Lessons from Malaysia: The Potential Role of Foreign Interests, Primary Reforms, and the State in Diversifying a Resource-Based Economy

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Introduction:

Since the early decades of their independence, Latin American countries have been subject to numerous and devastating internal and external shocks, contributing to unstable patterns of development. Civil war, terrorism, narcotics, political corruption, and civil unrest on the domestic level combined with market crashes, export price downswings, increasing oil costs, and recessions on the international level have repeatedly halted economies in their tracks and in some cases, even reversed their development. Many theories have been put forward by economists and other academics offering diagnoses of the region's problems, yet there are few that provide possible solutions. Among these few are those that look to other regions of the world that have experienced success under similar conditions to determine if they could be used as a model. Thus far, the most viable models have been taken from the small European states that now form part of the European Union and those East Asian countries whose rapid growth over the last few decades has been termed nothing less than a "miracle." For the purposes of this paper, I will be looking to the latter and to Malaysia, in particular.

Despite the physical and cultural distances between them, Malaysia shares a number of common traits with many Latin American countries. For example, it was a colony of several consecutive nations for several centuries until it won its independence in 1957, it has access to a wealth of natural resources, both agricultural and mineral, and it is home to a large indigenous population. However, unlike many countries in Latin America, Malaysia was able to use all three of these factors to expand and develop its economy. Its colonial legacy provided it with a foundation, its resource endowment provided it with funds, and its indigenous communities provided it with workers, owners, and innovators. As of the late 1960s, Malaysia was the largest exporter of rubber and tin of all developing country exporters. These two resources accounted for the greatest share of the country's export revenues at 35% and 19% respectively.[1] Yet, in spite of or perhaps, as the evidence of this paper may suggest, thanks to its dependence on these resources, within forty years, Malaysia's economy diversified to the point that rubber and tin now make up less than 2% on average of the country's exports, while electronics and palm oil products have replaced them as the top two (see appendix).[2] Although Malaysia has yet to be considered a fully developed nation on par with other East Asian successes such as Japan and South Korea, this remarkable rate of change and growth sets a desirable precedent. The changes made to the rubber industry in this period are particularly noteworthy.

While the industry underwent numerous and varied reforms in the critical period between the early 1960s and the late 1970s, this paper will highlight those changes which led to the establishment of backwards and forwards domestic linkages not only within rubber, but other natural resource industries as well. In order to determine whether similar results could conceivably be achieved in Latin American industries should they implement the same strategies, I will conduct a brief analysis of the economy's move towards diversification, focusing on the development of backwards and forwards domestic linkages and how they were created and encouraged by foreign owners, primary industry reforms, and the state. I will do this by subsuming the steps taken to establish these linkages under four general factors related to their causes and effects, namely foreign patronage and control, vertical disintegration and skilled labour training, economies of scale and worker entrepreneurship, and finally, expansion based on existing factor endowments. With this analysis complete, I will draw attention to potential advantages and disadvantages for this model in the Latin American context.

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[1] John T. Thoburn, *Primary Commodity Exports and Economic Development: Theory, Evidence and a Study of Malaysia* (New York: John Wiley & Sons, Ltd., 1977), 7.
[2] Department of Statistics Malaysia, "Key Statistics," *Malaysia Statistics Agency*, http://www.statistics.gov.my/english/frameset_keystats.php

Foreign Patronage and Control

In beginning my discussion of the role of foreign interests in the diversification of the Malaysian rubber industry and, subsequently, the Malaysian economy, I believe it is important to explain exactly what I mean by "patronage and control." The latter is fairly self-explanatory, being a former colony, a large percentage of Malaysia's natural resource industries before and after 1957 were owned by foreign interests. However, despite extensive foreign ownership, the vast majority of rubber export revenues did not go to overseas investors. For example, in 1972, 74.5% of the total income went to domestic interests, while only 16.8% went to foreign interests, leaving the remaining 8.7% unallocated. This was owed in large part to high shares in wages on the part of Malaysian workers as well as appreciable tax payments to the Malaysian government.[3] This retention put Malaysians in a slightly better position to negotiate terms with foreign owners, thereby altering the nature of the relationship. The patronage aspect refers to the guiding role that foreign intervention played in developing linkages for the rubber industry as well as for other industries that involved foreign interests.[4] The founding of the Chemical Company of Malaysia (CCM) as a subsidiary of a larger British firm provides an excellent example of this role.

