of their higher fertility levels. Historically, the Bumiputera were rural-based, although they have become more urban over time. By contrast, the Chinese have always been predominantly urban.

In 1957, Malaysia was a low-income agrarian economy, whose mainstays were rubber and tin production. Business was small-scale, largely localized and predominantly family-based. Over time, the economy has diversified beyond agriculture and primary commodities, such that manufactured goods now account for a larger share of GDP and total exports than is the case in some industrialized countries.

Since 1970, Malaysia's economic development strategy has been guided by three long-term policies, viz. the New Economic Policy (NEP), 1970–90; the National Development Policy (NDP), 1990–2000; and the National Vision Policy (NVP), 2001–10. While the emphasis in these three long-term development policies has always been on economic growth, development was also to benefit all groups or communities in society in an equitable manner.

The overriding objective of the NEP, maintained in the NDP and the NVP, was to maintain national unity through the eradication of poverty among the entire population and the restructuring of Malaysian society so as to reduce the identification of race with economic function and geographical location. The redistributive objective was to be achieved through a wide range of direct redistribution policies to assist the Bumiputera to obtain parity with the non-Bumiputera in income and wealth.

## Malaysia's Trade, Growth, and Poverty: An Overview

Malaysia's economy is one of the most open economies among developing countries. Exports of goods and services grew at 14 per cent per annum during the period 1971–90, and at the higher rate of some 17 per cent per annum between 1991 and 2000. As a percentage of GDP, exports of goods and services rose from 46 per cent in 1970 to 123 per cent in 2005 (Table 2.1).

Table 2.1

Exports of Goods and Services, Malaysia, 1970–2005

| Variable                                 | 1970        | 1980         | 1990         | 2000         | 2005         |
|--|-------------|--------------|--------------|--------------|--------------|
| Exports of goods and services*           | 5,389       | 30,676       | 88,675       | 427,004      | 611,082      |
| Imports of goods and services*           | 4,888       | 29,342       | 86,241       | 358,530      | 494,529      |
| GDP at purchasers' value*                | 11,829      | 53,308       | 119,081      | 343,215      | 495,239      |
| Exports of goods and services (% of GDP) | 45.6        | 57.5         | 74.5         | 124.4        | 123.4        |
| Imports of goods and services (% of GDP) | 41.3        | 55.0         | 72.4         | 104.5        | 99.9         |
| <b>Total (% of GDP)</b>                  | <b>86.9</b> | <b>112.6</b> | <b>146.9</b> | <b>228.9</b> | <b>223.2</b> |

Source of data: Malaysia, DOS, *Malaysia Economic Statistics—Time Series (2006b)*.

\* RM million.

Over the same period, Malaysia's economic growth performance has been remarkable. The economy has grown in real terms at 6 per cent or so a year (Table 2.2). Notwithstanding occasional recessions (for example, in 1985 and 1998)<sup>11</sup>, real GDP growth averaged 6.7 per cent over the period 1971–90 and 7 per cent a year over the period 1991–2000. Since 2000, real GDP growth has slowed slightly to about 5 per cent a year. It is evident that there has been a strong positive correlation between export growth and the growth in GDP.

<sup>11</sup> Demery and Demery (1991, 1992) show that Malaysia's recovery from the 1985 recession was not only rapid, but accomplished without any harmful effects on poverty and income distribution.

Table 2.2

Annual Growth Rates of Gross Domestic Product, Malaysia, 1971–2005 (%)

| Growth rate                                | 1971–5 | 1976–80 | 1981–5 | 1986–90 | 1991–5 | 1996–2000 | 2001–5 |
|--|--------|---------|--------|---------|--------|-----------|--------|
| Average annual growth rate of real GDP (%) | 7.1    | 8.6     | 5.8    | 6.7     | 8.7    | 4.7       | 4.5    |

Sources of data: Malaysia, EPU, Five-Year Plans (various years).

The central theme of the NEP, the NDP, and the NVP has been economic growth with equity. In 1970, about half (49.3 per cent) of Malaysian households were poor, the majority being Bumiputera who were predominantly rural. Over time, poverty rates have tumbled and by 2004 just 5.7 per cent of households were below the national poverty line.<sup>12</sup> In the post-1970 period, there have been episodes of rising and falling inequality, although taking the three and a half decades together, income inequality narrowed, the Gini coefficient falling from 0.52 in 1970 to 0.462 in 2004.

The openness of the Malaysian economy, its rapid economic growth, and the substantial reduction in poverty rates suggest that Malaysia provides a good illustration (at country level) of the evidence reviewed in Chapter 1. This chapter reviews the Malaysian experience under three broad headings: (a) Trade Policy, (b) Structural Transformation, and (c) Poverty and Income Inequality.

## Malaysia's Trade Policy

The rapid expansion of Malaysia's external sector has been largely the result of the trade policies pursued by successive governments. The broad objectives and strategies of the country's international trade policies as they have evolved over time are set out in Box 2.1.

<sup>12</sup> The poverty line income in 2004 was, in 'real' terms, higher than that used in 1970.

### Box 2.1 International Trade Objectives, Strategies, and Policies in Malaysia's National Plans

| Period  | Objectives and Strategies   | Policies  |
|---|---|---|
| <p><b>PRE-NEP<br/>1960–1970</b></p> <p>First Malaysia Plan,<br/>1966–1970</p>   | <p>Fuller and more efficient use of natural resources.</p> <p>Expansion of economic base to reduce dependence on raw material exports.</p> <p>Generation of higher income through expanding domestic production and increasing exports of manufactured products.</p>  | <ul style="list-style-type: none"> <li>• Promotion of traditional and new export possibilities.</li> <li>• Industrial development led by private sector.</li> <li>• Favourable investment climate, industrial estates, and transport; power and communication provided by government.</li> <li>• Foreign private entrepreneurship and capital welcomed.</li> <li>• Techniques of production evolved.</li> <li>• Protective tariffs for selected infant industries.</li> <li>• Tax incentives and subsidies to facilitate industrial development.</li> </ul>   |
| <p><b>NEP; OPP1<br/>1971–1990</b></p> <p>Second Malaysia Plan,<br/>1971–1975</p> <p>Third Malaysia Plan,<br/>1976–1980</p> <p>Fourth Malaysia Plan,<br/>1981–1985</p> <p>Fifth Malaysia Plan,<br/>1986–1990</p> | <p>Based on two-pronged approach of</p> <ul style="list-style-type: none"> <li>• poverty eradication and</li> <li>• restructuring of society.</li> </ul> <p>Increased production for export, including new industrial and agricultural items.</p> <p>Greater processing of raw materials.</p> <p>Further substitution of domestic production for imports.</p> <p>Malaysia Incorporated—emphasizing cooperation between government and private sector.</p> | <ul style="list-style-type: none"> <li>• Increased direct government participation in industrial development.</li> <li>• Improved export incentives.</li> <li>• Free trade and export processing zones established.</li> <li>• Promotional and publicity efforts by government to attract foreign capital and expertise.</li> <li>• Promotion of domestic production of intermediate and capital goods.</li> <li>• Emphasis on productivity increases and more intensive production methods.</li> <li>• Progressive and selective privatization of government services.</li> <li>• Overall protection in industry reduced to a reasonable level.</li> <li>• Encouraging joint ventures with international corporations, using foreign technology and local resources.</li> <li>• Ensuring availability of finance for exports.</li> <li>• Liberalized equity guidelines.</li> </ul> |
| <p><b>NDP; OPP2<br/>1991–2000</b></p> <p>Sixth Malaysia Plan,<br/>1991–1995</p> <p>Seventh Malaysia Plan,<br/>1996–2000</p>   | <p>Promotion of a balanced, broad-based, resilient, and internationally competitive economy.</p> <p>Enhance potential output growth, achieve further structural transformation, and attain balanced development.</p> <p>Moving towards capital-intensive and technologically sophisticated industries.</p>  | <ul style="list-style-type: none"> <li>• Accelerating productivity and efficiency, primarily through private sector initiatives.</li> <li>• Accelerating the diversification of industries.</li> <li>• Reorientating industries to target production for the world market.</li> <li>• Encouraging large-scale production for economies of scale.</li> <li>• Further liberalization and deregulation of industries.</li> <li>• Development of a modern, competitive, and technologically innovative small and medium industry (SMI) sector.</li> <li>• Greater role of trade and industry associations to improve standards and quality.</li> <li>• Establishment of new trade networks, especially within regional trade blocs.</li> <li>• Development of industrial estates.</li> </ul>  |
| <p><b>NVP; OPP3<br/>2001–2010</b></p> <p>Eighth Malaysia Plan,<br/>2001–2005</p> <p>Ninth Malaysia Plan,<br/>2006–2010</p>  | <p>Greater responsiveness to challenges and opportunities from global competition.</p> <p>Enhance position as strategic and cost-effective location for foreign investment.</p> <p>Improve knowledge management, accumulate new skills, and change mindsets.</p>  | <ul style="list-style-type: none"> <li>• Developing domestic industries to be globally competitive.</li> <li>• Strengthening resilience to external shocks.</li> <li>• Focus on more efficient use of labour and capital as well as improvement in skills, technology, and managerial capability.</li> <li>• Greater application of information and communications technology and knowledge.</li> <li>• Increased intra-regional trade using AFTA and other bilateral arrangement mechanisms.</li> <li>• Identifying and developing new sources of growth, particularly in services, to become the regional centre or hub.</li> </ul>   |

The key phases of Malaysia's trade policy, and its evolution over time, can be summarized in four phases:

- Phase I: Import substitution to encourage the growth of domestic industries that produced simple consumer goods (1957–70). Like many developing countries, Malaysia started its industrial development by adopting an import-substitution strategy. Tariffs were mostly for protecting infant industries producing consumer durables. Moderate tariff protection was the key instrument used to encourage new investment in manufacturing. The protection afforded domestic manufacturers was not great. The average tariff rate in 1965 was estimated at only 13.0 per cent. Very few quantitative restrictions were used to limit imports.
- Phase II: From 1970 to 1980, export-oriented industrialization was introduced, FTZs were established and tariffs were gradually reduced. Protectionist measures practised during the import-substitution phase were mild, which made the transformation from import substitution to export-orientated industrialization relatively smooth. Incentives were granted to encourage manufactured exports, partly linked to export performance.
- Phase III: From 1980 to 1985, Malaysia introduced a second round of import-substitution measures for heavy industries, such as for the automobile, petrochemical, iron and steel, and cement industries. Under this policy, high protection was given for the chosen industries in the form of high import duties, or import restrictions for competing products.<sup>13</sup> Tariffs on a wide range of manufactured goods were substantially increased in the first half of the 1980s as part of the move towards heavy industrialization. The average effective rate of protection increased from about 25 per cent in the early 1960s to 70 per cent in the early 1980s.

<sup>13</sup> This policy is best illustrated by the tariff structure of the automotive industry. With the advent of the first national car, Proton, the import of completely built cars was limited by a predetermined number. In addition, the import duty of completely knocked down parts for non-national cars was raised while the national car enjoys a lower duty for similar imports. The protection for the national car industry has since been modified under the requirement of the AFTA.

- Phase IV: From 1985 to the present, the economic crisis of 1985–7 led to the introduction of a structural adjustment reform package, including significant tariff reductions and the removal of quantitative restrictions. As a result, the average effective rate of manufacturing protection declined to below 30 per cent by the late 1980s. From the late 1980s, further tariff reductions were introduced as part of the common effective preferential tariff (CEPT) of the ASEAN Free Trade Agreement (AFTA) and a second round of export-orientation through a cluster-based approach was initiated. More recently, Malaysia's initiative to sign bilateral FTAs with major trading partners is bringing about further liberalization of its trade regime. By 2005, there were only limited restrictions being applied in Malaysia's trade policy. These are largely found on selected products, such as rice and the automotive industry.

Phase IV in particular has seen a substantial liberalization in Malaysia's international trade. At the time of independence, import duties were imposed mainly as a revenue-raising measure. In the late 1960s and especially in the 1970s, more tariffs were imposed to protect the emerging import-substituting industries, but incentives were also granted to export-oriented industries and exports were not penalized. Overall, however, tariff protection was kept at a low and modest level. The coverage of the tariffs was gradually reduced in the late 1980s and 1990s, especially with the launching of the AFTA and the commitments made to the WTO for greater liberalization. Malaysia's tariff regime currently compares favourably with many other Asian countries (Table 2.3).

The decline in average tariff rates masks some sectoral variations. For items related to the agriculture sector, Malaysia's tariff rates stand at less than 5 per cent, with particularly low rates for live animals (less than 4 per cent) and fruit and vegetable products (about 2 per cent). The tariff rates for fats and oils, mineral products, chemicals, as well as wood and wood articles do not exceed 2 per cent. Optical and precision instruments also attract tariff rates that are below 2 per cent.

In some sectors, however, average tariff rates are relatively high, giving protection to particular industries. Relatively high tariff rates are maintained in prepared foodstuffs (11 per cent); plastics (15 per cent); textiles and apparel (17 per cent); footwear (19 per cent); and vehicles (53 per cent).

**Table 2.3** Weighted Mean Tariff Barriers, Selected Asian Countries, c.1990 and c.2004 (%)

| Country         | Year        | All Products | Primary Products | Manufactured Products |
|-----------------|-------------|--------------|------------------|-----------------------|
| China           | 1992        | 32.1         | 14.1             | 35.6                  |
|                 | 2004        | 6.0          | 5.6              | 6.0                   |
| India           | 1990        | 56.1         | 34.1             | 70.8                  |
|                 | 2004        | 28.0         | 36.9             | 25.3                  |
| Indonesia       | 1989        | 13.0         | 5.9              | 15.1                  |
|                 | 2003        | 5.2          | 3.1              | 5.8                   |
| Japan           | 1988        | 3.6          | 4.4              | 2.7                   |
|                 | 2004        | 2.4          | 3.9              | 1.6                   |
| Korea Rep. of   | 1988        | 14.0         | 8.3              | 17.0                  |
|                 | 2002        | 10.0         | 19.0             | 5.0                   |
| <b>Malaysia</b> | <b>1988</b> | <b>9.7</b>   | <b>4.6</b>       | <b>10.8</b>           |
|                 | <b>2003</b> | <b>4.2</b>   | <b>2.1</b>       | <b>4.6</b>            |
| Pakistan        | 1995        | 44.4         | 36.1             | 49.2                  |
|                 | 2004        | 13.0         | 8.9              | 15.7                  |
| Philippines     | 1988        | 22.4         | 18.5             | 23.4                  |
|                 | 2003        | 2.6          | 5.0              | 2.0                   |
| Singapore       | 1989        | 1.1          | 2.5              | 0.6                   |
|                 | 2003        | 0.0          | 0.0              | 0.0                   |
| Thailand        | 1989        | 33.0         | 24.3             | 35.0                  |
|                 | 2003        | 8.3          | 4.4              | 9.3                   |
| Vietnam         | 1994        | 20.6         | 46.7             | 13.1                  |
|                 | 2004        | 13.7         | 16.7             | 12.5                  |

Source of data: World Bank (2005).

Malaysia's tariff rates remain high for vehicles, far higher than those of its neighbours. This is a striking case, since it highlights how prolonged protection can damage an industry's export competitiveness. The automobile industry in Malaysia has been heavily protected and has not been exposed to the discipline of foreign competition. The domestic market in Malaysia was too small to reap the essential benefits of economies of scale and, as a consequence, the Malaysia automobile industry would find it hard to compete with producers from the rest of the world without the protection of tariffs.

