MALAYSIA

MALAYSIA

by David Creffield

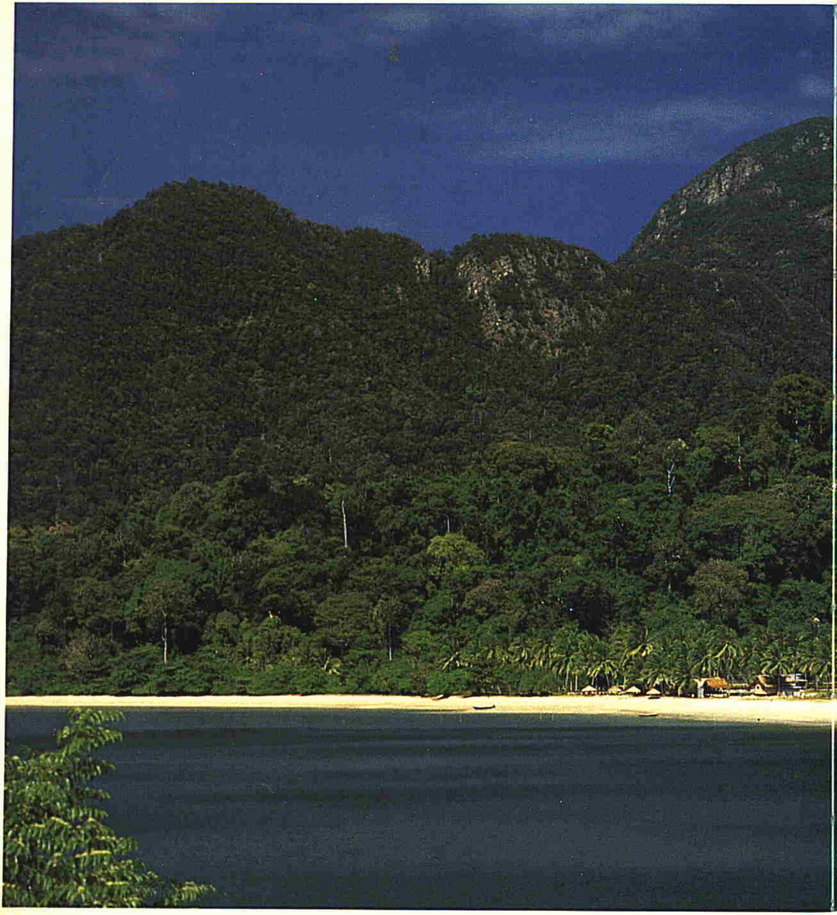
Published by Euromoney Books
and
New Straits Times Press (Malaysia) Berhad
in association with
Arab-Malaysian Merchant Bank
Bank Bumiputra Malaysia Berhad
Malaysia Airlines
Kumpulan Guthrie Berhad
Malaysia Mining Corporation
PERNAS
PETRONAS
Public Bank Berhad
Projek Lebuhraya Utara-Selatan Berhad
United Malayan Banking Corporation Berhad

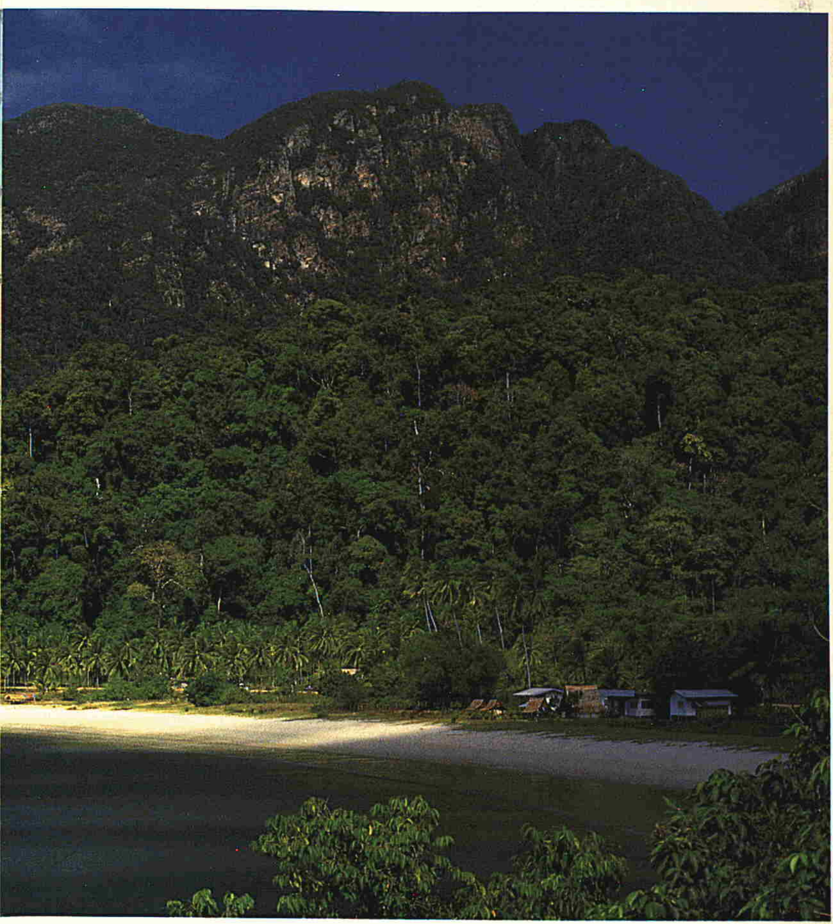
Published by
Euromoney Publications PLC
Nestor House, Playhouse Yard, London EC4V 5EX
and
The New Straits Times Press (Malaysia) Berhad
Balai Berita, 31 Jalan Riong
59100 Kuala Lumpur, Malaysia

