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The Malaysian Economic Development Challenge: Can Productivity Growth Co-exist With Income Redistribution?*

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Abstract

Malaysia's Vision 2020 calls for the country to reach fully developed industrial status by that year. Even before the recent Asian financial crisis called attention to the need for Asian economies to become more efficient, Malaysia recognized that future growth increasingly has to come from improved productivity. At the same time, Malaysia has as one of its public policy priorities the economic improvement of its indigenous Malay population (bumiputeras). This paper discusses Malaysian growth patterns and challenges. It reviews the tensions between the dual goals of stimulating growth and redistribution of income and wealth, including encouragement of stimulate small and medium enterprises (SME's) as a way of fostering bumiputera capitalism. Finally, it reviews a very specific policy--the Vendor Development Program--intended to encourage bumiputera suppliers to large and multi-national manufacturers in Malaysia.

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Introduction

Malaysia presents an interesting study in government policy toward business. The country is widely perceived as business-friendly and not greatly afflicted by the corruption, cronyism, institutional weaknesses, and political instability that characterize several of its neighbors. Nevertheless, it is a nation where the role of government in guiding the economy is very strong. Malaysian policy has long aimed for two important goals: economic growth to eradicate poverty and restructuring society through redistribution of income and wealth. Both of these objectives are related to maintaining racial harmony in an ethnically diverse society.

This paper discusses the tensions between the dual goals of growth and redistribution and how the financial crisis of 1997 has changed the trade-off between the two ends. It will evaluate how one specific government initiative, the Vendor Development Program, attempts to achieve both goals.

Background

Malaysia's Economy

Prior to the summer of 1997, Malaysia was properly regarded as one of the "Asian Miracle" economies. Real economic growth in the 1990's averaged above 8% so that by the middle of the decade per capita GDP had reached about 50% of developed status. (See Table 1.) Unemployment was so low that

foreign workers were routinely brought in to meet the economy's demand for labor. All of this was achieved with remarkably low measured inflation.

Nevertheless, there were signs that the Malaysian miracle was fragile. Current account deficits were persistent and required offsetting inflows of capital thus contributing to increased borrowing. Labor shortages forced up wages and prices increased rapidly in non-tradables such as real property and financial assets.

In the latter half of 1997, Malaysia fell victim to the financial crises that gripped much of Asia. Whether as a result of its own problems or merely because of its location and contagion, the country felt the pains of the crisis. The currency was buffeted in exchange markets, stock market values crashed, inflation spurted, and most significantly, growth was displaced by significant economic contraction. (See Table 2.)

Ethnicity and Race

There is little doubt that ethnicity and race play an important role in Malaysia's political economy. As in the case of other Southeast Asian nations, there is a significant Chinese population that controls a larger-than-proportional part of the economy. (See Table 3.) However, unlike in those other countries, the Chinese are a large minority. A period of racial tensions and rioting in the 1960's left deep impressions among citizens and politicians in the country. This has translated into public policies that are perceived as important to maintaining domestic tranquility.

The Dual Goals: Growth and Redistribution

Out of the need to maintain ethnic peace grew the twin pillars of Malaysia's socio-economic policies: the eradication of poverty and the restructuring of society. In other words, economic growth and redistribution of income and wealth, mainly from Chinese and foreign interests to indigenous Malays, the "bumiputeras". [Gomez and Jomo, pp 22-23.]

The objectives of growth and redistribution were manifested in various government policies. The New Economic Policy of the 1970-90 period implemented numerous schemes for stimulating general economic development as well as bumiputera capitalism. Included in the latter were various ethnically-based labor and equity participation requirements. At the start of the 1990's, the New Economic Policy was supplanted by the 6th Malaysia Plan that sought to maintain growth by strengthening the export and import-substitution sectors. In addition, bumiputera entrepreneurship was encouraged through a focus on small and medium enterprises (SME's).