### *Composition of Exports and Imports*

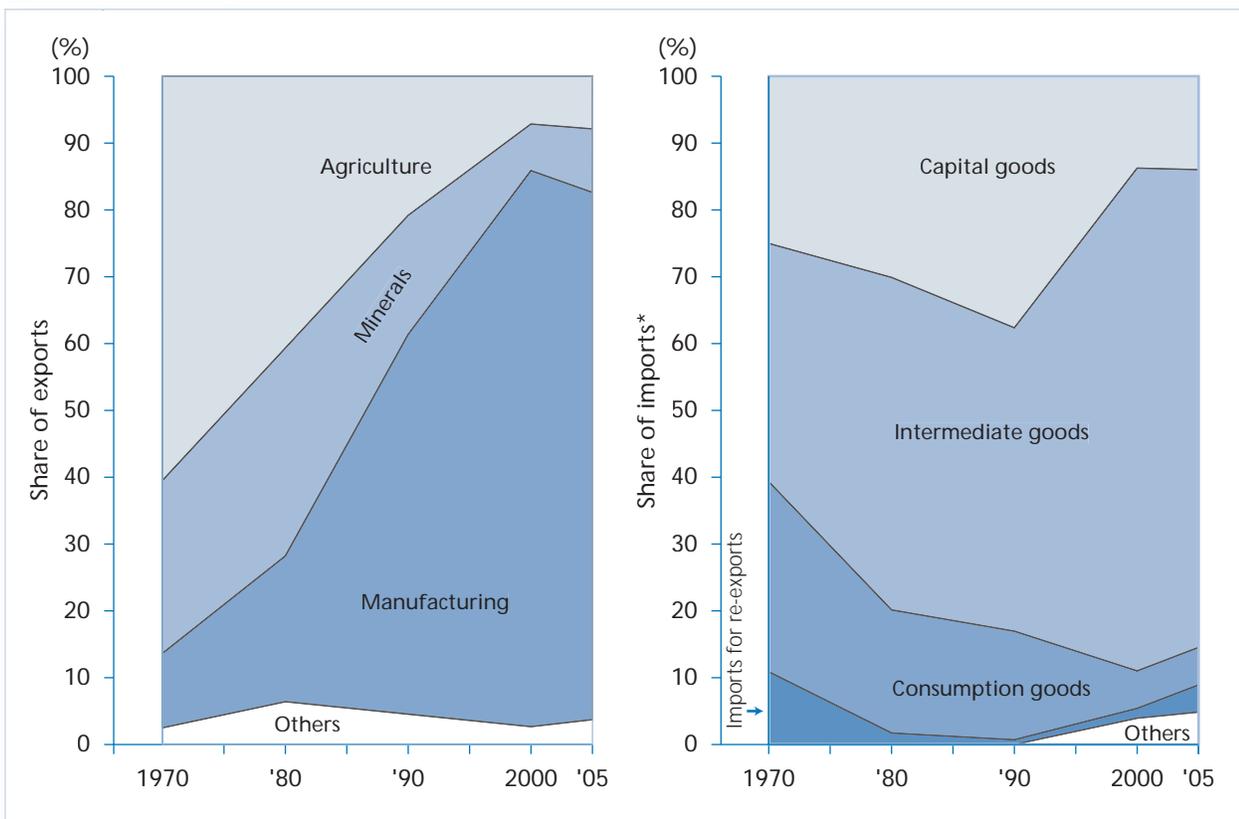
As a consequence of Malaysian trade policy, both the pattern of exports and the direction of trade have shown very significant changes. Particularly dramatic were the changes in the composition of exports. In

the 1970s, rubber, palm oil, and forestry products were the main export earners. In 1970, these three primary products together contributed as much as 55 per cent of exports, with the manufacturing sector accounting for a mere 12 per cent (Figure 2.1).

From the 1980s onwards, manufactured goods have dominated Malaysian exports, while forestry, rubber, and oil palm jointly have diminished in importance. The share of manufactures in total exports rose to 81 per cent in 2005. Within the manufacturing sector, the electrical and electronics subsector has become ever more important. And the growing importance of manufacturing has led to changes in the pattern of imports, with a growing share of intermediate goods (less than half in 1970 to almost three quarters in 2005) and a declining share of consumption goods (Figure 2.1).

Figure 2.1

Structure of Merchandise Trade, Malaysia, 1970–2005



Sources of data: Bank Negara Malaysia, Annual Report (various years).  
\* Data for 1970 to 1990 are based on imports by economic function and starting 2000, data are based on broad economic categories.

The petroleum industry plays a strategic role in the Malaysian economy, accounting for about 4 per cent of Malaysia's exports in 2005. It is also a major contributor to government revenue (Box 2.2).

### Box 2.2 Malaysia's Petroleum Industry

Petroleum exploration in Malaysia started at the beginning of the twentieth century in Sarawak, where oil was first discovered in 1909, and first produced in 1910. Before 1975, petroleum concessions were granted by state governments, with oil companies being given exclusive rights to explore and produce resources. Oil-producing companies then paid royalties and taxes to the Government.

In 1974, Malaysia's national petroleum corporation, Petroliaam Nasional Berhad (Petronas) was established. Petronas is wholly owned by the Malaysian Government. It is vested with the entire oil and gas resources in Malaysia and is entrusted with the responsibility of developing and adding value to these resources. Since its incorporation, Petronas has grown to be an integrated international oil and gas company with business interests in more than 30 countries.

Petronas plays a strategic role in the Malaysian economy, accounting for about 4 per cent of Malaysia's exports in 2005. The petroleum industry makes an increasing and substantial contribution to government revenues through taxes, royalties, and dividends- accounting for 29 per cent in 2005 compared with just 8 per cent in 1975.

| Federal Government Revenue Source     | 1975 * | 1980  | 1990  | 2000   | 2005   |
|---------------------------------------|--------|-------|-------|--------|--------|
| Petroleum income tax                  | 322    | 1,736 | 2,644 | 6,010  | 14,566 |
| Petroleum royalty/gas                 | 78     | 345   | 627   | 1,763  | 3,293  |
| Total revenue from petroleum industry | 400    | 2,758 | 7,481 | 12,869 | 30,872 |
| % of total Federal Government revenue | 7.8    | 19.8  | 25.3  | 20.8   | 29.0   |

Sources of data: Malaysia, Treasury, <http://www.treasury.gov.my>; Bank Negara, Monthly Statistical Bulletin (2006c).  
\*Figures in millions of RM.

Additionally, Petronas has made major investments in companies and projects that are peripheral to its core hydrocarbon business. As at end of October 2005, the PETRONAS Group comprised 101 wholly-owned subsidiaries, 19 partly-owned firms and 57 associated companies.

### Direction of Trade

Trade policies have also had a significant effect on the direction of trade. In line with the commitment to open regionalism, Malaysia continued its active participation in the Association of South-East Asian Nations (ASEAN), Asia-Pacific Economic Cooperation (APEC), and the Asia-Europe Meeting (ASEM). Participation aims, inter alia, at fostering cooperation in a broad range of regional and global trade issues (Box 2.3). Malaysia is also active in subregional initiatives within ASEAN that contribute to increased trade, notably the Indonesia-Malaysia-Thailand Growth Triangle and the Brunei-Indonesia-Malaysia-the Philippines-East Asian Growth Area.

### Box 2.3 Trade Policy Agreements

Malaysia is the world's eighteenth largest exporting and twentieth largest importing nation. As is to be expected of a country with these attributes, its trade policy is to pursue multilateral trade liberalization through the WTO. Only a rules-based multilateralism provides the predictability and transparency that a small developing country with limited leverage and negotiating power requires. Given the difficulties and protracted nature of the WTO's 149 members reaching consensus, however, Malaysia and other countries are complementing the multilateral approach with regional and bilateral trading arrangements. The WTO allows such arrangements provided that tariffs are substantially eliminated on all trade and that they are not more trade-restrictive to countries that are not party to the arrangement. In this way, the pursuit of regional and bilateral free trade agreements (FTA) can be considered as building blocks to freer world trade.

The FTAs that Malaysia pursues include not only trade in goods but also services. The country has gone further to negotiate closer economic partnership/cooperation (CEP/CEC) agreements, or agreements that, in addition to trade in goods and services, also include investment, trade facilitation, and other areas of economic cooperation. Other areas of economic cooperation cover competition policies, protection of intellectual property rights, standards development, conformity assessments, education and training, research and development, small and medium enterprises (SMEs) development, and so forth. Malaysia is at various stages of negotiating/implementing the following:

#### *Multilateral*

WTO Doha Development Round (2001)

#### *Regional*

ASEAN–China FTA (2002–2010/15)  
ASEAN–Australia and New Zealand CEP (2002–7)  
ASEAN–India CEC (2003–2011/16)  
ASEAN–Japan CEP (2003–12)  
ASEAN Economic Community (2003–20)  
ASEAN–Republic of Korea FTA (2004)

#### *Bilateral*

Malaysia–Japan Economic Partnership Agreement (EPA) (2003–2005)  
Malaysia–India CEC (2004)  
Malaysia–Australia FTA (2004–)  
Malaysia–New Zealand FTA (2004–)  
Malaysia–United States FTA (2006)

#### *Others*

Global System of Trade Preferences Among Developing Countries (GSTP)(1989)  
Trade Preferential System Among Organization of the Islamic Conference (TPS–OIC) (2004)  
Preferential Trading Arrangement (PTA) Among Group of Developing Eight (D8) (2004)

As the importance of the manufacturing sector has grown, the USA has become a critically important destination for Malaysia's exports, accounting for about one-fifth of the country's value of exports in 2005 (Table 2.4). Exports to China and Hong Kong have also grown markedly. The shares of exports to the European Union (EU) and Japan have declined.

In 1970, imports from countries of the EU and Japan made up some 41 per cent of Malaysia's total imports; by 2005, the corresponding figure was just 26 per cent. In contrast, imports from ASEAN countries and from the USA have grown substantially in share (Table 2.4).

| Country/<br>Regional group | 1970                         |                              | 1980                          |                               | 1990                          |                               | 2000                           |                                | 2005                           |                                |
|----------------------------|------------------------------|------------------------------|-------------------------------|-------------------------------|-------------------------------|-------------------------------|--------------------------------|--------------------------------|--------------------------------|--------------------------------|
|                            | Exports                      | Imports                      | Exports                       | Imports                       | Exports                       | Imports                       | Exports                        | Imports                        | Exports                        | Imports                        |
| USA                        | 13.0                         | 8.5                          | 16.4                          | 15.0                          | 16.9                          | 16.7                          | 20.5                           | 16.6                           | 19.7                           | 12.9                           |
| Europe Union               | 19.2                         | 23.0                         | 16.9                          | 15.4                          | 14.9                          | 14.6                          | 13.7                           | 10.8                           | 11.7                           | 11.6                           |
| United Kingdom             | 6.6                          | 13.4                         | 2.8                           | 5.4                           | 3.9                           | 5.5                           | 3.1                            | 2.0                            | 1.8                            | 1.5                            |
| Germany and Netherlands    | 6.3                          | 5.9                          | 9.6                           | 6.0                           | 6.5                           | 5.0                           | 6.7                            | 3.7                            | 5.4                            | 5.2                            |
| Australia                  | 2.2                          | 5.5                          | 1.4                           | 5.5                           | 1.7                           | 3.7                           | 2.5                            | 1.9                            | 3.4                            | 1.9                            |
| Japan                      | 18.2                         | 17.7                         | 22.8                          | 22.9                          | 15.8                          | 24.0                          | 13.1                           | 21.0                           | 9.4                            | 14.5                           |
| Republic of Korea          | n/a                          | n/a                          | n/a                           | n/a                           | 4.6                           | 2.6                           | 3.3                            | 4.5                            | 3.4                            | 5.0                            |
| China                      | 1.3                          | 5.2                          | 1.7                           | 2.4                           | 2.1                           | 1.9                           | 3.1                            | 4.0                            | 6.6                            | 11.5                           |
| Hong Kong                  | 1.2                          | 2.1                          | 1.9                           | 1.4                           | 3.2                           | 1.9                           | 4.5                            | 2.7                            | 5.8                            | 2.5                            |
| Taiwan Province of China   | n/a                          | n/a                          | n/a                           | n/a                           | 2.2                           | 5.5                           | 3.8                            | 5.6                            | 2.8                            | 5.5                            |
| ASEAN                      | 24.7                         | 15.6                         | 22.4                          | 16.4                          | 28.9                          | 18.9                          | 26.5                           | 24.1                           | 25.8                           | 24.5                           |
| Singapore                  | 21.5                         | 7.2                          | 19.1                          | 11.7                          | 22.7                          | 14.9                          | 18.4                           | 14.4                           | 15.6                           | 11.7                           |
| India                      | 0.4                          | 1.5                          | 2.2                           | 0.9                           | 1.6                           | 0.7                           | 2.0                            | 0.9                            | 2.8                            | 1.0                            |
| Other countries            | 19.8                         | 20.9                         | 14.3                          | 20.0                          | 8.1                           | 9.5                           | 7.1                            | 8.0                            | 8.6                            | 9.1                            |
| <b>Total (RM million)</b>  | <b>100.0</b><br><b>5,163</b> | <b>100.0</b><br><b>4,289</b> | <b>100.0</b><br><b>28,172</b> | <b>100.0</b><br><b>23,451</b> | <b>100.0</b><br><b>79,646</b> | <b>100.0</b><br><b>79,119</b> | <b>100.0</b><br><b>373,270</b> | <b>100.0</b><br><b>311,459</b> | <b>100.0</b><br><b>533,790</b> | <b>100.0</b><br><b>434,030</b> |

Sources of data: Bank Negara, *Monthly Statistical Bulletin* (2002 and 2006b); *Quarterly Economic Bulletin* (various years).

## FDI and FTZs

Chapter 1 noted that, according to Berg and Krueger (2003), FDI usually follows trade openness. The Malaysian experience is a good example. Malaysia has always welcomed FDI and it has played a central part in Malaysia's economic restructuring and poverty reduction.

Malaysia provided various incentives to attract FDI inflows, including liberal tax policies, unrestricted profit remittances, and repatriation of capital related to FDI, coupled with liberalization of

equity rules. The multinational corporations (MNCs) were targeted and industrial promotion missions led by the Malaysian Industrial Development Authority (MIDA) were launched for this purpose. Many of the leading MNCs based in the USA, Japan, and Europe invested in Malaysia. Malaysia continues to attract sizable FDI flows, although with substantial annual variations (Table 2.5).

Table 2.5

Foreign Investment in Approved Projects, Malaysia, 1980–2005

| Year | Total Investment (RM million) |
|------|-------------------------------|
| 1980 | 730                           |
| 1985 | 959                           |
| 1990 | 17,629                        |
| 1995 | 9,144                         |
| 2000 | 19,849                        |
| 2004 | 13,144                        |
| 2005 | 17,883                        |

Source of data: Bank Negara, *Monthly Statistical Bulletin* (2006b).

The Government used a mix of incentives to make Malaysia a favourable location for MNCs. Fiscal incentives in the form of tax holidays and pioneer status were extended to MNCs that located in the FTZs. These FTZs were essentially export enclaves which supported the promotion of the export-oriented industries, thus keeping their transaction costs low. Infrastructure facilities were also provided to the manufacturing industries in the FTZs.

Malaysia did not have labour unions in the electronics and electrical industry. In addition, an abundant supply of reasonably educated and relatively inexpensive labour was available to the MNCs, particularly in the 1980s. The demand for unskilled labour in the electronics and electrical subsector helped mop up the excess labour that would otherwise have contributed to the poverty in the rural areas. Export-oriented manufacturing continues to drive growth, providing employment for unskilled and semi-skilled workers and, thereby, contributing to poverty eradication (Box 2.4).

**Box 2.4 How Did Malaysia's Free Industrial Zones Help Reduce Poverty?**

**F**ree industrial zones (FIZs) are designated areas where companies manufacture and export products without being subject to customs and excise duties and sales and service taxes. The Free Zone Act 1990 allows for the establishment of FIZs (previously known as FTZs) for manufacturing and free commercial zones (FCZs) for repackaging, trading, and transit activities. FIZs and FTZs are used here interchangeably.

Malaysia adopted a policy of establishing such areas when it was apparent that import-substitution strategies were not going to result in high levels of manufacturing output, investment, employment, and technology. Given the primacy of the poverty-eradication objective in the 1970 NEP, labour absorption, especially of rural unemployed and underemployed, took on an added urgency. In that year, official unemployment stood at 8 per cent of the labour force, with most of the lesser developed northern states of Peninsular Malaysia registering higher figures. FIZs were seen as a means of achieving a number of policy objectives simultaneously, the most important of which was that of job creation.

The first FIZ was established in Bayan Lepas, Penang in 1972. By the end of 1973, 28 firms had located in FIZs, employing 21,200 workers or 7 per cent of the total manufacturing workforce. In 1984, there were a total of 10 FIZs with 104 firms and 81,700 workers. This represented about 10 per cent of the total. FIZs also contributed strongly to the growth of manufactured exports, particularly of electronic, electrical, and textile and apparel products. From 1973 to 1983, FIZ exports grew by an average of 37 per cent a year and accounted for more than half of all manufactured exports by the mid-1980s. Malaysia's FIZs have generated returns that are well above the economic (opportunity) costs of inputs.

FIZs have, however, been the subject of some controversy. Among the many issues (including working conditions, health and safety standards, labour restrictions, inter-industry linkages, and technology transfer), one that is of direct relevance to the poverty question is worker compensation. Put simply, do FIZ workers earn more, less, or the same as workers outside FIZs?

Working with a relatively limited sample survey, Datta-Chaudhuri (1982) examined the average monthly earnings of female FIZ employees in 1980 and found them to be 'lower than for unskilled workers in plantation agriculture or urban modern sector service jobs'. Females account for over 70 per cent of the FIZ workforce, with most being young and Bumiputera. Rasiah (1993) came to the opposite conclusion when analysing later data from 1988. He found that 'foreign firms in Malaysian FTZs pay considerably higher wages than most local firms'. His finding was supported by the World Bank (1992), which found that wages in the FTZs of developing countries tended to be not only equal to or higher than those outside the zones, but also higher than the opportunity costs of most of those employed.

FIZs thus help break the poverty cycle. Labour market conditions may not be immediately conducive to FIZ firms paying much above the general market for unskilled labour but, over time and with depleting stocks of unskilled labour and greater competition for workers, firms can be expected to bid up wages in order to attract better workers. Their larger scale of production and higher productivity mean that they are able to afford to pay well when demand conditions warrant. The downside is that FIZ workers are also more likely to be laid off in times of recession or industry consolidation.