ISBN 1 870031 88 1

Typeset in the United Kingdom by PW Graphics
and printed in Malaysia by Tien Wah Press

Contents





Preface

The year 1985 marked an important watershed in the economic history of Malaysia. Since independence in 1957, Malaysia had experienced rapid growth and economic development with growth rates averaging a comfortable 6-7 per cent per annum in the sixties, seventies and early eighties. As a result per capita incomes expanded markedly from a mere US$200 in 1957 to nearly US$1,900 in 1988. In 1985, however, the Malaysian economy faced its worst ever recession with an across-the-board collapse in commodity prices. The economy contracted significantly and gross domestic product registered a negative growth of 1 per cent, the most severe deflation since independence.

The recession and the rapid loss in the terms of trade contracted incomes consecutively for two years between 1985 and 1986. This in turn reduced aggregate domestic demand and further decreased economic activities in the country. The economy too had been saddled with the twin deficits on the government's fiscal budget and the balance of payments, which had developed in the early eighties due to the expansionary fiscal policy adopted to generate growth.

Faced with this serious challenge the government recognised the need for major structural adjustments to move the economy out of recession as well as to correct the twin imbalances which had clearly become unsustainable. Instead of taking the traditional route of pump priming the economy the government saw the need for a complete structural adjustment to put the economy back on its path of sustainable growth. This turnaround in policy stance required the government to change the emphasis in its economic philosophy from one of promoting growth through public sector expansion to that of encouraging private enterprise and initiative as the new engine of growth. The government thus adopted a package of measures to reduce the size of the public sector as well as measures to stimulate private sector confidence and increase its role in the economy.

The government therefore embarked on an austerity drive to consolidate the public sector finances and to correct the twin imbalances. Expeditures were thus retrenched and the public sector fiscal deficit brought under control. Major prepayments were undertaken to reduce the nation's level of foreign debt and bring the debt servicing ratio to a more prudent level from 18.7 per cent of GNP in 1986 to 13.3 per cent in 1988. A further programme was also instituted to bring the Non-Financial Public Enterprises (NFPEs) under strict fiscal supervision and to privatise these NFPEs where possible. A policy decision was made not to create new NFPEs which would compete with the private sector.

As the share of government participation in the economy was progressively reduced, the need for the private sector to take up the slack had to be encouraged. In this respect therefore a concerted effort was undertaken to create a more liberal and deregulated environment conducive to private investment and enterprise. Thus the licensing conditions under the Industrial Coordination Act and foreign equity ownership regulations were liberalised whilst generous fiscal incentives were also given to encourage private investment. The corporate income tax rate was reduced while the new Promotion of Investment Act provided even more favourable incentives for manufacturing, agriculture and tourism.

In addition an Industrial Master Plan was adopted which provided the broad perspective for the long-term industrialisation of the economy. Small and medium-scale industries were further encouraged to build important industrial linkages as well as job potential for the economy. Policies where thus geared towards increasing productivity, efficiency and cost reduction, all aimed at maintaining Malaysia's competitiveness in the international market.

In support, monetary policy was formulated to ensure adequate access to financial resources for productive investment whilst domestic price stability was maintained so that gains in competitiveness would not be reduced by inflation. The exchange rate of the Malaysian ringgit also depreciated in line with market forces. This further increased the competitiveness of Malaysian exports. At the same time deregulation and liberalisation measures were also undertaken to strengthen and modernise the financial services in support of the new demands for innovation and greater competition.