Concurrently, Dr. Mahathir Mohamad set an ambitious long-run agenda. In "Vision 2020" the Prime Minister challenged his country to reach fully developed status by that year. Included as one of eight central objectives of Vision 2020 is the "fair and equitable distribution of wealth," to narrow the gaps of income and wealth between the races and to encourage SME's and entrepreneurship, especially among bumiputeras.

The Tension between Growth and Redistribution

The Need for Efficiency

Well before the Asia crisis of 1997, concern was expressed about the sustainability of Asia's miracle. In work published as early as 1992, Young noted that much of Asia's growth was "input-led." That is to say, growth was largely the result of the use of more of the factors of production, i.e., labor and capital, and such growth is subject to diminishing returns. To avoid the limitations of diminishing return requires an emphasis on greater efficiency in the use of inputs. Only through efficiency-led growth, where total factor productivity is increasing, will growth be sustainable in the long run. Krugman raised the visibility of this argument in his influential 1994 article in Foreign Affairs that elicited much response among Asian political leaders.

In spite of the empirical and political quarrels associated with the Young-Krugman assessment of Asian prospects, the need to concentrate on efficiency-led growth was recognized in Malaysia. The 7th Malaysian Plan (1996-2000) promulgated in 1996 specifically addressed the issue of productivity by calling for less growth from inputs and more from the efficient use of such factors. (See Table 4.) Such efficiency would be encouraged by industrial diversification and deepening and through privatization of state-owned businesses.

While recognizing the need to enhance economic efficiency, the 7th Malaysian Plan continued the theme of redistribution. It called for support of

SME's and of bumiputera entrepreneurs, including vendors to large manufacturers and MNC's.

Throughout Asia, the financial crisis highlighted how structural inefficiencies create obstacles to continue growth. These structural problems include corruption and cronyism, weak financial institutions, and misguided industrial policies. To varying degrees, each of the Asian crisis countries was affected by these problems. Another possible source of structural inefficiencies is the attempt to redistribute.

The Equity-Efficiency Trade Off

The trade-off between policies that seek to promote an equitable distribution of income and wealth and the efficiency needs of an economy long have been recognized. [See, for example, Okun, 1975.] In the short-run, policies designed to create a more equitable distribution of income or wealth create disincentives by increasing costs and/or reducing profits. They can also increase perceived risks since the ability to control a particular venture may be reduced by redistribution policies. Such policies also provide opportunities for "rent-seeking" behavior by those who try to utilize the redistribution policies for personal (rather than social) gain. Furthermore, redistribution policies encourage countervailing activities among those from whom the income or wealth would be redirected. [See Gomez and Jomo, pp 47+, for how this occurred in Malaysia.] These rent-seeking and countervailing activities decrease social welfare by diverting resources from value-added activities.

Policy Responses to the 1997 Crisis

Through the 1997 financial crisis and its aftermath, Malaysia continues to support redistribution policies. Since the crisis was largely centered on macro-economic issues and financial institutions, these concerns received the most attention and publicity. However, the commitment to equity remains strong. The National Economic Recovery Plan (NERP) calls for “continuing the equity and socio-economic agenda,” including promotion of bumiputera equity ownership and entrepreneurship through financial support and support to SME vendors and suppliers. [Government of Malaysia, Office of the Prime Minister, National Economic Action Council (NEAC), “National Economic Recovery Plan,” located at website <http://neac.gov.my>.]

Though there continues to be support for redistribution policies, there is also recognition that the equity-efficiency trade-off has changed since the onset of the crisis. Thus, the government’s response has been to reduce the emphasis on equity in hopes that this will enhance growth. For example, the NERP allows for the sale of bumiputera equity to non-bumiputeras. It relaxes the equity (and export) requirements that existed in manufacturing. (See Table 5.) Equity rules for property purchases have also been suspended. [NEAC, “White Paper: Status of the Malaysian Economy,” 1999, located at website <http://neac.gov.my>.]