Malaysia's success at reducing poverty is a direct result of the early creation of non-agricultural employment (NAE) opportunities, particularly in the FIZs and especially for females. NAE made it possible for many more dual-income households to be established and for greater income supplementation. More than any factor, however, Athukorala (1996) argues that it was the increase in the real wages of unskilled labour that was responsible for the overall reduction in poverty in the country.

Since 1980, Malaysia has maintained an open policy towards trade and investment, with FDI playing a crucial role in capital formation and the development of the economy (Ariff 1992). FDIs have been a significant instrument in employment creation and, through it, poverty reduction. This is particularly so because unskilled labour inputs were drawn from the rural areas, where the incidence of poverty was high, to the assembly lines in the FTZs located in the urban centres.

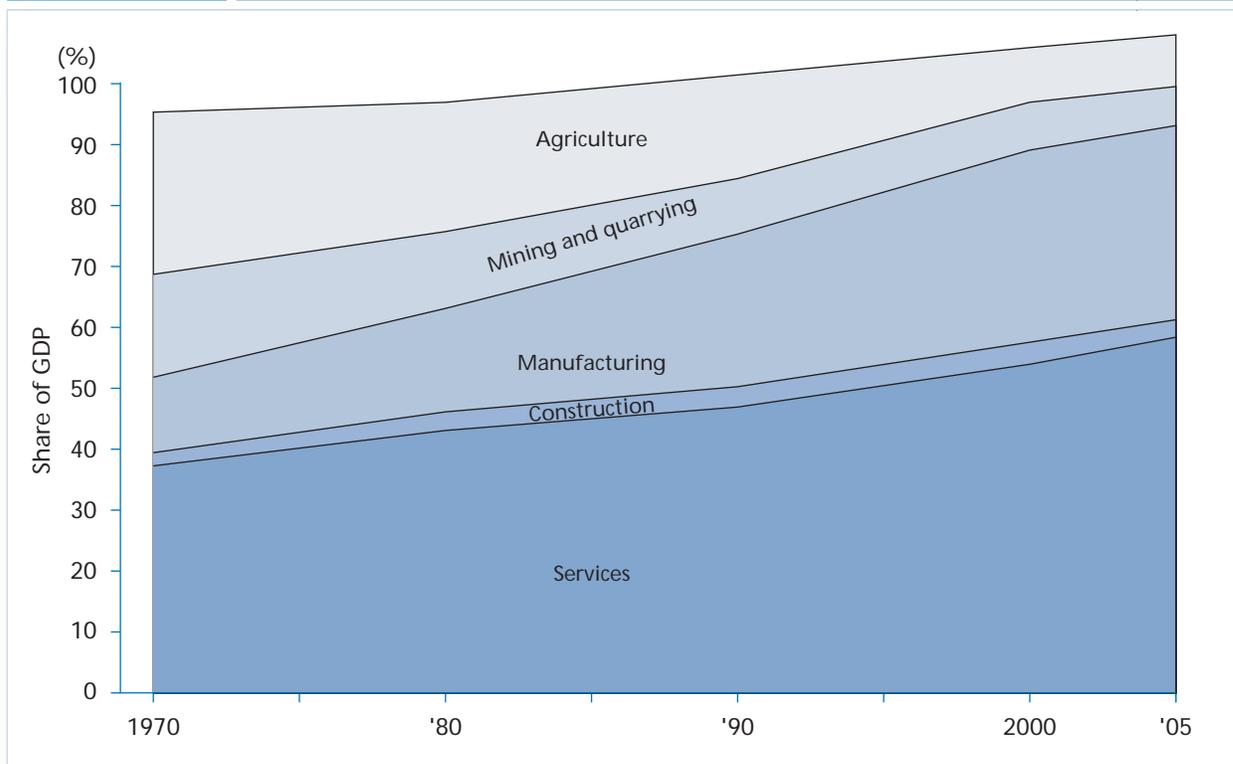
Malaysia was favourably disposed to attracting FDI and this was especially true after the recession of 1985 and with the First and Second Industrial Master Plans (1986–95 and 1996–2005). The overriding importance given to FDI can be noted from the flexibility with which the Industrial Coordination Act (ICA) was implemented. The ICA was introduced in 1975, and it was ostensibly aimed at ensuring that Bumiputera equity participation targets were met in the manufacturing sector. Nevertheless, firms with full foreign ownership were still operating in the FTZs after the enactment of the ICA (Rasiah 1993). The Government was pragmatic, willing to waive NEP targets in the larger interest of making Malaysia a favoured destination for the inflow of FDI. Following the drop in FDI inflows into Malaysia subsequent to the East Asian financial crisis, equity constraints were eased and export conditions in the manufacturing sector improved (Tham 2003).

## Structural Transformation

Progressive trade liberalization and the inflow of FDI have had significant effects not only on Malaysia's economic growth (as already noted), but also on its structure. Malaysia has experienced a dramatic transformation of its economy, changing it from a largely raw material producer to a manufacturing-based one (Figure 2.2). In 1975 the share of the agriculture sector in GDP was 24.5 per cent and that of the manufacturing sector was 15.3 per cent. By 2005, however, the share of agriculture in GDP had shrunk to 8.2 per cent, while that of manufacturing had risen to 31.6 per cent. Manufacturing value added in 2005 was more than 3 times larger than that of the agriculture sector. Throughout the period, the service sector has been the main contributor to GDP, accounting for almost 60 per cent by 2005.

Figure 2.2

Gross Domestic Product by Industry of Origin, Malaysia, 1970–2005 (%)



Sources of data: Malaysia, DOS, National Product and Expenditure Accounts (various years); Bank Negara (2006b).  
 Note: The above do not add to 100%. Imputed bank service charges have not been deducted and import duties have not been included.

### **Economic Growth and Employment**

With the changing patterns of exports and domestic production, it is no surprise that employment patterns also changed significantly as a result, with substantial favourable knock-on effects on poverty. Agriculture declined in importance as a source of employment. Its share shrank from over 40 per cent of total employment in 1975 to only 20 per cent at the end of the century and below 15 per cent in 2004 (Table 2.6). By contrast the share of total employment in manufacturing rose from 15 per cent in 1975 to over 20 per cent in 2004.

Growth in the manufacturing sector has also been linked to the strong growth in other modern sectors of employment, such as business and financial services. The transfer of Malaysia's workforce from low-

Table 2.6

Employment by Sector, Malaysia, 1975–2004

| Sector  | Percentage distribution by sector |                |                |              |                |                |                |
|---|-----------------------------------|----------------|----------------|--------------|----------------|----------------|----------------|
|   | 1975                              | 1980           | 1985           | 1990         | 1995           | 2000           | 2004           |
| Agriculture, forestry, hunting, and fishing     | 42.4                              | 37.2           | 30.4           | 26.0         | 20.0           | 18.4           | 14.8           |
| Mining and quarrying                            | 1.0                               | 1.0            | 0.8            | 0.6          | 0.4            | 0.3            | 0.3            |
| Manufacturing                                   | 15.0                              | 16.1           | 15.0           | 19.9         | 23.3           | 22.8           | 20.3           |
| Construction                                    | 4.6                               | 5.7            | 7.4            | 6.3          | 8.0            | 8.6            | 8.9            |
| Electricity, gas, and water supply              | 1.0                               | 1.4            | 0.6            | 0.7          | 0.6            | 0.5            | 0.6            |
| Wholesale, retail trade, hotels and restaurants | 13.8                              | 14.5           | 17.6           | 18.2         | 17.9           | 19.2           | 23.1           |
| Transport, storage and communication            | 4.1                               | 4.4            | 4.3            | 4.5          | 4.7            | 4.5            | 5.3            |
| Services  | 18.0                              | 19.8           | 23.9           | 23.7         | 25.1           | 25.7           | 26.7           |
| <b>Total employed (000s)</b>                    | <b>3,567.2</b>                    | <b>4,787.6</b> | <b>5,653.3</b> | <b>6,685</b> | <b>7,644.9</b> | <b>9,321.7</b> | <b>9,986.4</b> |
|   | Average annual growth rate (%)    |                |                |              |                |                |                |
|   | 1975–80                           | 1980–85        | 1985–90        | 1990–95      | 1995–00        | 2000–04        |                |
| Agriculture, forestry, hunting, and fishing     | -1.8                              | -0.7           | 0.2            | -2.6         | 2.3            | -3.7           |                |
| Mining and quarrying                            | 1.9                               | -0.9           | -2.5           | -3.8         | -3.4           | 6.0            |                |
| Manufacturing                                   | 5.9                               | 2.0            | 9.0            | 5.8          | 3.5            | -1.2           |                |
| Construction                                    | 6.6                               | 8.6            | 0.2            | 7.3          | 5.4            | 2.7            |                |
| Electricity, gas, and water supply              | 9.8                               | -14.7          | 8.3            | 0.1          | 0.0            | 4.4            |                |
| Wholesale, retail trade, hotels and restaurants | 3.8                               | 7.2            | 4.0            | 2.4          | 5.3            | 6.3            |                |
| Transport, storage and communication            | 3.9                               | 3.1            | 4.3            | 3.4          | 3.3            | 5.7            |                |
| Services  | 4.9                               | 7.1            | 3.2            | 3.8          | 4.5            | 2.7            |                |
| <b>Total</b>                                    | <b>2.4</b>                        | <b>3.3</b>     | <b>3.4</b>     | <b>2.7</b>   | <b>4.0</b>     | <b>1.7</b>     |                |

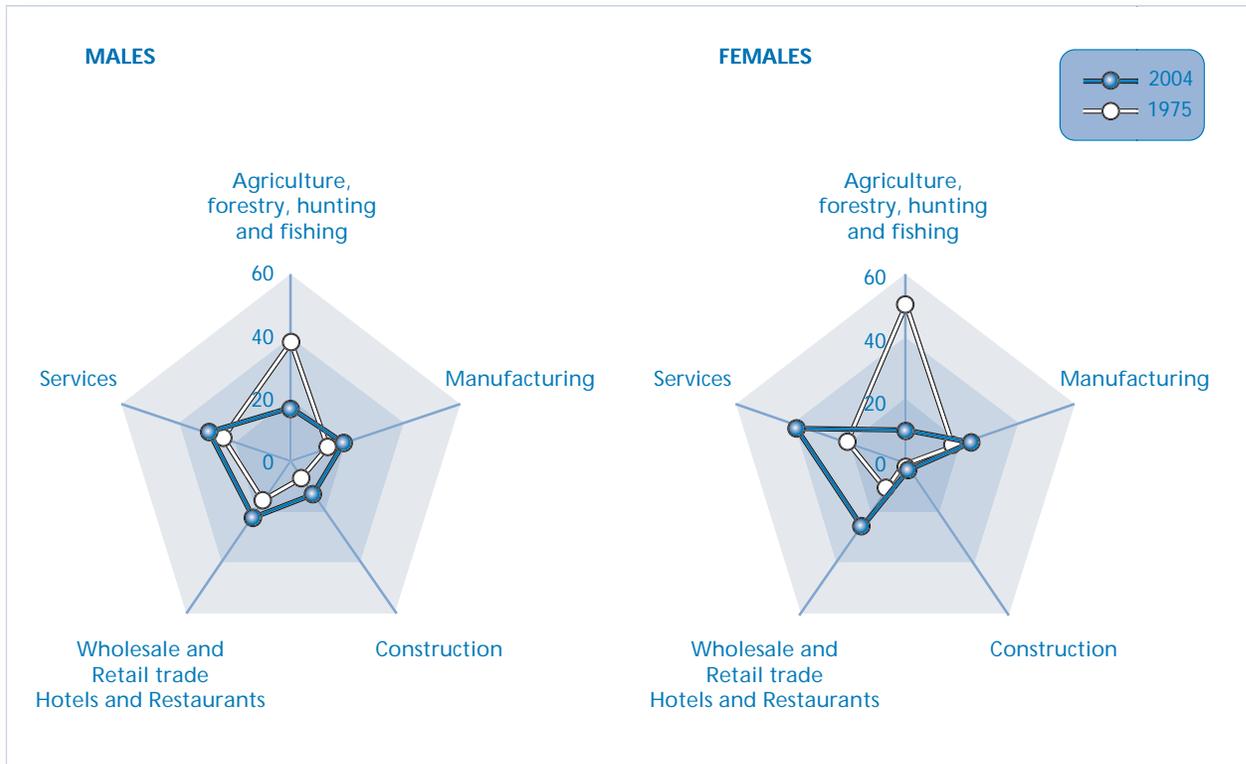
Source of data: Malaysia, DOS, Labour Force Survey (various years).  
Note: Data for 1975 are for Peninsular Malaysia.

income sectors in the rural areas to the manufacturing and other modern higher wage sectors in urban areas was a mechanism through which international trade positively contributed towards national poverty reduction.

Differential growth in employment by sector led to major changes in the relative sectoral shares of Malaysia's workforce (Figure 2.3). By 2004, the relative share of employment in the non-agricultural sectors is shown to be relatively evenly spread for males. By contrast, for females, there has been a major relative increase in employment in wholesale, retail, and services with a continued relatively small share of employment

Figure 2.3

Shares in Employment by Sector and Sex, Malaysia, 1975 and 2004 (%)



Sources of data: Malaysia, DOS, Labour Force Survey (1975 and 2004).

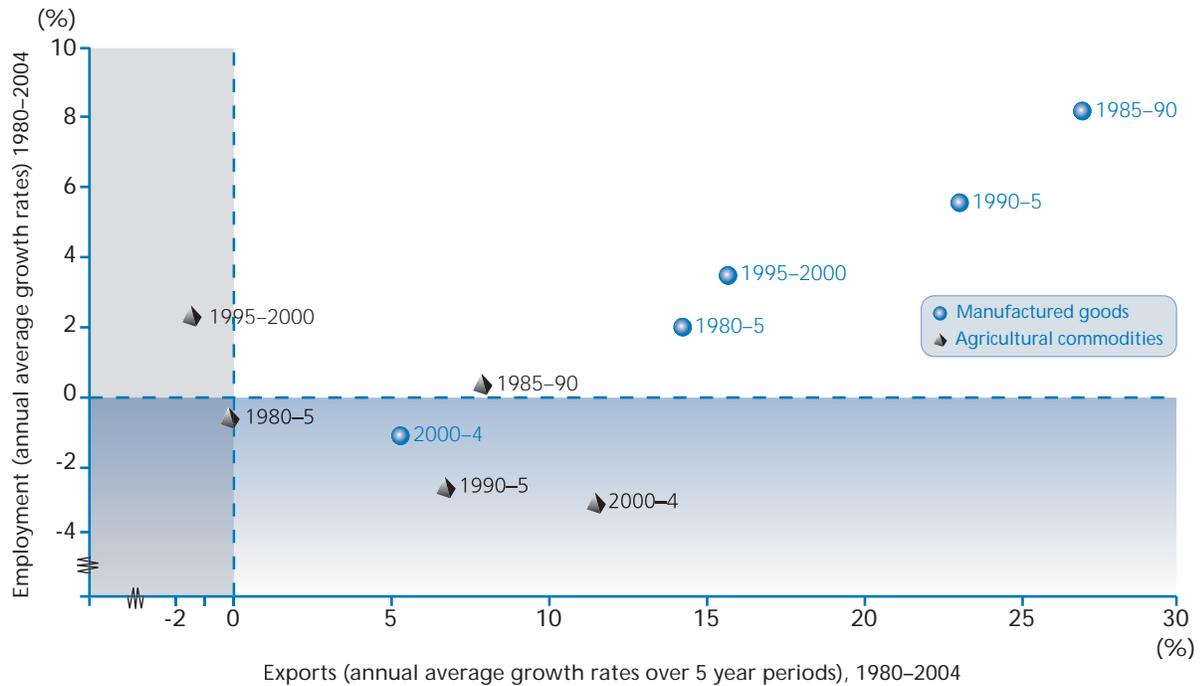
Note: Services include finance, insurance, real estate, business activities, transport, storage, communication, and other services.

in the construction sector. For both sexes, but especially for females, the sharp decline in the share engaged in agricultural employment is evident.

Malaysia's experience illustrates the positive relationship between the growth in exports and the growth in manufacturing output and employment. As Malaysia's growth rate of manufactured exports grew during the period 1980–2004, so too did the growth in employment in manufacturing (Figure 2.4). By contrast, Figure 2.4 also shows that in times when agricultural exports were rising most rapidly, agricultural employment declined even faster. This may well indicate a reduction in surplus agricultural workers and the use of a more capital-intensive production in agriculture.