Because of the low technological specification required in the production of rubber, the industry requires few backwards linkages (see diagram). Among the most important inputs it does require, however, are chemical products (i.e. formic acid, fertilizer, weedkiller, etc). Before the establishment of CCM in 1963, and its expansion from 1965-1967, the rubber industry had to

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[3] Thoburn, *Primary Commodity Exports*, 150.
[4] Nicholas J. White, *British Business in Post-Colonial Malaysia, 1957-1970: 'Neo-colonialism' or 'disengagement'?* (London: Routledge-Curzon, 2004), 167.

import chemical products at a higher cost. Since the production of these products became domestic, the input costs for the industry decreased and the capital it did spend was for the most part retained locally. However, the company was only able to achieve success in such a small market because it was protected by tariffs and subsidies. This is not at all surprising since practically all of Malaysia's infant chemical industries were subsidiaries of multinational corporations, a fact which does not lead to a lessening of dependence on foreign capital but, as in Malaysia's case, does lead to advances in the ability to diversify. As we will see, this patronizing relationship created the opportunity for Malaysian workers to learn from their foreign employers and to apply that knowledge elsewhere in the economy.[5]

However, it is important to note that, although foreign interests, particularly the former colonial powers, ultimately contributed to the development of the local economy, it was not their foremost intention. Initially, they were reluctant to invest in the establishment of local manufacturing firms as subsidiaries of their own companies, believing that they would absorb too much capital for too little return.[6] However, by the late 1960s, the Malaysian state had abandoned its more *laissez-faire* attitude to managing the economy and had begun a series of restructuring plans following the New Economic Policy put forward by the Razak government. Under the NEP, greater conditions were placed on these companies in exchange for retaining their stake in the Malaysian market.[7] Faced with competition from other powers, many of these companies were forced to comply.

Vertical Disintegration and Skilled Labour Training

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[5] Thoburn, *Primary Commodity Exports*, 158-160

[6] White, *British Business*, 176-177.

[7] Khoo Boo Teik, "Malaysia: Balancing Development and Power," in *The Political Economy of South-East Asia: Markets, Power, and Contestation, 3rd Edition,* eds. Garry Rodan, Kevin Hewison, and Richard Robison (UK: Oxford University Press, 2006), 175-177.

Foreign firms in Malaysia organized the production process in rubber and other natural resource industries into a two-tier system of project design and manufacturing. Basically, these firms took on the job of innovating and designing products while subcontracting the products' manufacture to local firms. This process was combined with a move towards the vertical disintegration of production in which the manufacturing of a product is divided into its component parts, each undertaken by competing local companies.[8] The advantages that came with organizing production in this way were numerous. Because each individual company focused on the manufacture of a particular component, it was able to specialize and perfect its production techniques, eventually leading to an increased demand for skilled labourers, which, through competition, provided the resources necessary to develop more sophisticated methods and products. Furthermore, as a result of the demand for skilled labour, foreign and local firms began introducing apprenticeship programs for their workers. In exchange for a temporary reduction in wages, workers would receive specialized and transferable training in the industry.[9] While these programs were in place in the manufacturing of rubber products, they were considerably more vital in the development of the engineering industry, which required far more specialized knowledge.

The restructuring of production in this way was another result of the processes set in motion by the NEP. Its principle goal was to increase *bumiputera* (Malays and other indigenous groups) shares of economic participation and employment to 30% by 1990.[10] It therefore encouraged vertical disintegration not only because it made local production more efficient given available resources and skill, but also because it increased accessibility to employment and

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[8] Thoburn, *Primary Commodity Exports*, 201
[9] Ibid., 202.
[10] Teik, "Malaysia: Balancing Development and Power," 176.

education opportunities for marginalized bumiputeras. Confronted with this restructuring and by the increasing acquisition of foreign companies by state enterprises, several foreign multinational companies eventually elected to hand over control of their subsidiaries to the state.[11]

Economies of Scale and Worker Entrepreneurship

Also as a result of the vertical disintegration of production, companies were not subject to economies of scale. Because there were so many backward linkages provided by smaller local firms, larger companies could not save money by purchasing in bulk. They therefore paid at the same rates as smaller companies when it came to input costs. While this came as no great advantage to the larger companies, for workers hoping to start their own manufacturing firms, it was just the advantage they needed. For this and other reasons, it was not uncommon for workers in this period to leave their jobs in natural resource industries such as rubber in order to become entrepreneurs and to start businesses of their own. They were able to do this both owing to the skill training they received in the apprenticeship programs provided by their former employer and to the subcontracts they received also from that employer.[12] The lack of economies of scale meant that it would be easier for these workers-turned-entrepreneurs to compete with larger, pre-established companies, provided they were granted some further protection in the way of tariffs and subsidies.[13] Most of these Malaysian entrepreneurs would become the owners and managers of the smaller manufacturing companies discussed in the previous section and would contribute to the same effects: job creation, production refinement, and expansion. This was a further result of the NEP goal to reduce ethnic conflict through increasing bumiputera economic participation

[11] Ibid., 177-178.
[12] Thoburn, *Primary Commodity Exports*, 200.
[13] White, *British Business*, 173.