The Vendor Development Program

Nature of the Program

The Vendor Development Program (VDP) is an effort of the Malaysian government to be responsive to both goals of growth and redistribution. The

VDP is run by the Ministry of Entrepreneur Development (MED) and aims to stimulate Malaysian SME's as "reliable manufacturers and suppliers of industrial parts and components required by large industries (LSI's) and MNC's." [MED, p. 1] It is thus an example of a stimulating growth through "industrial deepening" and import substitution and redistribution through encouragement of SME's, especially for bumiputeras.

The VDP works by establishing "anchor companies" (LSI's and/or MNC's) that are willing to participate. As of 1996 there were 54 anchor companies signed up, but only 27 anchor companies with vendors in place under the program. These anchors included domestic LSI's such as Proton (the national carmaker) and Sapura (telephone equipment) and MNC's such as Philips, Hitachi, Sony, and Samsung. Table 6 presents a list of the anchor companies and the number of vendors participating for each company. Each anchor company signs a "tripartite agreement" with MED and a financial institution that agrees to participate. As of 1996, the VDP targeted eleven industrial sectors from specific (automobile and film production) to general (exports). Through the VDP, eligible applicants may obtain financing, technical, and other assistance. The latter category includes information systems, financial management, management training, and infrastructure.

To qualify to participate in the VDP, an SME must meet a number of conditions. These include at least a 70% equity holding by Malaysians, having skilled workers with relevant line experience, being receptive to advice and

guidance (especially from the anchor company), and having a viable business plan that includes cash flow analysis.

The VDP is managed by a Program Coordinating Committee that develops specific policies and coordinates and facilitates the channeling of assistance and management consultancy to the vendors. The committee meets with anchor companies to encourage their initial and expanded participation and identifies potential new anchors. For example, the Malaysian government, anticipating a decline of the home appliance industry as MNC's seek lower-cost locations, announced plans to for a government-owned home appliance manufacturer along the Proton model. This company would be a logical anchor for the VDP. The Committee also meets with vendors to insure they are meeting quality standards. MED also participates in SME "expos" that attempt to link anchors and potential vendors.

A potential vendor makes application to the MED and if it meets the stated criteria MED will issue a letter authorizing the vendor to approach an anchor company. Table 7 indicates the scope of work expected of the anchor company in the vendor relationship. If the candidate vendor meets with the approval of the anchor company the vendor arrangement is made and the anchor company becomes a "captive market" for the vendor.

A key component of the VDP is the role of financial institution. As of 1996, sixteen banks had been recruited to provide a package of financial assistance to vendors accepted by the anchor company. The level of assistance can vary depending on the needs and viability of each vendor project. Table 8 shows the

types of financial services that may be provided. The financial institution might also provide a financial package to the anchor company to assist the vendors in quality and productivity enhancement. The institutions are required to submit a quarterly report on progress and status of the financial package.

Proton Vendor Characteristics

A full assessment of the VDP is beyond the scope of this paper. However, using data supplied by MED it is possible to discern some patterns in vendor participation for Proton, the national car company. These data indicate why the government perceives SME's as being an important tool for industrial deepening and redistribution.

As was indicated in Table 6, above, among anchor companies, Proton had the largest number of participants (19) in the VDP. However, these represent a relatively small proportion of Proton's vendors. As is shown in Table 9, Proton had 138 vendors for which MED had size and ownership data. [The actual number of vendors was 140, but for two of these the relevant data were not reported.] Of those vendors, 69 qualified (by Malaysian government standards) as SME's in that they had paid up capital of RM2.5 million or less.

A comparison of SME and non-SME vendors shows some clear patterns. First, and not unexpectedly, the non-SME vendors are substantially larger than their SME counterparts. Median paid-up capital for the non-SME vendors is RM10 million versus RM1 million for the SME vendors. Ownership patterns also differ. SME's overall have statistically significant greater Malaysian ownership

and specifically greater bumiputera ownership and thus significantly less foreign equity participation.