Figure 2.4

Relationship Between Annual Growth Rates of Exports and Employment, Malaysia, 1980–2004

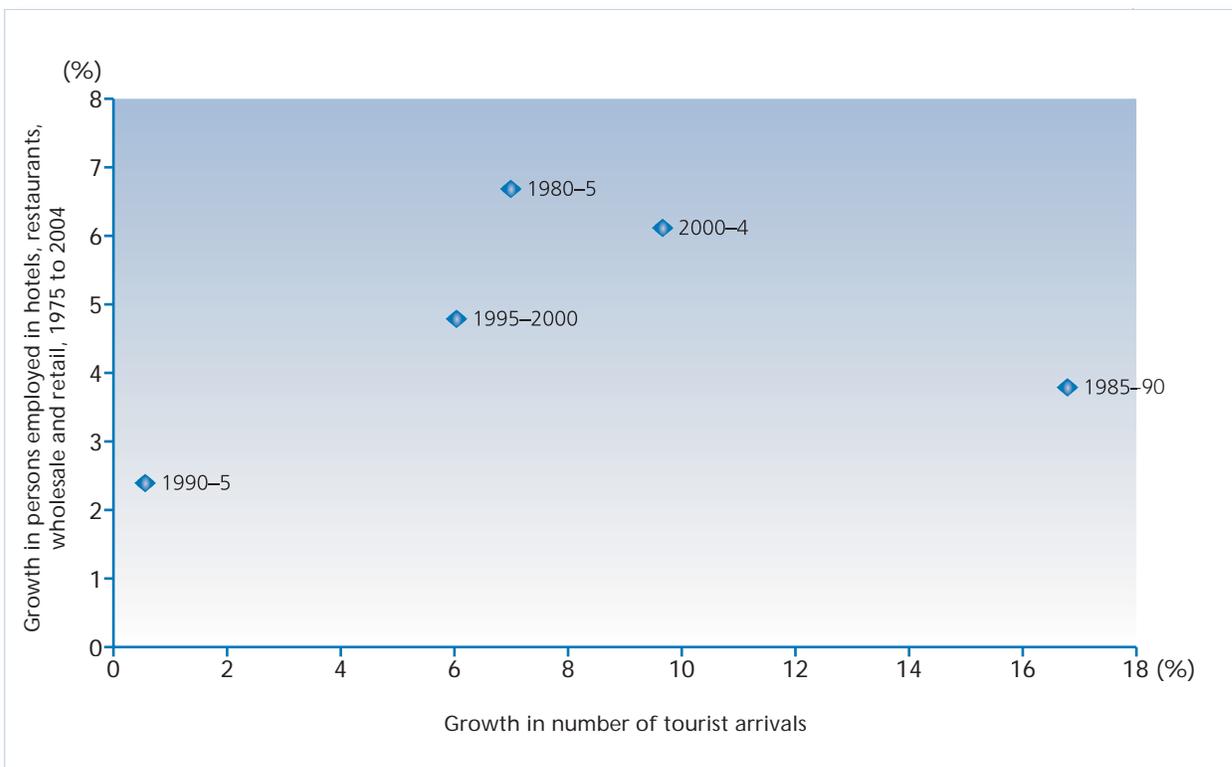


Sources of data: Malaysia, DOS, Labour Force Survey (various years); Bank Negara, Annual Report (various years).

International trade includes trade in services such as tourism and international finance, as well as in manufactured and primary commodities. In Malaysia, there has also been a positive relationship between tourist arrivals and employment in sectors affected by increased tourist inflows, especially hotels and restaurants (Figure 2.5). While the employment growth is also affected by increased domestic consumption expenditure, the independent effect of increased tourist arrivals is evident.

Figure 2.5

### Relationship Between Tourism and Employment in Hotels, Restaurants, Wholesale and Retail, Malaysia, 1975–2004



Sources of data: Malaysia, DOS, Labour Force Survey (various years); EPU, Five-Year Plans (various years).

### Female Employment

The growth of trade has also been a powerful factor in the empowerment of Malaysian women through modern sector employment. It provided women with choices to move away from their traditional roles as homemakers and agricultural workers, as well as leading to improvements in their standard of living (Box 2.5). In the three and a half decades following 1970, as the number and share of women in agriculture fell, there were major increases in female employment in manufacturing and services.

The growth in female employment in manufacturing was particularly marked during the period up to the mid-1980s, when manufacturing growth was most labour-intensive. For example, in the period 1985-90, the growth of females in the manufacturing sector rose

### Box 2.5 Major Contribution of Women to Poverty Reduction

Malaysia's success at poverty reduction has been attributed to factors such as public provision of rural infrastructure, land development, technical assistance, credit extension and education, training and technical skills. Yet the story of poverty alleviation in Malaysia would be grossly incomplete without relating the significant role that women have played in the process. Indeed, there are good reasons to believe that success may well have been more elusive had women not been mobilized in these efforts.

In 1970, only 32 per cent of working age females (15–64 years) was in the labour force. Even then the majority were employed in rural agriculture, where poverty was highest. In the years that followed, better paying jobs in the manufacturing sector were created. This had the predictable effect of raising the female labour force participation rate (LFPR) and by 1980 this had risen to 44 per cent. Most of the women were first-time job market entrants in their early twenties. Female labour force participation at ages 20–24 grew from 42 per cent in 1970 to 54 per cent in 1980; it increased to 61 per cent in 1990, and by 2003 stood at 62 per cent.

The migration of women out of low-productivity agriculture into manufacturing jobs removed excess labour from the rural sector and supplemented household incomes with their remittances home. Aminah (1998) points out that this was a very significant socio-economic event because it represented a break of 'established societal norms against the movement of unaccompanied young women'. So dramatic, in fact, was the response of women that she concluded: 'Malaysian women have benefited more than men from (export-oriented) industrialization.' Women represented 90 per cent of the garment, 85 per cent of the textile, and more than 75 per cent of the electronics workforce.

Poverty reduction is not merely a matter of raising household incomes but also of breaking the poverty cycle. In this respect, policies to ensure equal access of females to education were an early deciding factor in helping to prevent the inter-generational spread of poverty. Hashim (1998) found that it was the movement of people out of the poverty-stricken sectors that had a much greater impact than any efforts to directly increase income. Education was the critical ingredient that enabled rural people to escape their poverty by facilitating mobility.

The fact that participation of school-age females (15–19 years) in the labour force fell from 1970 to 1980 and 1990 indicates that their education was not sacrificed. This is further corroborated by a study of textile workers in Johor in 1986, which showed that the majority of workers were Malays, first-time entrants and with upper secondary education and above.

Since the 1990s, manufacturing has declined as a source of employment for first-time female labour force entrants. Its place being taken by the services sector, which includes community, social and personal services, public administration, finance, insurance, real estate and business services, and whole and retail trades and hotels and restaurants. While addressing issues of role conflicts and gender differences in access, compensation, and career advancement will remain a considerable challenge for some time to come, the growing participation of women in the labour force will very likely continue to keep the forces of poverty at bay.

by some 11 per cent per year (Table 2.7). Subsequently, the rate of growth moderated and has even declined in the most recent period (2000-4), as the manufacturing sector became more capital-intensive.

As a result of their increased participation in modern sector employment, the share of women in all sectors, apart from agriculture

Table 2.7

Female Employment by Sector, Malaysia, 1975–2004

| Sector  | Percentage distribution of total female employment |                |                |                |                |                |                |
|---|--|----------------|----------------|----------------|----------------|----------------|----------------|
|   | 1975   | 1980           | 1985           | 1990           | 1995           | 2000           | 2004           |
| Agriculture, forestry, hunting, and fishing     | 50.3   | 43.8           | 33.8           | 25.3           | 16.9           | 14.0           | 10.6           |
| Mining and quarrying                            | 0.4  | 0.4            | 0.2            | 0.2            | 0.2            | 0.1            | 0.1            |
| Manufacturing                                   | 17.0   | 18.4           | 19.0           | 26.8           | 29.4           | 27.1           | 22.8           |
| Construction                                    | 0.9  | 1.0            | 1.2            | 0.8            | 1.5            | 1.5            | 1.8            |
| Electricity, gas, water, and sanitary services  | 0.1  | 0.2            | 0.1            | 0.2            | 0.2            | 0.2            | 0.2            |
| Wholesale, retail trade, hotels and restaurants | 10.8   | 12.0           | 19.1           | 19.2           | 20.5           | 22.1           | 25.0           |
| Transport, storage, and communication           | 0.8  | 1.0            | 1.3            | 1.5            | 1.7            | 1.7            | 2.2            |
| Services  | 19.8   | 23.2           | 25.3           | 26.1           | 29.6           | 33.2           | 37.2           |
| <b>Total employed ('000)</b>                    | <b>1,230.9</b>                                     | <b>1,601.8</b> | <b>1,952.9</b> | <b>2,374.3</b> | <b>2,588.4</b> | <b>3,235.4</b> | <b>3,588.7</b> |
|   | Average annual growth rates                        |                |                |                |                |                |                |
|   | 1975–80  | 1980–5         | 1985–90        | 1990–5         | 1995–2000      | 2000–4         |                |
| Agriculture, forestry, hunting, and fishing     | -2.3   | -1.2           | -1.9           | -6.4           | 0.8            | -4.3           |                |
| Mining and quarrying                            | 5.7  | -5.8           | 0.2            | 4.0            | -10.1          | -10.5          |                |
| Manufacturing                                   | 6.0  | 4.6            | 10.8           | 3.6            | 2.8            | -1.7           |                |
| Construction                                    | 4.6  | 8.1            | -4.2           | 14.9           | 4.1            | 7.4            |                |
| Electricity, gas, water, and sanitary services  | 19.9   | -24.3          | 29.2           | -0.6           | 2.1            | 8.3            |                |
| Wholesale, retail trade, hotels and restaurants | 4.8  | 13.2           | 4.0            | 3.1            | 6.0            | 5.6            |                |
| Transport, storage, and communication           | 8.7  | 8.5            | 6.8            | 4.1            | 4.3            | 9.7            |                |
| Services  | 6.2  | 5.7            | 4.5            | 4.3            | 6.8            | 5.4            |                |
| <b>Total</b>                                    | <b>2.2</b>   | <b>4.0</b>     | <b>3.9</b>     | <b>1.7</b>     | <b>4.5</b>     | <b>2.6</b>     |                |

Sources of data: Malaysia, DOS, Labour Force Survey (various years).

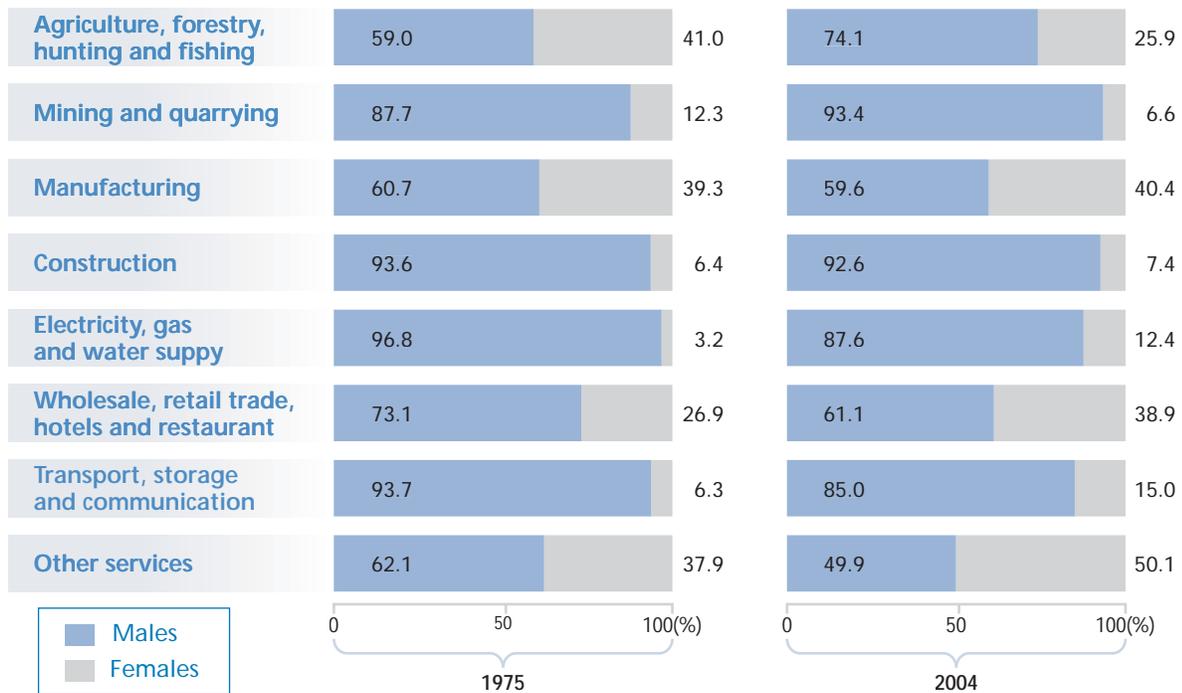
Note: Data for 1975 and 1975–80 growth rates are for Peninsular Malaysia.

and mining and quarrying, has grown over time (Figure 2.6). Given the increased educational attainment of Malaysian women, and with further likely increases in female labour force participation rates, significant gains can be expected in gender equity in modern sector employment.

Table 2.8 provides further insights into male and female employment in Malaysia. Over the period 1995–2003, it can be seen that the percentages of both male and female employees (i.e. wage workers) have risen and that this pattern has been accompanied by a decline in the percentages of both own account and family workers. These trends are normal in the course of economic development. Unpaid family work has

Figure 2.6

Male and Female Employment Shares by Sector, Malaysia, 1975 and 2004



Sources of data: Malaysia, DOS, Labour Force Survey (1975 and 2004).

traditionally been an important source of employment for females, especially those engaged in informal and home-based agricultural and manufacturing activities. The move to wage work is therefore considered positive for women because it involves regular income and is accompanied by amenities required by labour law such as mandatory holidays, worker compensation, and maternity benefits.

This is not to say, however, that female workers earn as much as their male counterparts. Average female wages in Malaysia are estimated to be lower than those of males, partly because females are disproportionately in lower skilled occupations.

Table 2.8

Male and Female Employment by Status, Malaysia, 1995 and 2003

| Sex and Year   | Employers | Employees | Own Account | Family Workers |
|----------------|-----------|-----------|-------------|----------------|
| <b>Males</b>   |           |           |             |                |
| 1995           | 3.4       | 72.5      | 20.9        | 3.3            |
| 2003           | 4.6       | 75.5      | 17.7        | 2.2            |
| <b>Females</b> |           |           |             |                |
| 1995           | 0.7       | 72.9      | 13.2        | 13.2           |
| 2003           | 1.2       | 77.5      | 11.7        | 9.6            |

Sources of data: Malaysia, DOS, Labour Force Survey (1996 and 2004).

### *Agriculture, Trade, and Rural Poverty*

When Malaysia first gained independence in 1957, it was still a typical colonial economy heavily dependent on the export of agriculture and primary commodities. The shift in agricultural resources began in the 1960s largely due to external forces. Sharp declines in agriculture prices between 1960 and 1965 led to a fall in the importance of agriculture to the economy; the unit value of rubber exports fell by more than 35 per cent.

Rubber production, however, continued to expand. Output increases were due to the increasing acreage planted under new high-yielding rubber clones. Rubber exports historically accounted for a sizeable share of Malaysia's total exports. Poor households tended to have rubber smallholdings while exports of rubber from plantations dominated total rubber exports. Farmers and households, usually, did not depend solely on income from rubber production. Reducing rural poverty hinged on raising productivity and promoting diversification.

Households with rubber smallholdings do respond to the price of rubber in the international market. When rubber prices increased, farmers increased their labour inputs and their rates of tapping for rubber. In response to widespread reluctance to upgrade rubber trees due to the cost of replanting and the opportunity costs caused by temporary loss of income, Malaysia established the Rubber Industry Replanting Fund, financed from a tax imposed on rubber exports. Poor households were given assistance to raise their productivity by replanting their rubber smallholdings with higher yielding clones. Replanting grants were provided according to the size of the area being replanted. The

rubber replanting schemes provided financial assistance to the smallholders to replant their ageing and low-productivity rubber holdings with the higher yielding rubber clones.

Plantations and larger smallholdings were able to better utilize this facility as they could more easily afford to allow particular areas to be replanted while working the rest of the planted area. For smaller smallholdings, the opportunity costs seemed greater as they did not have other land to continue working on. As a consequence, the government set up the Rubber Industry Smallholders Development Authority (RISDA). RISDA provided larger replanting grants to smallholders and facilitated replanting in other ways to help improve production efficiency and the quality of products.

In the late 1960s, the decline in the price of rubber impacted the profitability of investment in rubber and led to the cultivation of oil palm as a means of raising the income of rural households (Box 2.6). Old

#### Box 2.6 Malaysia's Palm Oil Industry

**A**lthough commercial planting of oil palm in Malaysia began in 1917, large-scale cultivation did not take off until the 1960s when Malaysia introduced agricultural diversification measures. Large tracts of rubber land were converted to oil palm. In 2005, palm oil exports made up 50.9 per cent of total agriculture exports.

Oil palm planted areas expanded from a mere 320,000 hectares in 1970 to over 4 million hectares in 2005. Of this, about 16 per cent are managed by the Federal Land Development Authority (FELDA) and about 24 per cent are independently run by smallholders and through other smallholder schemes. Although declining, smallholder involvement in oil palm cultivation remains significant.