With the structural adjustment implemented by the government, the economy took a significant turnaround in 1987 and 1988. From a slow start in 1986, the economy recovered markedly supported by an external boom in commodity prices as well as strong domestic fundamentals. The volume of trade surged beyond expectations, recording double-digit growth, resulting in a strong surplus on the current account of the balance of payments. At the same time domestic demand accelerated in response to the rapid rise in income while business confidence returned to the economy, inducing a strong expansion in private investment. Thus private investment rose from a negative rate of 8.1 per cent in 1985 to 23.5 per cent in 1988. More encouraging was the strengthening of the government's finances, particularly the budget current account. Thus the current account of the Federal Government Budget turned around from a deficit of M$2,042 million in 1987 to a surplus of M$143 million in 1988. Manufacturing output in particular rose rapidly induced by strong external demand and the support of a more competitive ringgit. Overall growth expanded beyond expectations with GDP rising by 8.7 per cent in 1988.

Structural adjustment had thus enabled Malaysia to ride out one of the most severe recessions on record and had laid the groundwork for future growth and development. The 1990s should present a decade of important challenges to the Malaysian economy with the international trading environment becoming increasingly difficult and protectionist in sentiment. Nevertheless the strong fundamentals in the economy should enable Malaysia to adjust better to fluctuations and uncertainties in the world economy. The history of the country had shown that resilience to manage uncertainty as well as willingness and the ability to make politically unpopular decisions are some of the strongest elements in Malaysian economic management. These are the qualities that will be drawn upon to enable Malaysia to remain competitive in the international market.

The key factor to future growth will therefore lie in Malaysia's capacity to produce and export. Given the small domestic market, growth expansion can only be accelerated through balanced growth and an outward looking stance. Policies will thus continue to be implemented to support this orientation, with private investment being the crucial element to achieve greater diversification and income generation. The public sector will continue to play an important supportive role in providing the necessary infrastructure to facilitate this growth. Public policy will thus remain flexible and pragmatic to be consistent with the need to remain competitive, resilient and growth-oriented as Malaysia enters the 1990s.

I am confident that the long-term growth prospects of the Malaysian economy are excellent. The political system has been severely tested in recent years and has shown its resilience and strength which augurs well for the future. We have built up a sound network of infrastructure, the financial system is being geared to serve the economy better while public services are efficient and are constantly upgraded. Malaysia therefore strides into the 1990s with confidence and optimism.

Dato' Paduka Daim Zainuddin

Introduction

Malaysia is opening its doors wide to the foreign investor. In an economic environment where manufacturing has become the country's primary engine of growth and where most manufacturing activity has been funded by foreign investment, the Malaysian government has recognised its importance and continues to encourage such investments and woo overseas entrepreneurs. Foreign investment is not limited to industry and manufacturing; incentives exist across a wide range of economic sectors and foreign businessmen receive the red carpet treatment for any proposal that brings either technology or expertise to the country. The already generous package of incentives on offer is continually being revised and enhanced.

Malaysia is expected to achieve Newly Industrialised Country (NIC) status by the end of the century, by which time industrial production is targeted to account for 80 per cent of GDP, against the present level of about 18 per cent. The greatest opportunities will be in industry and manufacturing, particularly in the downstream processing of Malaysia's wealth of raw materials. There is great scope for the expansion of rubber-processing industries and, as intensive logging of Malaysia's tropical rain forests is curtailed, a rapid growth of timber-based industries is anticipated.

Growth will depend on foreign investment for expansion, modernisation and technology transfer. With a population of only 17 million, Malaysia's domestic market is correspondingly small and thus most manufacturing is aimed at markets overseas, reflected in a skewing towards multinational investments in electronics and textiles.

Outside industry, opportunities also exist in transport, tourism and communications. Although Malaysia's infrastructure is better than that of many of her neighbours, there is a determination on the government's part not to allow infrastructure to become a hindrance to further development. The ambitious M$4.5 billion highway project currently under construction will see a new expressway stretching from one end of Peninsular Malaysia to the other by the middle of the 1990s, and a major docks redevelopment is also planned for the 1990s.