The redistribution power of the VDP program can be seen by breaking down the group of 69 SME's into those participating in the VDP versus those that do not. As indicated by both the median and mean paid-up capital, those participating in the VDP are slightly smaller than those that do not. Those SME's that do not participate in the VDP have larger Malaysian ownership, but this is not held by bumiputeras. Only with the VDP vendors is bumiputera ownership remarkably different. Of the 17 SME's participating in the Proton VDP only three have any non-bumiputera ownership and each of those involves foreign participation, not local, non-bumiputera equity. The percentage of equity participation by bumiputeras in the VDP enterprises is overwhelming larger than for non-VDP SME's.

Implications

It is impossible to gauge the overall effectiveness of the VDP program in terms of its costs and benefits either to Malaysia's economy overall or to sectors of that economy. However, even this cursory review does suggest some conclusions. First, the VDP is not a necessary condition for industrial deepening and import substitution. It is apparent from the assessment of the Proton VDP data that these have occurred even without the VDP. Only 17 of Proton's 138 vendors belong to the VDP. In addition, SME development would occur without the VDP since the majority (52 of 69) of Proton's SME vendors are not in the VDP. [It is plausible that other government programs/incentives might have

promoted these relationships.] Neither is the VDP a sufficient condition for SME development. Of the 54 anchor companies, 27 have no vendors participating in VDP as of 1996 and 11 have only one VDP vendor. It is clear, however, that the VDP does support bumiputera ownership of SME's and therefore enhances the redistribution goals of the Malaysian government.

Conclusions

The objective of seeking social equity remains an important goal for Malaysian policy. However, the financial crisis has forced a relaxation of some of the redistribution policies in hopes of stimulating growth.

Preliminary evidence suggests that the Vendor Development Program has been successful in encouraging some bumiputera capitalism. However, much more research must be done to determine if the program has been effective in doing so. Such research could address the following issues:

1. How have VDP SME's managed during the period of the financial crisis?
2. Do anchor companies participate in the VDP because it makes economic sense or is it a "countervailing" activity intended to ward off more onerous government intervention?
3. Have the costs of supporting the VDP and participating SME's been worth it?

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**Table 1: General Economic Characteristics of Malaysia
(1996, unless otherwise stated)**

Population (millions)	21
Per capita GDP (US \$)	4,672
Per cap PPP GDP (US \$)	9,500
GDP % from Agriculture	13%
Real GDP Growth 1992-96	8.6%
CPI Inflation	3.5%
Unemployment (1994)	2.9%
Exchange rate (ringgit/\$)	2.52
Current Account (US \$ millions)	-4,701
Gross Reserves (US \$ millions)	27,009

Sources: IEU, Country Report, Malaysia Brunei, 4th quarter, 1997

Malaysia Department of Statistics, Yearbook of Statistics, 1994, p. 201

Table 2: Effect of the Asian Economic Crisis on Malaysia				
	1996	1997	1998	1999
Real GDP Growth, %	8.6	7.7	-6.7	2.0
CPI Inflation, %	3.5	2.7	5.3	5.0
Exchange rate (ringgit/\$)	2.52	2.90	4.24	3.80
Short-term interest rate, June		7.3	11.1	3.09
KLSE Composite, June		1,058	421	776
Current Account, % of GDP	-5.1	-5.4	13.7	
External debt, % of GDP	41.3	65.4	60.9	
Foreign Reserves, prior Dec. (US \$ mm)	27.0	27.0	21.7	27.16 (Jan)

Sources: The Economist, various issues; Far Eastern Economic Review, various issues; National Economic Action Council, Office of the Prime Minister, Government of Malaysia, "White Paper: Status of the Malaysian Economy," 1999, Table 1

Table 3: Domestic Role of Overseas Chinese				
	Population		Business Output	
Country	as % of total local population	Millions	as % of total local economy	GDP contrib \$ bil
Malaysia	32	6	60	48
Indonesia	4	8	50	98
Philippines	1	1	40	30
Thailand	10	6	50	80
Vietnam	1	1	20	4

Source: *The Economist*, "Survey: Business in Asia," 3/9/96, p. 10

Table 4: Malaysian Contribution of Factors of Production (%)			
	1971-90	1991-95	1996-2000 (planned)
GDP Growth	6.7	8.7	8.0
Labor	2.3	2.5	1.7
Capital	3.2	3.7	3.0
Total factor productivity	1.2	2.5	3.3

Source: Government of Malaysia, Economic Planning Unit, "Seventh Malaysia Plan 1996-2000," Kuala Lumpur, 1996, p. 37.