Much of the success of the Malaysian palm oil industry is credited to the private sector. However, public policies in support of private investment in palm oil also played a major role and extended participation to poor rural communities. One of the most important of these policies was the replanting grant for smallholders. Replanting grants were initially used to finance and encourage the replanting of old rubber trees with new, high-yield varieties. Beginning in 1962, rubber smallholders were allowed to use these grants to switch to oil palm. This made it possible for large numbers of smallholders to absorb temporary income losses, while shifting from rubber to palm oil production.

Such policies were complemented by strong institutional support from three main institutions: (a) the Palm Oil Registration and Licensing Authority (PORLA), which took care of the regulatory and licensing functions; (b) the Palm Oil Research Institute of Malaysia (PORIM), which is involved in public sector research and development efforts; and (c) the Malaysian Palm Oil Promotion Council (MPOPC), which undertakes public relations and market promotion of palm oil mainly in the export markets. The activities of PORLA, PORIM, and MPOPC were funded by a tax on palm oil exports. PORLA and PORIM have since been merged to form the Malaysian Palm Oil Board, which is financed by a tax of RM11 for every tonne of palm oil or palm kernel produced.

rubber holdings were replanted with oil palm, while new acreage under oil palm increased rapidly. Smallholder farming, where the poor were engaged, benefited greatly from these developments.

At the same time, the Federal Land Development Authority (FELDA), in helping raise the incomes of landless farmers, focused much more on the investment and expansion of palm oil (Box 2.7). Acreage under rubber in the land development schemes accounted for a shrinking share of the total acreage.

### Box 2.7 Land Development and Rural Poverty

In the 1960s, rural poverty in Malaysia was attributed to the inaccessibility of small farmers to productive assets, such as land and capital. Large and extensive land development and settlement schemes became a catalyst for rapid rural development. Government agencies, such as FELDA, Federal Land Consolidation and Rehabilitation Authority (FELCRA), RISDA, and other state government agencies were created to help modernize the agricultural sector, eradicate poverty, and overcome unemployment. Suitable agricultural land was opened up by FELDA and several state government agencies for distribution to poor landless farmers.

Under the FELDA settlement scheme, each settler was allocated an agricultural area of 4 hectares and a house lot of 0.10 hectare. FELDA spent about RM50,000 to emplace a settler and his family in the scheme. This included the cost of infrastructure, agricultural development, and the cost of land allocated. Each settler had to repay 58 per cent of the total costs over a period of 15 years after the agricultural area has commenced production (Teoh 2002).

The FELDA settlement scheme is a three-stage development package. In Stage 1, cooperative landownership was practised to equip settlers with the know-how of field maintenance and harvesting. In Stage 2, the settlers would be accustomed to managing a smaller block or field in order to be more self-reliant. In Stage 3, the settlers were given their individual land titles. However, FELDA continues to centrally manage the scheme.

By 1996, a total of 114,338 settlers and their families were resettled in 309 FELDA schemes throughout the country. The income of FELDA settlers has seen significant improvements although incomes fluctuated with the international prices of the raw commodities. Between 1984 and 1990, the average income per settler family planting rubber was RM522 per month, net of all loan deductions. For those planting oil palm, monthly net incomes averaged RM685.

FELDA improved the income and standard of living of settlers and created viable communities, where settlers obtained titles to their land. It also took control and planned for inter-generational mobility. However, FELDA faces a number of challenges moving forward. One of the primary challenges is building capacity within the settler community to manage their own lots, given the primary focus on achieving basic socio-economic targets in the preceding years has necessitated the centralization of management powers of such schemes.

To ensure continued sustainability of FELDA schemes, the development of small and medium enterprises (SMEs) within the schemes will be promoted. These SMEs will focus on capacity building among settlers, particularly in management skills, and imbue settlers with entrepreneurial skills. Besides capacity building for existing settlers, FELDA also emphasizes the development of next generation settlers.

Agriculture in Malaysia is also comprised of non-industrial or food commodities, that contributed a substantial amount of the total value added of the agriculture sector. Poverty rates, particularly among fishermen and padi farmers, were high, and under the National Agricultural Policy, considerable assistance was given to these communities.

Trade in agricultural commodities, however, did little to absorb surplus rural labour or to improve the income of *padi* and rubber smallholders. Reductions in poverty among these communities tended to occur as a result of increasing urbanization and industrialization.

### ***Industrialization, Trade and Urban Poverty***

Malaysia's industrial development has made a major contribution to the reduction of absolute poverty, especially urban poverty. Serious industrial development began in the late 1960s. Before then, manufacturing industries made only a small contribution to the growth of the economy and the sector was dominated by small enterprises. Rapid population growth and slower growth of employment opportunities led to high levels of unemployment, especially among urban youths. Following the racial riots of May 1969, the Government embarked on a strong push to restructure the economy to eradicate poverty and to reduce the identification of ethnicity with economic function. Accelerating the growth of manufacturing industries was a key part of the development strategy.

#### **Labour-intensive and Export-oriented Industries**

Both the electronics and electrical industry (Box 2.8) and the textiles and apparel industry (Box 2.9) made major contributions to Malaysia's export-led growth. The manufacture of semi-conductors from the late 1960s, and later other labour-intensive electronic products, generated employment opportunities for the low-income rural and urban households. Many of the activities involved assembly operations which did not make excessive demands for highly skilled labour. The manufacture of electronic products in Malaysia was part of the global relocation of manufacturing industries by the MNCs in their search for low-wage centres and an ample supply of labour.

## Box 2.8 Malaysia's Electronics Industry

Malaysia's electronics industry contributes significantly to the country's manufacturing output, exports, and employment. From its modest beginnings around 1970, with a handful of companies employing less than 600 workers, by 2004, the industry has created some 369,000 jobs, with gross output of RM183.1 billion and exports of RM241.5 billion. It accounts for about 36 per cent of total employment in the manufacturing sector and about 64 per cent of total manufactured exports.

Malaysia's Electronics Industry, 1997-2004

| Year | Output*    |          | Employment* |          | Exports**  |          | Imports**  |          |
|------|------------|----------|-------------|----------|------------|----------|------------|----------|
|      | RM billion | % growth | 000s        | % growth | RM billion | % growth | RM billion | % growth |
| 1997 | 85.6       | 12.6     | 343.3       | 4.3      | 107.3      | 17.0     | 75.2       | 11.3     |
| 1998 | 106.7      | 24.6     | 341.7       | (0.5)    | 146.7      | 36.7     | 92.5       | 28.8     |
| 1999 | 129.8      | 21.6     | 382.0       | 11.8     | 179.7      | 22.5     | 109.8      | 12.6     |
| 2000 | 167.1      | 31.0     | 423.6       | 10.9     | 212.7      | 18.4     | 143.4      | 30.6     |
| 2001 | 144.4      | (15.1)   | 355.8       | (16.0)   | 182.6      | (14.2)   | 122.1      | (14.9)   |
| 2002 | 136.6      | (5.4)    | 345.5       | (3.0)    | 188.4      | 3.2      | 138.6      | 13.5     |
| 2003 | 147.1      | 7.7      | 360.0       | 4.2      | 183.2      | (2.8)    | 138.3      | (0.2)    |
| 2004 | 183.1      | 23.9     | 369.0       | 2.5      | 213.0      | 16.2     | 151.3      | 9.4      |

Sources of data: Malaysia, DOS, Monthly Manufacturing Statistics (various years); External Trade Statistics (various years).

The growth of Malaysia's electronics industry was mainly due to large inflows of FDI. The first big wave of electronics firms coming into Malaysia was dominated by MNCs, many from the USA and Japan, seeking to capitalize, inter alia, on the available supply of cheap labour for their labour-intensive assembly processes. Other factors that attracted investment are Malaysia's market-oriented economy, its young and relatively educated workforce, its available supply of good infrastructure, and a government committed to maintaining a business-friendly environment. A second wave of firms arrived in Malaysia in the late 1980s, driven by the strong appreciation of the yen and the withdrawal of the generalized system of preferences from the newly industrializing countries (NICs) in Asia in 1988.

The Malaysian electronics industry is characterized by three regional agglomerations. Penang is the largest in terms of numbers of firms, employment, and value added, followed by Klang Valley and Johor. From the early 1970s, the Government established export processing zones (EPZs) in these areas to attract FDI, promote manufacturing exports, and provide urban industrial jobs, particularly for the then predominantly rural Malays (Box 2.4).

In addition to good infrastructural facilities, incentives given to foreign-owned companies that invested in the EPZs include pioneer status, labour utilization relief, investment tax credit, accelerated depreciation, export allowance, and export refinancing facility. Restrictions were placed on unionization in pioneer industries to ensure labour stability in the early years. These, along with an aggressive investment promotion mission, led to the electronics industry becoming the main engine of growth for Malaysia's economy.

Malaysia benefited beyond job creation and export generation from technology transfers in the electronics industry. The MNCs have played a major role in enhancing the skills and entrepreneurial base of Malaysia. Malaysian employees, learning by doing in dynamic MNCs, have gained critical knowledge for new firm creation, which led to a mushrooming of local ancillary firms linked to the electronics industry. In Penang, technology transfer has increased the extent of specialization, creating a network of second- and third-tier suppliers, from which large suppliers source their components. Several of Penang's supplier firms have developed their own process engineering and original equipment manufacturing capabilities to supply the MNCs in Malaysia, thus resulting in increased localization of inputs.

Progress towards new product development capabilities is, however, a challenge. Malaysia's electronics industry is still mainly active in the lower value added segments. There is a lack of indigenous technological management capability to engage in higher value added activities associated with new product design and development. Further, the networking capabilities across the supply chain are also insufficiently developed. Given rising production costs and competition, especially from China, there is a move into higher value added activities.

### Box 2.9 Malaysia's Textiles and Apparel Industry

The first commercial manufacturing of textiles began in Malaysia in 1957 with the production of a small range of cotton fabrics for domestic consumption. In 1963, the first export-oriented garment factory began in Penang and by the late 1960s and early 1970s Malaysia's textiles and apparel industry was flourishing. Many companies, both local and export-oriented, were set up especially in Penang, Taiping, Ipoh, and Johor.

In 1970, the value of Malaysian textiles and apparel exports was just RM31.2 million. By 2004, exports of textiles and apparel had reached RM9.7 billion, making it the sixth largest contributor to total earnings from manufactured exports. The textile and apparel industry is also a significant source of employment. By 2004, there were about 900 companies in production, employing more than 68,000 workers.

The majority of the large textile firms are foreign-based MNCs, which operate within EPZs. They consist mainly of Japanese corporations in the north and Taiwan Province of China firms in the south. The Government encourages investments in this industry and has gazetted several textile products/activities as promoted products/activities under the Promotion of Investment Act 1986. Investments may also be considered for tax incentives in the form of pioneer status or investment tax allowance.

Over time, Malaysia's textiles and apparel industry has moved up the value added chain. Up until 1974, the export of textiles was greater than apparel. However, since the late 1970s, apparel exports exceeded exports of textiles. In 1986, garments accounted for 53.3 per cent of the value of Malaysian textiles and apparel exports, and this proportion increased to 72 per cent in 1993.

In order to maintain a niche position and remain competitive, Malaysia's textiles and apparel industry in Malaysia is increasingly focusing on the manufacturing of high-end apparel, expanding production of primary textiles and non-woven fabrics, as well as producing Malaysian-branded apparel for the export market.

Source: Malaysia, MIDA (<http://www.mida.gov.my>)

### Industrial Estates

In order to promote manufacturing industries, industrial estates were also established in selected centres throughout the country. Industrial land, at subsidized costs, was provided to investors. Utilities were also provided for the industries in the industrial estates. Foreign as well as domestic investors established their manufacturing plants in the industrial estates.

As part of its industrial policy, the Government has pursued a policy of picking prospective 'winners'. Industrial policy in Malaysia has played a complementary role to the primary objective of promoting the macroeconomic target of export-led growth. It has attempted to champion industries such as the automotive, iron and steel, and shipbuilding industries. In these attempts, the Government has had only

limited success in promoting competitive, export-oriented industries. The failure to pick 'winners' in the automotive, iron and steel, and shipbuilding industries has meant that public expenditure in these areas did not achieve the anticipated results.

In 1970, as many as 21 per cent of urban households were poor. By the early years of the new millennium, urban poverty had declined to around 2 per cent. In large part, this decline can be attributed to the marked increase in urban employment.

## Poverty and Income Inequality

The Malaysian experience indicates that consistent, strong, export-led economic growth promotes poverty reduction. Poverty reduction in Malaysia has been successful (Table 2.9), largely due to the strong export-led growth rates that the country has enjoyed. This has, especially, been so from the 1970s to the 1990s. In the 1970s, the average growth rate was 7.5 per cent, dropping to an average of about 5.8 per cent in the next decade, and rising again to an average of 7.1 per cent in the 1990s. Following the Asian financial crisis, the real GDP growth dropped to recessionary levels, but soon recovered. In 2000, the growth rate reached 8.5 per cent.

| Table 2.9                 |      | Poverty Rates, Malaysia, 1970–2004 (% of households) * |      |      |      |      |      |
|---------------------------|------|--|------|------|------|------|------|
| Poverty rate              | 1970 | 1976   | 1985 | 1990 | 1995 | 1999 | 2004 |
| Poverty (% of households) | 49.3 | 42.4   | 20.7 | 16.5 | 8.7  | 8.5  | 5.7  |

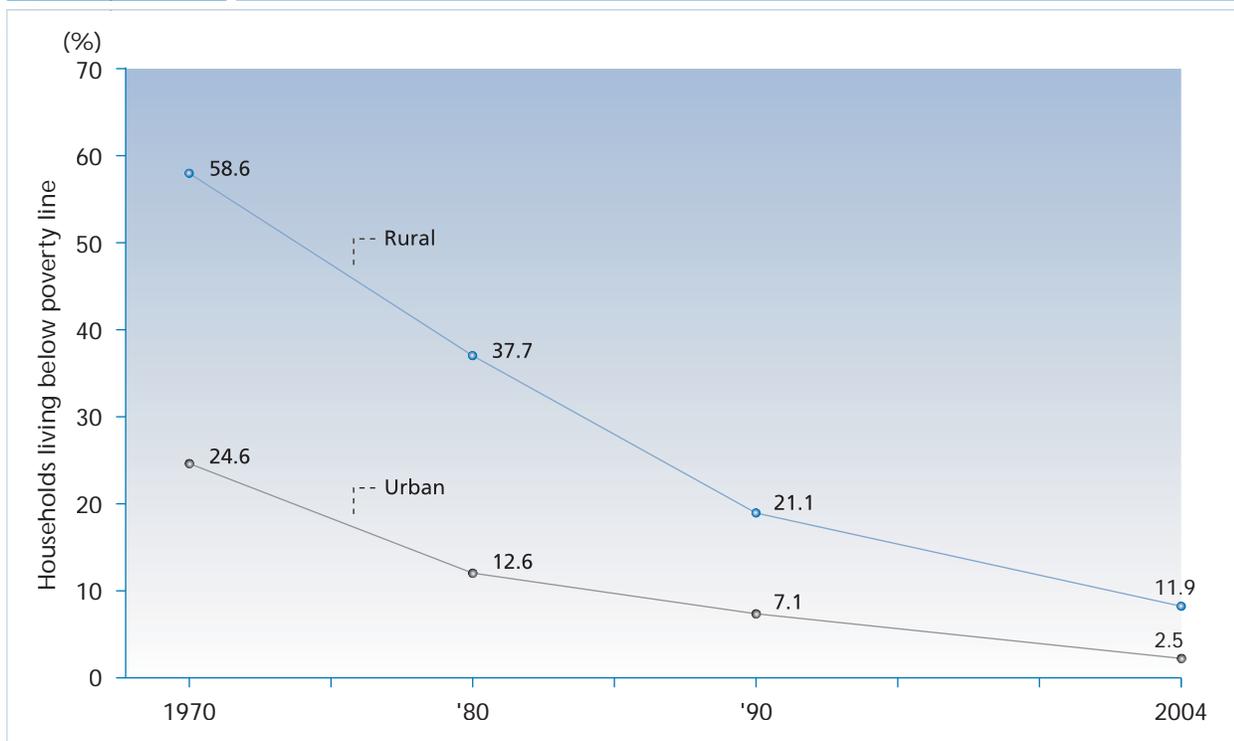
Sources of data: Malaysia, EPU, Five-Year Plans (various years).

\* In this and subsequent tables, the poverty rates for 2004 are based on an improved methodology and hence are not strictly comparable with figures for earlier years.

In 1970, a much larger percentage (58.6 per cent) of rural households were poor compared to urban households (24.6 per cent) (Figure 2.7). The reduction of poverty has been faster among urban households than among rural households, falling from 21 per cent in 1970 to around 2.5 per cent in 2004. The corresponding reduction for rural areas was from 59 per cent to about 11.9 per cent. Currently, absolute poverty in Malaysia is largely a rural phenomenon.

Figure 2.7

Urban and Rural Poverty Rates, Malaysia, 1970–2004



Source of data: Malaysia, EPU, Five-Year Plans (various years).