(e.g. ownership) by providing incentives and subsidies for nascent bumiputera-owned companies.[14]

Expansion Based on Existing Factor Endowments

Yet another factor which contributed to the successful diversification of the economy and one that is related to all of the other factors so far mentioned was that Malaysia's development in these industries was able to follow a fairly natural and steady progression. Beginning with the technology and know-how necessary for the rubber industry, during downswings in rubber prices, companies in that industry were able to diversify and expand their production to palm oil, which required the same basic skills with some moderate sophistication and a higher capital investment. Similarly, technological advances made in the palm oil industry led to advances in the manufacturing industries required to process the raw material, which involved the use of more sophisticated electrical machinery and led to necessary innovations in the engineering industry, and, ultimately, the electronics industry. Of course, the actual process is infinitely more complicated than this, but overall and quite basically, this is the development timeline that these industries have followed in the last forty or so years.[15]

Unfortunately, there has been a precedent set in many developing countries for attempting to force diversification in the economy by establishing completely new and potentially lucrative industries in areas that do not have the factor endowments necessary to support them.[16] Needless to say, these attempts have rarely been successful. In Malaysia's case,

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[14] Ibid., 182-183

[15] See Thoburn and White for development overviews and the UNSTATS (unstats.un.org) Malaysia profile for up-to-date economic and social stats.

[16] Consider the Great Leap Forward introduced by Mao Zedong in the late 1950s and the failure of backyard steel furnaces.

not only would they have been unnecessary for the nation's development, they would have been detrimental to it. Thankfully, despite internal and external pressures, no such attempts were made.

However, this is not to say that the Malaysian government played no part in managing the economy, quite the opposite. Despite the great deal of praise it has been given for adopting "pro-growth, pro-investment, and pro-market policies" while maintaining an open economy (see appendix for 'openness' data), the state has intervened extensively in order to further its own social and political agenda.[17] This agenda was geared towards reducing the ongoing and increasingly hostile conflicts between the major ethnicities in the country: bumiputera, Chinese, and Indian. Unfortunately, though these conflicts have been alleviated somewhat by the measures taken under the NEP and its succeeding policies, they remain a serious concern.[18]

Conclusion

In four decades, Malaysia has gone from being the number one exporter of rubber and tin of all developing countries to having those exports make up the least of its top ten. Its state-led development over these years contributed greatly to the expansion of the economy into more sophisticated industries such as electronics and electrical appliances. It did this by (1) renegotiating its relationship with resident foreign interests so that it could take advantage of what they had to offer in the way of investment and experience, (2) vertically disintegrating production in order to use the nation's strengths (i.e. ample labour supply) and to provide workers with specialized and transferable skills, (3) protecting small firms from competition with larger firms by reducing economies of scale, thereby permitting opportunity for worker

[17] Teik, "Malaysia: Balancing Development and Power," 171.
[18] Ibid., 192.