Another stimulus to development should come from the privatisation of transport and communications, along with a host of other economic activities. Hungry also for a larger slice of the lucrative tourism pie, Malaysia is promoting tourism activities and forecasting much higher growth than its neighbours in the 1990s. As an indication of its confidence in being able to attract increasing numbers of tourists, Malaysia's national airline, Malaysia Airlines, is replacing its entire fleet of aircraft. Much slower than its neighbours to recognise tourism as a valuable source of foreign exchange, the industry also offers considerable opportunities for foreign investors.

Complementing the investment incentives to the foreign investor are the benefits of an increasingly sophisticated banking and financial system. Measures have been taken to deregulate the financial system and enhance competition in banking. An active secondary market for the trading of government securities has been created. Following the banking scandals of the mid-1980s, considerable re-regulation by the central bank has taken place to enhance the safety-net of the banking system. The sector is also benefiting from Malaysia's strong economic recovery following the recession of the mid-1980s.

Much of the credit for the recovery is claimed by the government, which initiated a series of new policies designed to revive the fortunes of the economy in the mid-1980s. The encouragement to private capital, the restrictions on the borrowing and investment of unprofitable state enterprises and the new regime of fiscal tightening have put government finances on a sound footing.

Malaysia has also enjoyed a long period of democracy and stability since independence, and it retains important political and economic links both within and outside the Asia-Pacific region. Malaysia is a member of ASEAN and of the British Commonwealth, ties which have helped provide important security to this emerging nation. Its position on the edge of the world's most rapidly growing region will be a vital determinant of its growth into the 1990s.

With its polyglot population, foreign businessmen might expect to encounter language difficulties, but this is not the case. Most Malaysians, particularly those in the cities, speak good English, although the introduction of Bahasa Malaysia as the language of learning in schools may affect the standard of English in the future. Standards of education are high and there is a large pool of graduate labour available.

Malaysia has sought to build a wide-ranging political and economic consensus by bringing the indigenous Malay Bumiputera population into the mainstream of business life. As a means of doing so – following communal conflicts in the late 1960s – the New Economic Policy was introduced in 1970. The policy has sometimes been seen as a disincentive to the Chinese community and a brake on domestic investment. Apart from giving Bumiputeras special privileges in education and employment, the NEP imposes conditions on employers, enforcing set levels of Bumiputera employment. Given the importance of this regulatory framework, foreign and local investors will scrutinise very carefully the new policy that will replace the NEP in 1990 which is expected to be a diluted version of the controversial original.

Chapter One

History: the nation's development

The cultural melting pot

The unique ethnic mix of present day Malaysia was fashioned by its location at one of the world's major geographical crossroads. Peninsular Malaysia formed a bridge that for thousands of years allowed the relatively easy intercourse of the peoples of mainland South East Asia and China with those further south in Indonesia and ultimately to the islands of the Pacific beyond. In more modern times, its strategic location made it a natural meeting point of traders from the east and the west.

The fertile soil and rich stock of resources on the land and in the surrounding waters provided an incentive for those early travellers to stay. This bounty of nature made Malaysia one of man's earliest homes, a presence testified to by Stone Age implements unearthed around the country.

The earliest inhabitants, the pioneers of a general movement of peoples from China and Tibet, were the Orang Asli, a nomadic people who are believed to have started arriving about 5,000 years ago. Their descendants still pursue a largely nomadic way of life in the jungles of Peninsular Malaysia, regardless of efforts to integrate them into the community. There are similar communities in Sarawak and Sabah, where the oldest indigenous peoples are respectively the Sea Dayaks or Ibans, and the Kadazans or Dusuns.

The next arrivals, the Malays, represented the second and third waves of migration and they brought with them more advanced farming techniques and metalworking skills and – over a period of about 3,000 years – these early settlers made the transition from a nomadic and food-gathering people to a food-producing economy based on the knowledge of agricultural techniques and animal domestication. It is these early Malay settlers who today make up the indigenous peoples of Malaysia and who are collectively classified as Bumiputera, or "sons of the soil".

In around the first century BC regular trading contacts began to be made with foreign countries, principally with China and India, and it was at this time that the Hindu and Buddhist elements of Indian culture made a major impact that was to last for over a thousand years. The significance of these elements began to wane when Indian and Arab traders who were adherents of Islam started to arrive in Melaka, which had developed as the focal point of foreign trade. The spice trade thus became a catalyst for the rise of Islam, which had become a significant influence as early as the thirteenth century. Islam received the official seal of approval in about 1410 when Melaka's first ruler, Parameswara, was converted. Within just 40 years it had become the official state religion under Sultan Muzaffar Shah.