A priority focus of the Malaysian Government since 1990 has been on reducing the rate of the hard-core poor-defined until the Ninth Malaysia Plan as households where the gross monthly income is less than half of the poverty line income (PLI). In 1985, an estimated 7 per cent of households in Malaysia were classified as hard-core poor: by 2004, this figure had fallen to less than 1 per cent (Table 2.10).

Table 2.10

Hard-core Poverty Rates, Malaysia, 1985–2004 (% of households)\*

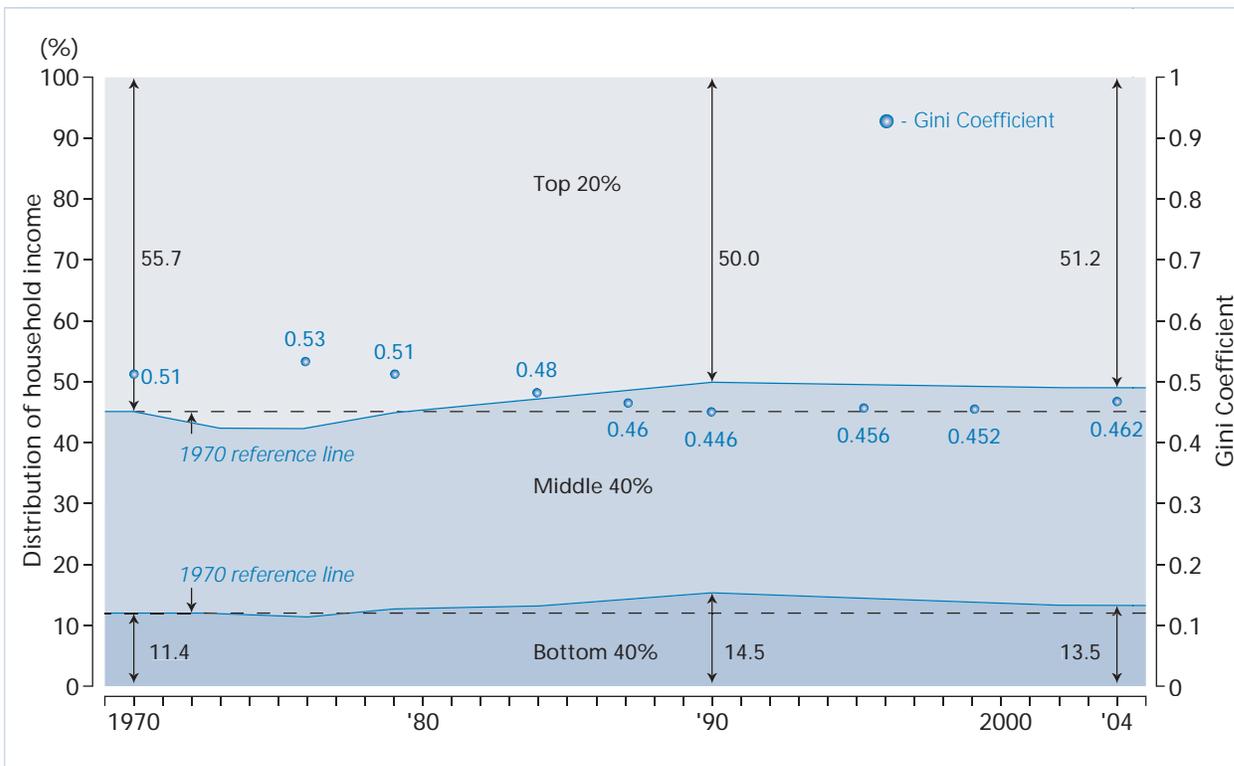
| Stratum | 1985 | 1990 | 1995 | 1999 | 2004 |
|---------|------|------|------|------|------|
| Total   | 6.9  | 3.9  | 2.1  | 1.9  | 1.2  |
| Urban   | 2.4  | 1.3  | 0.9  | 0.5  | 0.4  |
| Rural   | 9.3  | 5.2  | 3.6  | 3.6  | 2.9  |

Sources of data: Malaysia, EPU, Five-Year Plans (various years).

\*Estimates for hard-core poverty were only computed from 1985 onwards.

Figure 2.8

Household Income Distribution and Gini Coefficient, Malaysia, 1970–2004



Sources of data: Malaysia, EPU, Five-Year Plans (various years); Outline Perspective Plan (1991b and 2001b).

The post-1970 period was marked not just by a sharp fall in poverty rates, but also by a reduction in income inequality (Figure 2.8). During the difficult years following the Asian financial crisis in 1997, however, inequality increased slightly. Thus, the income share of the top 40 per cent of households fell markedly up to 1990. Since 1990 that share has increased somewhat, whereas the income share of the bottom 40 per cent has fallen.

On the whole, export-led growth produced positive results in reducing poverty. But it was realized that export-led growth was a necessary but not a sufficient condition for poverty reduction. Growth without equity could be socially destabilizing, and that without social stability, economic stability could not be guaranteed. With this perspective in mind, the Government directed its efforts at ensuring an equitable distribution of resources. The NEP was devised primarily to attend to the problem of inequity. A rationale behind the NEP was to ascertain that the trickle-down effect of export-led growth would reach poor Bumiputera.

Although the NEP was directed at improving the condition of Bumiputera and ensuring that they participated more actively in the economy, the Government did not compromise on growth as a goal: equity considerations were secondary to growth. In the 1970s, the Government allowed fully foreign-owned firms to operate in the manufacturing sector, so long as these firms could contribute substantially to exports. This was a pragmatic approach since it is not feasible to sustain affirmative action policies in a stagnant economy. The NEP strategy called for high growth rates in order to avoid disruptive redistribution.

### *Vulnerability to External Fluctuations*

Malaysia's policy of economic openness has helped to reduce poverty. Nevertheless, its economy is vulnerable to external fluctuations and shocks. The Asian financial crisis, which began in July 1997, provided an example of how external shocks can affect an open economy and impact upon the poor. By August 1998, the Malaysian ringgit had depreciated by 40 per cent against the US dollar. The impact in terms of GDP was similarly severe, with GDP contracting by 7.4 per cent in 1998, as compared with sustained high growth in the previous years. Following the crisis, household incomes fell. Nominal per capita income, which was RM12,051 in 1997, dropped to RM11,835 in 1998. Although poverty remained at much the same levels, income inequality has tended to increase.

There are, of course, risks to openness from externally driven shocks. And there is thus a need to have in place safety nets that can mitigate the impact on the poorest sections of society.

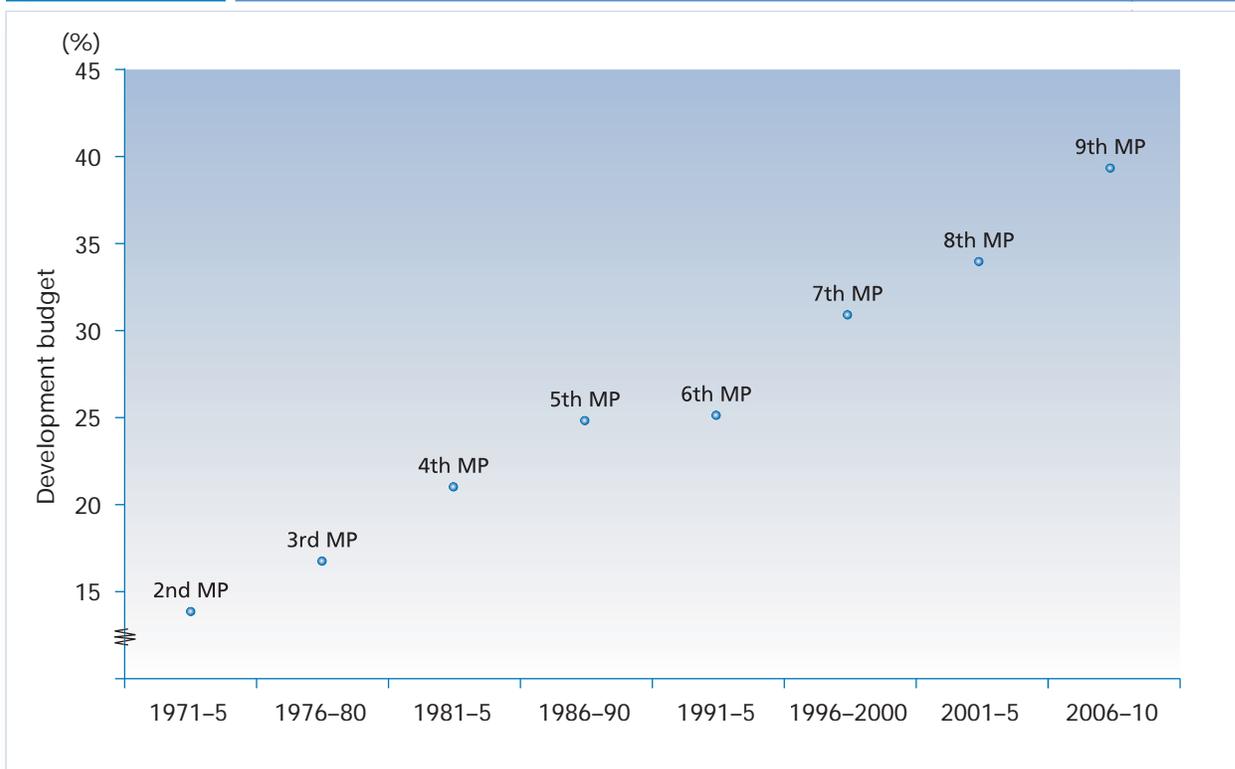
### *Complementary Policies for Poverty Reduction*

Malaysia's liberal trade policy provided the Government with resources to implement a range of pro-poor programmes. By enabling rapid economic growth, the external trade sector, nurtured under a liberal trade regime, provided the financial resources necessary to undertake programmes specifically targeted at low-income and poor households.

International trade-led growth strategies to reduce poverty were thus supported by programmes that were directed at poor households (UNCT, Malaysia and Government of Malaysia 2005; Ariff and Nambiar 2005). Since 1970, social sector expenditures have consistently been a high and rising proportion of the federal development budget in successive five-year periods (Figure 2.9). The Ninth Malaysia Plan 2006-10, sets targets to eradicate hardcore poverty and halve absolute poverty by 2010, with increased allocations for rural poverty-reducing programmes (Malaysia, EPU 2006)

Figure 2.9

## Public Development Expenditure on Social Programmes in the Malaysia Five-Year Plans, 1971–2010



Sources of data: Malaysia, EPU, Five-Year Plans (various years).

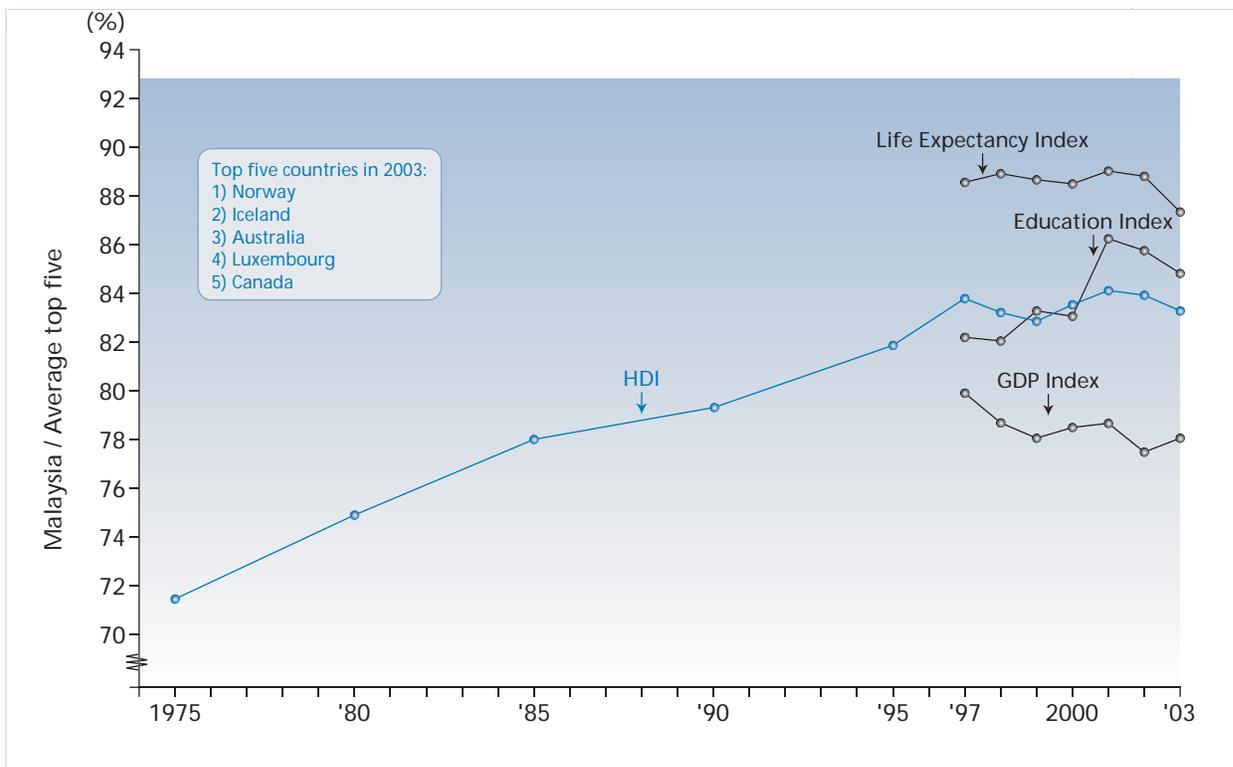
Malaysia adopted two broad strategies to eradicate poverty: (a) the expansion of the economy, to which external trade has made a major contribution; and (b) government-led affirmative action programmes designed to increase human development. Among the programmes implemented are the following:

- Resettlement of the landless and those with uneconomic holdings in new land development schemes, such as those of FELDA and the establishment of regional development schemes under regional development authorities (RDAs).
- In situ development of existing agricultural land through land consolidation.
- Double-cropping (e.g. rice), off-season cropping, and inter-cropping.
- Ensuring better prices for the products of the poverty groups. For example, in the case of padi, there is a guaranteed minimum price (GMP) at which the commodity is bought from the farmers.
- Subsidies to farmers for production inputs, such as fertilizers, free technical advice through extension services, and marketing infrastructure as provided by the Federal Agricultural Marketing Authority (FAMA).
- Infrastructure development, such as rural roads, to improve market access for farm produce and the provision of irrigation facilities. The effect of such support measures is to lower production costs for farmers and consequently raise their net income.
- Education support, for example, the provision of financial assistance, free textbooks, and meals.
- Health and nutrition programmes targeted in particular towards increasing access by the rural poor.
- Provision of micro-credit loans by Amanah Ikhtiar Malaysia (AIM) to poor persons, especially the rural poor. AIM provided opportunities to poor households who lacked access to credit from formal financial institutions.

Malaysia has achieved most of the MDG targets. By 2005, the country was on the threshold of achieving high human development as reflected in the human development index (HDI) and it had narrowed the gap between itself and the world's highest ranked countries (Figure 2.10). Looking separately at the three dimensions of the HDI, Malaysia's achievements in the areas of health and education have been even more marked than the increases in per capita income, relative to the world's top five countries in human development.

Figure 2.10

Malaysia's Progress in Human Development and its Components Relative to the World's Top Five HDI Countries, 1975–2003



Sources of data: UNDP 2005.

## Summary and Conclusions

Malaysia has progressively liberalized its trade. Its average tariff rates compare favourably with most Asian countries. Malaysia is now one of the most open economies in the world.

From the early 1970s, the international demand for labour-intensive products transformed Malaysia's manufacturing sector through the growth of export-oriented industries. FDI, attracted by, inter alia, Malaysia's infrastructure, human resources, and government incentives, contributed markedly to the development of export-oriented industries.

The proportion of manufactured products in total exports rose from 12 per cent in 1970 to as much as 85 per cent in 2000, falling back slightly since then. The most dynamic sector in manufacturing is electronics, and Malaysia is currently one of the world's major exporters of semi-conductors and electronic components. For these reasons, Dollar and Kraay (2001) include Malaysia amongst the world's 24 post-1980 'globalizers'.

International trade was facilitated by exchange rate stability and a competitive exchange rate. For the greater part of post-Independence, the ringgit's value was managed according to a trade-weighted basket of currencies. It was only in 1998 in response to the Asian financial crisis that the ringgit was temporarily pegged at RM3.80 per US dollar. The exchange rate was de-pegged in July 2005, and is now again managed on the basis of a basket of currencies.

Growth of the external trade sector has been a major contributor towards Malaysia's economic growth and the substantial increases in per capita income. Rapid economic growth, averaging between 6 and 7 per cent per year since 1970, led to growth in employment opportunities which in turn helped to reduce poverty considerably. Export-oriented industries, with their correlates of modern sector employment opportunities and raised incomes, contributed significantly to urban and rural poverty reduction.