Industry	Limitation on Foreign Equity Ownership (%)	
	Prior Rule	Relaxation
Telecommunications	30	61
Shipping agencies	49	70
Forwarding agencies	30	49
Insurance companies	49	51
Business property	30	None

Source: NEAC, "White Paper: Status of the Malaysian Economy," 1999, located at website <http://neac.gov.my>.

Table 6: VDP Anchor Companies and Number of Vendors, 1996	
Number of Vendors	Anchor Companies (Number of Vendors)
More than 10	Proton (19) General Lumber Furniture (12)
6-9	Sapura (9) Perbadanan Pembangunan Bandar (6)
5	Sony Electronics Perbadanan Kemajuan Negeri Selangor
4	Philips and JVC Video Sharp Roxy Appliances
3	Sony Video; Perodua Automobile; Matsushita Industrial
2	JVC Electronics; Sony TV Industries; Sharp Roxy; Sharp Roxy Electronics; TDK Malaysia
1	Sony Audio; Hitachi Electronics; Sony Mechatronics; Copal Precision; Sharp Manufacturing; Zen Concrete; Matsushita Electric; Hitachi Airconditioning Samsung Electron Devices; SMK Electronics Pohmay Resources

Source: MED, Franchise and Vendor Division, mimeograph

Table 7: Scope of Work of Anchor Company
1. Meet directly with potential vendors' inquiries, including holding meetings and hosting plant visits
2. Vet applications by within two weeks and complete such a review within eight weeks
3. Evaluate vendor's application on basis of technical, commercial, financial and management considerations
4. Make final acceptance decision
5. Submit proposal on its vendor development scheme covering: number of vendors, components to be subcontracted; sales turnover; investment; technical and infrastructure required; skills training; R&D; financial package
6. Report quarterly to the Vendor Development Committee on progress of vendor development scheme
7. Encouraged to develop its own vendor development unit within the company

Source: MED, Franchise and Vendor Division, "Template Agreement Between the Government of Malaysia With Anchor Company and Bank/Financial Institution", pp 6-7.

Table 8: Items Covered in Financial Packages for SME's in VDP
1. Venture capital
2. Soft loans
3. Accounts receivable financing
4. Credit facilities/guarantee
5. Insurance guarantee
6. After-sales management and financial consultancy
7. Technical assistance funds
8. Holding of vendors' workshops/seminars

Source: MED, Franchise and Vendor Division, "Template Agreement Between the Government of Malaysia With Anchor Company and Bank/Financial Institution", p. 8.

Vendor Type	N	Paid-up Capital (RM thous)		Average Percent Equity		
		Median	Mean	Bumi	Non-Bumi	Foreign
All vendors	138	2,750	10,012	48.3%	25.4%	26.3%
Non-SME vendors	69	10,000	18,992	42.5%	23.0%	34.5%
SME vendors	69	1,000	1,032	54.0% ¹	27.9% ²	18.2% ³
Not in VDP	52	1,000	1,050	40.3%	37.0% ⁴	22.8%
In VDP	17	600	978 ⁵	95.9% ⁶	0.0%	4.1%

Notes:

1. Significantly larger than non-SME's with p-value 0.04 (using t-test; non-equal variances)
2. Not significantly larger than non-SME
3. Significantly smaller than non-SME's with p-value less than 0.01
4. Significantly greater than non-SME's with p-value 0.01
5. Not significantly different from non-VDP
6. Significantly greater than non-VDP at p-value less than 0.01

Source: Mimeographed data from MED, Franchise and Vendor Division