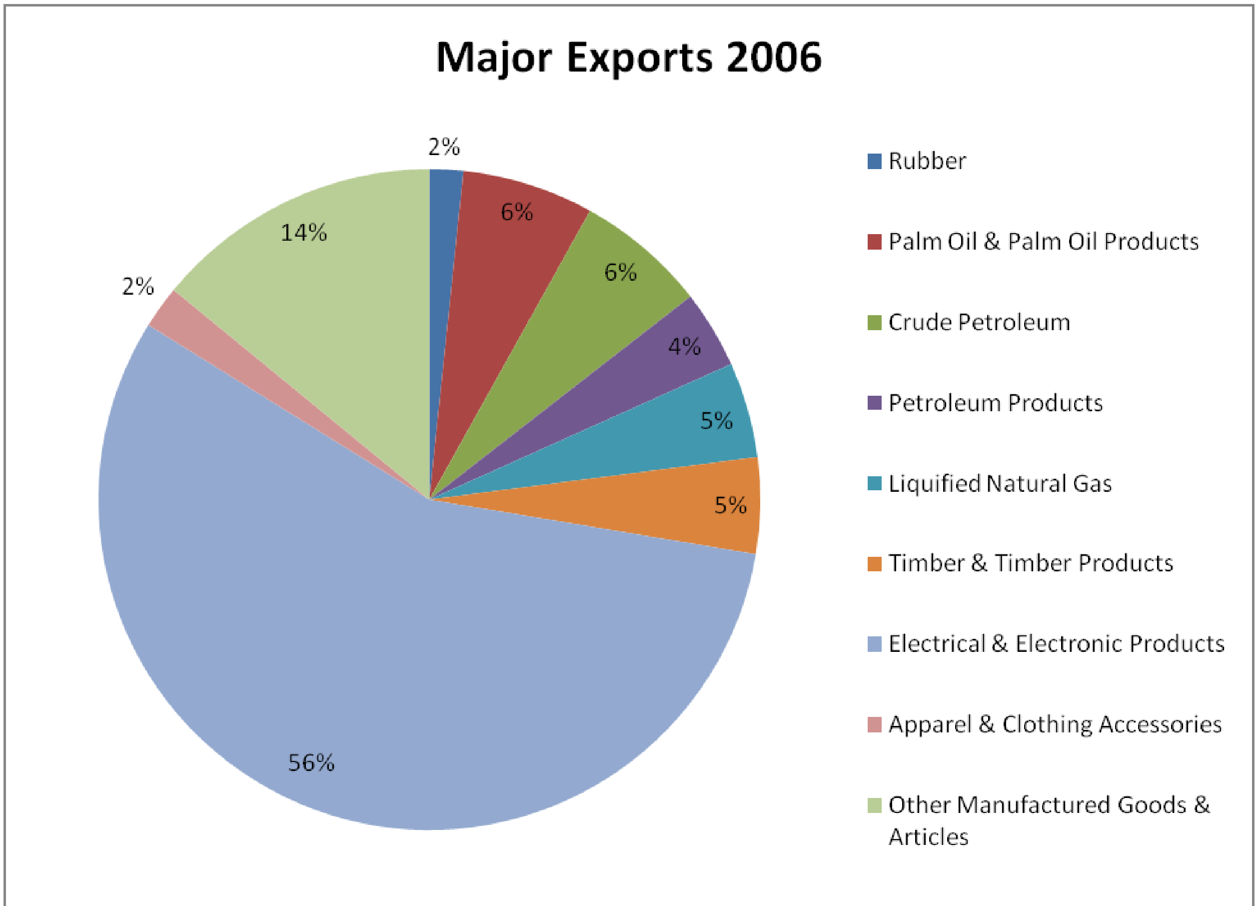
entrepreneurship, and (4) allowing industries to evolve naturally from existing ones instead of trying to force them to improve without the appropriate factor endowments. These far from simple steps provided the Malaysian economy with the foundations necessary to diversify and to shift its reliance from natural resources to much more flexible and therefore more stable industries.

There are many who would argue that Malaysia's success in this area cannot be recreated in the Latin American context because Latin American countries have already developed beyond the point where similar reforms could be implemented.[19] They emphasize that East Asian countries were able to develop along these lines only because certain internal preconditions were met at an opportune time in history. These preconditions included the status of human resources (i.e. high density and population growth), accessibility to natural resources, a stable agricultural and industrial base, high domestic savings and investment, and stable macroeconomic policy.[20] As it stands, Latin American countries arguably meet a number of these preconditions but many have not achieved the stable macroeconomic policy critics argue is required in order to follow the East Asian model. According to this model, it is the state that is responsible for achieving this precondition.[21] Unfortunately, in many Latin American countries, volatile political situations pose considerable obstacles to their economic stability and therefore, to their development. Nevertheless, if these obstacles can somehow be overcome and these governments can stabilize their countries' economies through appropriate macroeconomic policy, this will put them in a better position to attempt at least the first step of the Malaysian model. However, previous

[19] Enzo Grilli and James Riedel, "The East Asian Growth Model: How General is it?" in *Sustaining Export-Oriented Development: Ideas from East Asia*, eds. Ross Garnaut, Enzo Grilli, and James Riedel (UK: Cambridge University Press, 1995), 61.
[20] Ibid., 32-56.
[21] Ibid., 34-35.

experiences foreign powers have left many in these countries with a highly pessimistic outlook that will be difficult to reverse.

APPENDIX



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Openness						
	1950-1960	1961-1970	1971-1980	1981-1990	1991-2000	Overall Average
Malaysia	88.75	83.31	87.84	114.44	201.19	115.11

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[22] Department of Statistics Malaysia, "Key Statistics."
[23] Hira, Andy, "Group Exercise for LAPE EA & Scan Models" handout in *POL 483 Lecture*, October 10, 2007.

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