Malaysia's experience with automobiles and its heavy industry supports the international experience that industrialization through import substitution is of only limited value. By contrast, the country's policy of export-oriented growth contributed markedly to improving human development. Malaysia's experience also highlights the pivotal role that the public sector can play in creating the enabling environment to support successful export-led economic growth and human development.

Finally, Malaysia's experience also shows that social sector development and adequate physical infrastructure, coupled with political stability, are necessary conditions to support export-led growth and human development.

# 3.

## CHALLENGES FOR MALAYSIA OF GLOBALIZATION AND REGIONALIZATION

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# CHALLENGES FOR MALAYSIA OF GLOBALIZATION AND REGIONALIZATION

As Chapter 2 demonstrated, Malaysia's openness to international trade led to three and a half decades of rapid economic growth, and growth led to exemplary poverty reduction and human development. Looking ahead, Malaysia is committed to eventually eradicating absolute poverty and reducing income inequality. The Ninth Malaysia Plan (2006–10) is targeting to halve overall poverty to 2.8 per cent and eradicate hard-core poverty by 2010. It also sets an ambitious Gini target of 0.35 to be achieved by 2020.

Malaysia, as one of the world's most open economies, where international trade plays a vital developmental role, has become increasingly integrated through globalization processes. Malaysia faces new challenges brought about by globalization and regionalization, which will require new policy and strategic approaches if further inroads are to be made in improving human development. As Malaysia charts out its next phase of development in striving to reach developed country status by 2020, a key question is: How will globalization and regionalization impact on Malaysia's international trade and growth, and through growth on poverty reduction and human development?

This chapter begins by outlining Malaysia's changing trade patterns, followed by a description of global and regional trends in international trade. It next discusses the impact of the changing patterns of globalization and regionalization on Malaysia's international trade, growth, and human development. It concludes by discussing the challenges posed by globalization and regionalization, separating the implications in terms of their impact on growth and on poverty.

## Malaysia's Changing Trade Patterns

With greater integration of the world's economies through international trade and capital flows, markets have become more and more dependent

on each other. Trade currently accounts for more than 200 per cent of Malaysia's GDP. In 2005, Malaysia was ranked as the nineteenth most globalized economy by Kearney's Globalization Index (Kearney 2005). Looking ahead, Malaysia's economy is expected to become even more globalized. Total merchandise trade is expected to reach close to RM3 trillion by 2020, from slightly less than RM1 trillion in 2005, almost a threefold increase. The composition and direction of its trade are, however, expected to undergo significant changes.

Malaysia's long-term development thrust is still guided by its Vision 2020, which is to achieve the status of a developed nation by that date. With a per capita income of US\$4,904 in 2005, Malaysia is currently between the per capita income of Mexico and Poland compared to the average per capita income of the Organisation for Economic Co-operation and Development (OECD) countries of US\$29,777 in 2005. In purchasing power parity (PPP) terms, Malaysia's per capita income in 2005 stood at US\$10,318, compared to US\$9,991 for Mexico, US\$13,364 for Poland, and the OECD average of US\$26,824.

Malaysia's growth over 2006-20 is anticipated to average 6.3 per cent per annum, raising PPP per capita income to around US\$27,000—the OECD average in 2005. International trade is expected to make a significant contribution to growth, and the growth targets will be pursued within an environment of greater liberalization, reduced trade barriers, and increased competition. Domestically, robust consumer spending, an expected pickup in private investment spurred by improving electronics exports, and higher government expenditure related to the start of the Ninth Malaysia Plan (2006-10) will also provide further support for growth (ADB 2006).

Malaysia's manufactured exports, which now account for about 80 per cent of total trade, will increase in share slightly but the composition will change. Exports will increasingly be more skills- and technology-intensive, as knowledge-based industries become more important to the economy (Box 3.1). Traditional agricultural exports are likely to decline, and there will be an emphasis on 'New Agriculture' (Box 3.2).

**Box 3.1 Upscaling Malaysia's Manufacturing**

During the Ninth Malaysia Plan period (2006-10), the focus of the manufacturing sector is to upscale the sector towards higher value added activities and upgrade its capacity in the provision of related services. A Third Industrial Master Plan (IMP3) (2006-20) will be launched in mid-2006 to build on the achievements of the past two industrial master plans. The further growth of competitive higher value added manufacturing industries and services will be a key objective. The IMP3 will take into account the global and regional trends in integration, and trends in international trade and capital flows, especially in responding to increasing competition. International trade and FDI flows are expected to play an important role in accelerating the pace of industrialization. Key strategic thrusts are likely to include further integration of Malaysian companies into regional and global networks, raising the contribution of services to growth, and focusing on developing human capital to support industrialization.

Growth will continue to be export-led and the impetus for growth and investment will come largely from technology and innovation-driven industries. Policies and programmes will be geared towards encouraging the private sector, and government-linked companies (GLCs) in particular, to take up new investment opportunities and build up indigenous capability to utilize new technology as well as develop new products and services that will generate new demand and expand markets.

Although non-resource-based products, especially electrical and electronic products, will continue to lead overall manufacturing exports, an essential component of industrial policy is to move towards the manufacturing of higher value added resource-based products, particularly within the agro-based and petrochemical subsectors. The aim is to optimize and value add to the utilization of Malaysia's natural resources. The development of the resource-based industries will also promote greater inter-industry and inter-sectoral synergies.

While building upon the capacity of industries to produce next generation products, efforts will be made to create new sources of growth, especially within the biotechnology and information and communications technology (ICT) industries to diversify and broaden the manufacturing base. Other areas of growth include shared services and outsourcing. To promote investment in these new growth areas, a RM600 million strategic investment fund will be established. The fund will be used to attract high-quality investment in projects which are knowledge-intensive and labour-saving and have a high-technology content involving research and development, intellectual property development, as well as human capital enhancement.

Further, in the face of an increasingly globalized and competitive world economic environment, the Ninth Malaysia Plan identified the need to strengthen Malaysia's position in the international value chain. Malaysia will undertake to expand the scope and coverage of its regional arrangements such as free trade agreements (FTAs) and economic partnership agreements to ensure greater access to markets, trade, and investment opportunities. Meanwhile, Malaysian firms are encouraged to forge and intensify strategic integration with foreign affiliates, especially in high-technology industrial activities and related services.

*Source:* Based mainly on the Ninth Malaysia Plan (2006-10).

### Box 3.2 Strengthening Malaysia's Agriculture

During the Ninth Malaysia Plan period (2006-10), the agriculture sector will be revitalized to become the third engine of growth after the manufacturing and services sectors. The focus will be on developing 'New Agriculture'. This will involve expanding large-scale commercial farming and venturing into high-quality and value added primary and processing activities, particularly biotechnology. The productivity, efficiency, and wealth-generating potential of the sector will be enhanced through wider application of modern farming methods and ICT, strengthening research and development, improving marketing capability, and promoting greater private sector investment, including foreign investment.

Optimization of land use as well as land consolidation and rehabilitation will be given priority. New land development will concentrate on expanding oil palm cultivation by the private sector. In addition, large-scale production and precision farming systems will be implemented in new production zones for fruits, vegetables, aquaculture, and livestock. Some of these zones will be developed for large-scale production by the private sector. This will involve the acquisition of large state land by the Federal Government to be leased by the private sector. The other zones will be developed for small-scale entrepreneurs and farmers.

Additionally, more effective measures will be undertaken to increase the incomes of smallholders, farmers, and fishermen. Ageing smallholders and farmers will be encouraged to participate in exit schemes through land consolidation and rehabilitation as well as group replanting programmes. Incomes of rubber and oil palm smallholders will be enhanced through replanting programmes using high-yielding clones based on the mini-estate and group farming concepts as well as mixed farming, including integration of livestock in plantations, aquaculture, and off-farm economic activities. Cocoa, pepper, and sago farmers, particularly in Sabah and Sarawak, will be provided with financial assistance to rehabilitate their farms through the estate-based concept as well as encouraged to participate in the related agro-based processing and activities. Padi farmers will also be encouraged to participate in mini-estates and group farming activities.

*Source:* Based on the Ninth Malaysia Plan (2006-10).

In moving towards developed nation status, Malaysia's services sector will grow more important and will increase its share of GDP above the 58 per cent share in 2005, to about two-thirds in the long term. Exports of services, which now account for a small proportion of total exports, are expected to grow at more significant rates, underpinned by robust growth in consumer spending and by new areas of growth, such as outsourcing of business services.

## Globalization and Regionalization—Trends and Issues

The benefits of rapid globalization, a phenomenon characterized by rapid integration and interdependence of the economies of the world, have not been evenly spread. Poverty is still high and inequality has widened in many countries, despite the pro-poor benefits that have been

claimed for globalization. Progress in poverty reduction and human development has been uneven between and within regions (UNDP 1999 and 2003). In poorer countries, the pace of progress has been held back by inequitable terms of trade, especially through protectionist measures in agriculture of the rich countries.

Globalization processes bring opportunities and challenges for Malaysia. Opportunities include easier access to markets, technology, capital, labour, and intermediate inputs, while challenges include vulnerability to external shocks and increased competition. Globalization compels countries to adopt best practices, sound policies, and good governance. It exposes policy missteps and policy failures with severe consequences. It tends to erode sovereignty and reduce the space for equity and affirmative action, but rewards efficiency and meritocracy.

### *Global Trade Patterns*

Malaysia's international trade growth prospects will be affected by global trends in international trade. The main features of global trade patterns are summarized below:

- The North American region (the USA and Canada) is the world's leading importer and second largest exporter. Its share of world exports increased from 16.6 per cent in 1995 to 17.3 per cent in 2004. Mexico, following the formation of the North American Free Trade Agreement (NAFTA), has become the largest trading partner of North America. China is the largest import source for North America. It is anticipated that the region would still maintain its position in global trade.
- The North East Asian region (comprising China, Japan, the Republic of Korea, Taiwan Province of China, and Hong Kong) was the fastest growing region in international trade. In 1996, it accounted for about 18 per cent of world trade, increasing its share to 19 per cent in 2004. China has become the largest exporter and importer in the region, and it is anticipated it will maintain its growth momentum.
- China's growth in trade and investments and its integration into the global economy have been phenomenal. China became the world's

third largest trading nation in 2004. In 1996, China's share of East Asian trade was 15 per cent, and by 2004 this increased to about one-third. About half of China's exports are to Japan, the USA, and Hong Kong; Malaysia is the fifteenth largest market for China's exports and the seventh largest import source. China's exports of higher value added capital and technology-intensive products have increased. Its exports of electrical and electronic products now exceed those of Japan and its machinery exports have overtaken Taiwan Province of China, while it has become the largest exporter of textiles from East Asia. Rapid growth has increased its imports of machinery and equipment, and of energy (that is, oil and raw materials).

- The EU is the world's leading exporter and second largest importer. Intra-regional trade accounted for 60 per cent of the EU's trade, an indication of the high level of the EU's integration. Germany, France, the UK, Italy, and the Netherlands accounted for about 69 per cent of the EU's total trade. By 2004, China had replaced Japan as the EU's third largest, while Malaysia remained its sixth largest trading partner.

### *Changing Patterns of Capital Flows*

Over the past twenty years or so, Malaysia has attracted a sizeable amount of FDI. Changes in the global and regional environment have impacted on FDI inflows. And Malaysia's own success in changing its position in the international division of labour has meant that it is beginning to be a significant net investor overseas. The major trends in FDI are as follows:

- The top global sources of FDI flows were the USA, the larger economies of the EU, and Japan. In the developing world, Asia was the largest source of global outward flows and it had increased its share to 8 per cent by the early 2000s, compared to 2 per cent in 1985. The major sources of the FDI outflows came from Hong Kong, Singapore, Taiwan Province of China, the Republic of Korea, China, and Malaysia.
- Between 2001 and 2006, Malaysia's outward investment amounted to roughly 3.2 per cent of its GDP. While the amounts of external

investment have fluctuated, these have not been lower than 2 per cent of GDP in these five years. Of these flows, 30 per cent have been to South-East Asian neighbours, notably Singapore and Indonesia; around 18 per cent to the USA; and 14 per cent to Europe. Malaysia's capability to invest abroad is potentially a key component of enhancing its international competitiveness and access to international technology.

- During the second half of the 1990s, global FDI flows grew rapidly due to the strong global economy, the boom in information technology (IT), and robust corporate activities in capital expansion and cross-border mergers and acquisitions (M&As). The USA, the UK, Germany and Belgium/Luxembourg were the largest recipients of global FDI inflows. The developed countries accounted for the bulk of global FDI inflows.
- FDI inflows to the developing countries were concentrated in the Asia-Pacific region and Latin America. Since the 1990s, North East Asia, especially China and Hong Kong, have become the largest recipients of FDI inflows.
- The size and pattern of global FDI flows were determined by global mergers and acquisitions which were transacted mainly in the developed countries, peaking in 2000 and valued at US\$1.14 trillion. Developing countries accounted for about 12 per cent of the global M&A sales during the 1990- 2003 period.
- FDI inflows into Asia increased in the second half of the 1990s and peaked in 2000. China attracted very sizeable FDI inflows, especially into manufacturing. Inflows into Hong Kong were mainly into services. Malaysia, Thailand, and India attracted additional FDI inflows, mainly into manufacturing.
- FDI inflows into ASEAN have been falling since the Asian financial crisis. Although inflows picked up in 2003, they remained below the pre-crisis level. China's attraction for FDI was the main factor for the decline in FDI inflows into ASEAN. By the early 2000s, ASEAN accounted for about 12 per cent of the total FDI flows to developing countries.

## *Regional Growth and Integration*

In considering the implications of regionalization on trade and poverty, it is useful to classify regionalization into three broad areas—the growth and integration of East Asia; the growth and integration of South-East Asia, that is ASEAN; and the growth and integration between ASEAN and East Asia.

The growth prospects for East Asia, comprising China, Japan, the Republic of Korea, and Taiwan Province of China, remain encouraging and are expected to be a major source of global economic growth, especially for the Asian region. China will continue to be the key economy that will drive the East Asian region. The relocation of enterprises from Japan, Taiwan Province of China, the Republic of Korea, and Hong Kong to China has influenced trade and capital flows in the East Asian region. The process of integration between the countries is expected to intensify.

Intra-ASEAN integration is increasing. ASEAN, with a population of about 500 million, can be broadly divided into two groups—that is, the more advanced countries comprising Singapore, Malaysia, Thailand, Brunei Darussalam, the Philippines, and Indonesia; and the less developed countries of Cambodia, Laos, Myanmar, and Vietnam, or the CLMV group. ASEAN-5, comprising Singapore, Malaysia, Thailand, Indonesia, and the Philippines, accounted for almost 93 per cent of total ASEAN trade, with Singapore (35.6 per cent in 2004) and Malaysia (25.2 per cent in 2004) having the largest shares. Even so the level of trade integration has not been very high. In 2004, intra-ASEAN trade accounted for just 21 per cent of total ASEAN trade. However, with the AFTA, the ASEAN Investment Area (AIA), and other programmes for ASEAN, integration is expected to increase. In the long term, ASEAN is moving towards an ASEAN Economic Community.

ASEAN is increasingly integrating with other East Asian countries. Efforts are also being made to forge greater integration with India, Australia, New Zealand, and the USA, through a number of FTAs and co-operation programmes. Of special significance is the integration with China, Japan and the Republic of Korea and the efforts to forge an East Asian community. It has been estimated that by 2010 ASEAN's trade with China will surpass its trade with the USA.

### *FTAs and Comprehensive Cooperation*

Asian, including ASEAN, integration will be propelled by a number of FTAs and comprehensive cooperation programmes. These measures, when fully implemented, are anticipated not only to have an impact on growth prospects, but to shape regional trade and capital flows. The key building blocks of East Asian integration are the integration of ASEAN with the North East Asian region, and the forging of an East Asian Economic Community. Increasing integration of two of the world's high-growth regions would enhance human development and the living standards of the region's peoples.

The WTO estimates that by 2005 there had been some 300 FTAs. There are two types of FTAs involving ASEAN member countries: first, bilateral FTAs initiated by individual members; and second, ASEAN-wide FTAs involving countries outside ASEAN. Singapore has taken the lead in forming bilateral FTAs with New Zealand, Australia, Japan, the European Free Trade Association (EFTA), and the USA. Meanwhile, ASEAN as a group has been negotiating FTAs with China and India; closer economic relations with Australia and New Zealand; and a comprehensive economic partnership with Japan.

Of particular importance is the ASEAN–China FTA (ACFTA). The ACFTA is to be realized within 10 years and include 'early harvest' provisions, cooperation in trade, investment, services, human resource development, agriculture, and the Mekong River basin development, leading to an Agreement on Economic Cooperation. It is anticipated that there will be three major components of the ACFTA covering trade in products, services, and investment, following the signing of the Framework Agreement.

Japan, the other large trading partner, is negotiating with ASEAN for an ASEAN–Japan Comprehensive Economic Partnership (AJCEP). The AJCEP covers a comprehensive programme for liberalization, facilitation, and capacity building, and also a differential treatment and assistance programme for the latecomers in ASEAN. Quantitative estimates show that the impact of tariff reductions, and other indirect effects, will increase ASEAN's and Japan's trade.