The Melaka sultanate

The emergence of the Melaka sultanate followed the decline of the Srivijaya empire. Its early rulers sought relations with the Chinese empire as a counterweight to the kings of Siam, their principal local rivals. At its peak, the Melaka sultanate covered the greater part of the peninsula as well as the east coast of Sumatra and it was the sultanate that subsequently established the states of Pahang, Johor and Perak. These were the earliest states to be founded in the Malaysian peninsula.

This period of about a hundred years from 1410 to 1511, before the penetration by the European powers, is considered the classical age of Malay culture. It gave the Melaka sultanate a strength and legitimacy that survived long after it was conquered by the Portuguese in 1511. It also established Melaka's role as the great entrepôt of the region and the state was a commercial, rather than military, power. But foreign trade remained under the control of the foreign communities in Malaysia, who were allowed to regulate themselves, a system that was perpetuated after the coming of European domination. Displacement from Melaka was not the end of the sultanate however, and successors rebuilt their power in Johor.

Sabah and Sarawak, however, did not come under the ambit of Melaka, being part of the Brunei sultanate which attained the brief height of its glory in the sixteenth century after the fall of Melaka. The rise of the Sumatran state of Aceh presented another challenge to the powers of the region, and it was with Aceh that the Dutch first sought to ally themselves.

European expansion

With the advance of the Europeans into the region, the power of both the Melaka and Brunei empires was crippled, in the case of Brunei in its infancy, by the establishment of the Spaniards in the Philippines and by the rise of Dutch power in Java. In 1641 the Dutch wrested control of Melaka from the Portuguese. From the mid-seventeenth to the mid-eighteenth century the Dutch controlled the region's commerce from Batavia (Jakarta), while Johor built itself into the strongest state, creating the Riau-Johor empire in the eighteenth century.

The arrival in the arena of the British with the resources and organisation of the Industrial Revolution wrought the most dramatic changes. Geared to exploiting Malaysia's resources for its rapid industrialisation at home, Britain rapidly put in place a new economic system from its bases in Penang (1786), Malacca (1824) and Singapore (1819), after earlier establishing a presence in north Borneo in 1773. The three Malaysian bases became known as the Straits Settlements, in which British laws were introduced and various departments were organised to administer land, collect taxes and to organise trade and development.

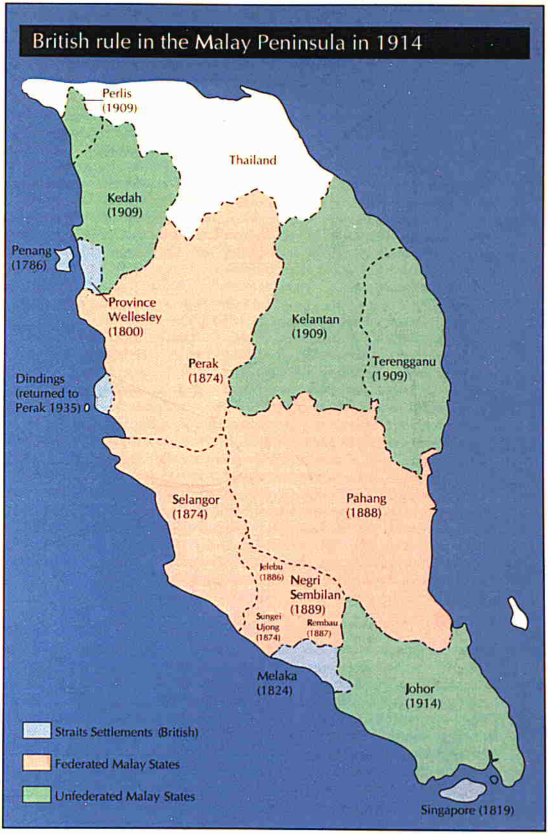
At this moment in history – when Britain began to transform Malaysia from a trading and subsistence economy to one based on the export of raw materials – Malaysia first became part of the world trading system. The east coast states, however, remained to a large extent unaffected. It was on the west coast where, driven by the demand for tin in Europe, a rapid political, economic and social upheaval took place.

This period also saw the emergence of new states with the establishment of Perlis in the north, which had been conquered and ruled by the Siamese for 20 years and had now been returned; Pahang, which freed itself from the Johor Empire; and Johor itself.

In 1824 the British and Dutch agreed the Treaty of London, which divided the Malay states into British and Dutch spheres of influence. This imposed British rule throughout the peninsula, whilst giving the Dutch a free hand in Java and Sumatra. During the early years of British rule the Settlements were unprofitable for the East India Company, which administered them. However, trade flourished and Singapore's deep-water port meant that it benefited particularly from the coming of steamships after 1845. In 1867 the Settlements secured colonial status, separate from India.