## Impact of Globalization and Regionalization on Trade and Poverty

Poverty reduction in Malaysia, in the past, was achieved against a mixed global and regional context—that is, with periods of protectionism and moves towards liberalization, and a different setting of global governance. What impact will globalization and regionalization have on levels of poverty and human development in the future?

### *Globalization, Regionalization, and Trade*

Against the backdrop of changing global trade patterns and greater regional integration, Malaysia's trading partners are expected to change. In the past, the USA, Japan, and the EU have been the major markets for Malaysia's exports. Increasingly, Malaysia will integrate more with East and South Asia, especially with China and India, which will become more important as destinations for the country's exports. Similarly, trade with the West Asian countries will expand further. The importance of the traditional markets is anticipated to decline.

In 2005, the USA, Singapore, and Japan continued to be the top three trading partners accounting for about 42.2 per cent of total trade, with the USA (16.6 per cent) still leading the top three countries. China's trade with Malaysia rose from 2.4 per cent in 1995 to 8.8 per cent in 2005, with similar rising shares recorded for the Republic of Korea, Hong Kong, and Thailand, and a stagnant share for Taiwan Province of China. Over time, the EU's share of Malaysia's total trade has fallen. Germany, the Netherlands, the UK, and France were the top four trading partners with 8.3 per cent of total trade in 2005. Rapidly emerging markets for Malaysia include South Asia, particularly India, West Asia, Russia, the Czech Republic, Brazil, Mexico, and South Africa. The United Arab Emirates, Saudi Arabia, Turkey, and Iran were the markets that recorded rapid growth for Malaysia's exports.

China is becoming increasingly integrated into the production networks in the East Asian, including the ASEAN, region. China's growing importance as a trading partner for Malaysia is expected to continue and it will be a force for East Asian integration. It is now Malaysia's fourth largest trading partner, increasing its trade from RM9.2 billion in 1995 to RM85.1 billion in 2005, almost an eightfold increase. In 2005, Malaysia's exports to China reached RM35.2 billion, while imports from China were valued at RM49.9 million. Malaysia's exports to China have also been changing: exports of electrical and electronics were the leading exports to China by 2005, while palm oil exports were the largest exports in 1995. In 1995, palm oil exports accounted for 37.3 per cent of total exports, falling to 12.6 per cent in 2005. Conversely, exports of electrical and electronics products increased to 43 per cent in 2005, compared to 5.1 per cent in 1995.

ASEAN is a major trading partner for Malaysia and integration through trade with ASEAN is expected to increase. In 2005, ASEAN accounted for about 26 per cent of Malaysia's exports and about one-quarter of its imports. Singapore, Thailand, Indonesia, and the Philippines are Malaysia's leading trading partners in ASEAN and the share of Malaysia's trade with Thailand, Indonesia, and the Philippines has been increasing from 5.5 per cent in 1995 to 10.4 per cent in 2005. Singapore's share recorded a fall from 16.3 per cent to 13.9 per cent, but the republic still retained its position as Malaysia's most important trading partner. Within ASEAN, the five countries which currently dominate and account for more than 90 per cent of ASEAN's trade are Singapore, Malaysia, Thailand, Indonesia, and the Philippines.

Malaysia has also been an early trade partner and investor in the new members of ASEAN—Cambodia, Myanmar, Lao PDR, and Vietnam. These countries have carried out extensive reforms and have joined or are joining the international trade bodies, such the WTO. These countries are on the verge of an economic take-off, assuming the international environment remains favourable. Malaysian trade and investment ties with these countries will be expanding.

## *Globalization, Regionalization, and Growth*

Sustaining economic growth, in the light of growing competition and changes in the comparative advantage of Malaysia's economy, will be vital. Growth is still a necessary condition for poverty reduction, and growth through international trade will be a key part of development strategy. Increasing demand for energy to support growth in the context of uncertainties about supplies and price volatility will have a bearing on Malaysia's growth achievements (Box 3.3).

### **Box 3.3 Addressing Negative Externalities of Globalization**

Industrialization and modernization are spreading everywhere, albeit at differing paces and with differing consequences. And as they spread, alongside increased GDP and reduced poverty, there is increasing fossil fuel use, natural resource depletion, and loss of biodiversity.

The energy-intensive lifestyle of those living in developed countries is now being adopted among rapidly developing Asian countries, especially China and India. And this means, inter alia, increasing emissions from automobiles, factories, and power plants. Climate change and global warming are consequences. So too are air and river pollution. Given the increased scale of global economic activity, international trade is a major driver of environmental change. Advancing economic growth requires intensifying the use of finite natural resources, but large-scale use of these resources is leading to ecological disequilibrium.

In order to respond to these challenges, and to help ensure sustainable human development, UNDP Malaysia is supporting the Malaysian Government to exploit renewable energy resources, including the development of biofuel using palm oil as a source of renewable energy to promote energy-efficiency programmes and technologies in the industrial and commercial sectors, as well as investing in a host of projects to ensure improved and sustainable environmental management. (<http://www.undp.org.my>)

Malaysia's pattern of international trade will undergo changes and there is the strong likelihood that it will become more integrated, through trade and capital flows, with the faster growing economies in East Asia, especially with China. Trade and capital flows are undergoing changes and will continue to change, especially as intra-South-East Asia and intra-East Asia integration intensifies, and the expected increasing integration between South-East and North East Asia occurs. As these economies are anticipated to sustain relatively high growth rates, Malaysia is well positioned to take advantage of the growth opportunities, but the extent that it will succeed in gaining markets for its products will be contingent on the economy's capability in raising its level of competitiveness.

## *Liberalization, Competition and Growth*

A fundamental feature of the global and regional environment is the push towards liberalization. Economies have been opening up and are subjected to greater competition. Trade reforms have been continuing and the liberalization of the trade regime is expected to continue: tariffs have fallen and will continue to fall, and there will be stronger pressures to remove non-tariff barriers. Many policies on the trade front have to be 'WTO-compliant'.

The benefits that have been claimed for free trade are based on two key assumptions: (a) there is full use of resources, and (b) there are perfect markets for risks. In reality, both conditions are usually violated. Trade liberalization is supposed to redirect resources from low-productivity protected sectors to more productive sectors. But many economies suffer from high unemployment and workers may just be pushed out of low-productive employment into unemployment. The free trade model also assumes an absence of risks but capital markets are inherently imperfect due mainly to the persistence of asymmetric information. Sequencing, therefore, does matter—that is, whether trade liberalization occurs before or after risks markets and social safety net programmes have been developed.

Much of the attention on liberalization has focused on the markets for products but there is an urgent need to open up the market for services, if services are to take off and generate new sources of growth. The current trading regime protects services, but if greater foreign involvement in a wide range of services would reduce prices, and improve the quality of services, from business to professional services, then these markets for services should be opened up and subjected to greater competition.

There are two key issues related to liberalization, and connected with content and timing, that have implications for inequality and poverty. Malaysia's current and capital accounts are open and with its WTO commitments, its bilateral commitments, and its commitments as a member of ASEAN, the economy is being liberalized further. Malaysia's commitment to pursue 'progressive liberalization' will allow it to pursue a well-sequenced approach. This will afford Malaysia some leeway to minimize the costs of adjustments, including the impact on low-income

groups, arising from continuing trade reforms. Progressive liberalization will also allow Malaysia to decide on the timing of the opening up of its subsectors. It is anticipated that the services sector will be last to open up.

## Challenges

### *Competition and Raising Competitiveness*

Malaysia's comparative advantage for the manufacture and export of labour-intensive products has eroded. In the past, labour-intensive, low-wage industries were instrumental in generating employment and absorbing unskilled labour, raising income, and reducing poverty. However, China, and other emerging economies, with ample supply of low-cost labour, have become more competitive and have attracted FDI. Further, domestic investors have also contributed to labour-intensive exports. Wages in these emerging economies are lower than in Malaysia and Malaysian labour-intensive export-oriented industries, such as electrical and electronics and textiles and apparel, are facing greater competitive pressures. Foreign-owned firms, including some TNCs, have relocated much of their labour-intensive operations to China and elsewhere, while many Malaysian enterprises have also invested overseas in low-wage cost countries, such as China and Vietnam, in order to remain competitive.

A key challenge for Malaysia therefore is how it can raise its level of competitiveness. Its export markets must grow, as exports are an important source of growth. As a trading nation, it is vital that the nation raises its level of competitiveness to maintain and to increase its market share of exports, and to diversify into new growth markets. With greater competition internationally to attract manufacturing on the basis of low cost, sustaining a high level of growth will require a shift to growth led by enhancing productivity. This will involve both moving up the value chain into new areas of competitive advantage and developing new products and services.

## *Competition from China*

China's rise as an economic power poses challenges and opportunities. China's strong competitive position in the manufacture and export of electrical and electronics products and its gradual expansion into high-technology products pose a challenge. China's huge market, relatively low labour costs, and still ample labour supply are boosting its competitive position.

Malaysia's bilateral trade with China has been growing. Exports grew from about RM1.7 billion in 1990 to about RM35 billion by 2005, and imports from RM1.5 billion to RM49.9 billion. The trade balance has fluctuated. Machinery and transport equipment account for slightly more than half of Malaysia's exports to China. Overall, Malaysia and China share the same export markets—that is, the USA, Japan, the Netherlands, and Hong Kong. There is also a significant 'overlap' in Malaysian and Chinese exports, and much of the overlap in exports originates largely from electronics and electronic items.

Monthly wages of unskilled production workers for some companies in the eastern seaboard cities of China could be 20–70 per cent lower, as compared with Malaysia. Some companies in Malaysia, such as Motorola, Sony Electronics, Acer Technology, Philips Electronics, Seagate Storage Products, Astee Advanced Power System, and Philips Semiconductor, have relocated some of their operations to China to take advantage of the lower labour costs.

With shortages in low-cost labour, Malaysia has imported cheap immigrant labour from neighbouring Indonesia and other labour-surplus Asian countries, not only for manufacturing but also for the construction, agriculture, and service sectors. Further, illegal immigrant labour now forms a sizeable proportion of the total immigrant labour force. The strains and social costs of having a large immigrant labour force are rising and the Government is now putting in place more stringent controls on the recruitment of foreign workers. Cheaper immigrant labour is but a temporary measure to stem the pressure for wage costs to increase.

Increasingly, Malaysia's response to the competitive challenge facing it is to restructure and upgrade its long-term industrial structure and to move up the value chain. This requires it to upgrade its manufacturing industries to high-technology and knowledge-intensive industries and at the same time to invest heavily in improving its human capital, especially in science and technology, so as to raise productivity (Box 3.4).

#### Box 3.4 Malaysia's Human Capital Vision

Malaysia has a vision to become a developed nation by 2020. Thus, in the next 14-year phase, Malaysia's developmental initiatives will be guided by its National Mission. Among its key thrusts are the following: to raise the capacity for knowledge and innovation and to nurture a 'first-class mentality'.

During the Ninth Malaysia Plan period (2006-10), investments in human capital will be given high emphasis so as to sustain economic resilience and growth, drive a knowledge-based economy, and foster a community with an exemplary value system. Policies and programmes will prioritize the improvement of the education system and ensure a holistic human capital development, encompassing knowledge and skills, a progressive attitude, and strong moral and ethical values.

The implementation of lifelong learning programmes will be accelerated to encourage skills upgrading among all segments of society, and education and training delivery systems will be expanded, particularly in the vocational and technical fields. Emphasis will also be given to the development of entrepreneurial skills at all levels of education, and training will be provided to facilitate the creation of an entrepreneurial society. Further, with the awareness that human resources in science and technology are essential for scientific discovery and innovation, efforts will be intensified to increase human capital investment.

The technological capability and capacity of SMEs will be strengthened to propel them up the value chain of the manufacturing, agriculture, and services sectors. Measures will be undertaken to encourage collaborative ventures among MNCs, GLCs, and SMEs to facilitate technology transfer and skills development as well as marketing.

With the inception of the Ninth Malaysia Plan (2006-10), the Multimedia Super Corridor (MSC) Malaysia will go into its second phase. The MSC is a designated zone designed to help Malaysia further advance into the information and knowledge age. Physically, it includes an area that stretches from the Petronas Twin Towers in Kuala Lumpur City Centre to the Kuala Lumpur International Airport, and it also includes the new administrative capital, Putrajaya, the intelligent city, Cyberjaya, and Technology Park Malaysia, which serves as a model for the development of the MSC. MSC Malaysia will promote local-foreign cooperation in information and communications research and development, and encourage the usage of domestic IT products and services. Under the second phase, new cybercentres will also be developed in Perak, Melaka, Johor, and Sarawak.

*Source:* Based mainly on the Ninth Malaysia Plan (2006-10).

### *Global Production Networks—Trade and FDI*

An important challenge for Malaysia is how it will respond to the development of the global and regional production network. The global and regional production network will determine, to a significant extent, trade and capital flows. In Asia, the development of global production networks has been driven largely by the TNCs in a number of key industries, especially in electronics and electrical products and in automobiles. Much of international trade now is intra-industry trade and involves, largely, inter-affiliate trade.

As international production systems play an increasingly dominant economic role, it also becomes more important to measure the extent and impact of the activities of TNCs and their foreign affiliates. The increase in the number of TNCs and its affiliates in the world economy has been linked to the increase in international production. Much of the exports of TNCs are related to intra-TNCs sales within the international production network. TNCs have had a profound impact on the worldwide restructuring of activities in the consumer electronics industry. Japanese firms, for example, established large-scale component plants and linked them tightly to the just-in-time procurement system. Their networks included plants under their own management, as well as a host of independent and semi-independent component suppliers operating on subcontract and original equipment manufacture (OEM) arrangements.

The competitive pressures to attract TNCs and to be integrated into the global production network will make demands on human capital resources. Malaysia is passing through the unskilled labour-intensive industrialization phase and is now entering the phase of a much more technologically intensive industrialization. Raising the quality of its human capital stock and supply will be crucial if it is to increase its productivity and compete for global markets.

### *Services and International Trade in Services*

As the pace of industrialization increases, trade in services is anticipated to grow. Services make up the largest sector in the Malaysian economy, and services have been identified as a potential new source of growth.

Especially with rising income, demand for services, including financial services, education, health, wholesale and retail trade, is expected to increase. Manufacturing-related services, business professional services, and ICT-related services will continue to expand.

The outsourcing of services from the developed countries is anticipated to accelerate as TNCs take advantage of lower costs of services in relatively low-labour cost economies. Outsourcing of services can cross borders, or it can remain within national boundaries. Malaysia, along with India and China, has been identified as one centre for the outsourcing of services.

Currently, Malaysia's export of services is small and the services account in the balance of payments has been recording sizeable deficits. Payments of services have been substantial. New growth opportunities opened up by international trade in services can provide new employment opportunities. But this will require more skilled and knowledge-based workers if the export of services is to be competitive.

## Conclusions

The global and regional developments summarized above highlight the changing environment that Malaysia will face as it embarks on its next phase of development. Sustaining growth through international trade will be a prerequisite for raising income levels and further improving human development. While it is envisaged that the private sector will be the engine of growth moving forward, increasingly, there will be a greater role for public-private sector partnerships, and for the public sector to continue to create the enabling environment to support export-led economic growth and human development.

Poverty reduction is also determined by the level and behaviour of inequality. A much higher increase in inequality, together with a high level of initial inequality, can affect economic growth and the speed of decline in poverty—that is, there is growth-poverty elasticity. If growth is accompanied by falling inequality, then poverty falls faster. While the Malaysian economy will be more integrated globally and regionally with

increasing international trade and capital flows, it will be necessary to supplement the pro-growth policies with other pro-distributive policies, if progress to eradicate poverty is to be sustained.

The impact of competition will require rapid adjustments to the demand and supply sides of labour and generally for human capital. As Malaysia's comparative advantage in labour-intensive industries that utilize unskilled labour continues to be eroded, it will need to move up the value chain and build up its capability to manufacture and export more skilled and technologically intensive products. Unskilled labour in the labour-intensive industries will have to be rechannelled to the new growth areas during this period of adjustment. Labour entering the market will have to meet the changing demands from these new economic activities.

New sources of growth are anticipated to expand. Beyond growth in more technology-intensive exports, a key part of increased trade will come from the growth of trade in services. Services and more knowledge-based services will grow in importance and will generate more employment opportunities. These services will include manufacturing-related services, logistics, ICT-related services, and business professional services.

With the anticipated increase in the use of high technology, a more educated and trained labour force will be required. Productivity and wage levels are anticipated to rise. The contribution of TFP is also expected to rise. A combination of these favourable factors, therefore, is required to raise income levels and eventually help to eradicate poverty.

Given political stability, the long-term growth prospects for the Malaysian economy are encouraging. A growth rate of slightly above 6 per cent per annum over the next 15 years is attainable. The economy will continue to be open and international trade will still be an important source of growth. The economy will increasingly become more integrated with the high-growth Asian economies, especially with China. Competition will intensify. As the economy progresses towards the status of a developed country, absolute poverty will be eradicated and Malaysia will advance to even higher levels of human development.

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