The extension of British rule

Colonial rule was extended gradually over Peninsular Malaya, advancing fitfully and often


British rule in the Malay Peninsula in 1914
Perlis (1909)
Thailand
Kedah (1909)
Penang (1786)
Province Wellesley (1800)
Kelantan (1909)
Terengganu (1909)
Perak (1874)
Dindings (returned to Perak 1935)
Selangor (1874)
Pahang (1888)
Jelebu (1886)
Negri Sembilan (1889)
Sungei Ujong (1874)
Rembau (1887)
Melaka (1824)
Johor (1914)
Singapore (1819)
Straits Settlements (British)
Federated Malay States
Unfederated Malay States

against the wishes of less expansionist authorities in London. This haphazard extension of control created a patchwork of states, each with differing relations with the British authorities. In 1874 the British signed the Pangkor Engagement with the rulers of Perak, by which a British resident was imposed on the sultan as adviser. Similar arrangements were made in Selangor and Sungei Ujong that year. After 1877, Perak built up its tin trade and put the state's finances on a sounder footing. Kuala Lumpur emerged as the capital of Selangor in 1880 and the state was developed under the vigorous Frank Swettenham.

Johor was brought under British protection in 1885 and a British resident was appointed in Pahang in 1888. Federation of the protected states was established in 1895.

In Borneo the British adventurer James Brooke had secured the title of "Raja" of Sarawak in 1841 in exchange for assisting the Regent of Brunei in putting down a rebellion. In 1847 the first territory was ceded to Brooke and he succeeded in pacifying the region. His successors paid off the state's debt, but development was limited. Meanwhile Sarawak was declared a British protectorate in 1888, along with North Borneo and Brunei.

In 1914 the political organisation of the present-day states of Malaysia was as follows:

1. The Straits Settlements: British crown colony headed by a British governor; consisting of Singapore, Malacca, Penang, Labuan, the Cocos Islands and Christmas Island. Capital: Singapore.
2. The Federated Malay States: British protectorate headed by a British high commissioner (the governor of the Straits Settlements): consisting of the states of Negeri Sembilan, Pahang, Perak and Selangor. Capital: Kuala Lumpur.
3. The Unfederated Malay States: British protectorate under the tutelage of a British advisor in each state responsible to the British high commissioner; consisting of Johor, Kedah, Kelantan, Perlis and Terengganu.
4. Sarawak: British protectorate ruled by the Brooke family. Capital: Kuching.
5. Sabah: British protectorate, headed by a governor appointed by the Chartered Company of British North Borneo. Capital: Jesselton (now Kota Kinabalu).

Difficulties in world markets for tin and rubber in the 1920s were accompanied by the floating of ideas of political decentralisation as a way of cutting expenditure. But the greatest problem of the inter-war years was in the emergence of racial rivalries and problems, with the British taking steps to curb Chinese immigration and retain Malaya's character as a Malay country. Greater authority was also devolved back down to the Federated States and some branches of the professions were opened to non-Europeans. Towards the end of the 1930s, the Sino-Japanese war and the alliance of the Kuomintang with the Chinese Communists had repercussions amongst Malaysia's Chinese community, from which the local Communists drew their support.

The beginning of nationalism

During the years of British rule a growing political consciousness began to develop among indigenous Malays and the immigrant population, but it was not until the end of the Second World War that the forces of nationalism began to emerge. They had been stimulated by the humiliating defeat of the British in Malaya and Singapore by the Japanese and the destruction of the myth of Western colonial supremacy. The activities of Malay Islamic reformists, Chinese revolutionary idealists and Indian nationalists did not prevent the British from resuming their authority after the war, but the colonial administrators quickly realised that they faced an entirely new political situation which demanded radical change. In 1945, the British announced proposals for the dissolution of the Straits Settlements and plans for a new Malayan Union. Penang and Malacca were to be forced into an arranged marriage with the other Malay states of the peninsula. Because of its large entrepôt trade, Singapore was to become a separate crown colony in the shake-up as were both Sarawak and British North Borneo, while Brunei was to remain a British protectorate.

Although slow in coming – food shortages, racial conflict and inflation were the main preoccupations – these new arrangements met with considerable opposition, both in Sarawak, where a strong campaign against Crown colony status culminated in the assassination of the British governor, and on the Malay peninsula where the proposed Malayan Union would have reduced the status of the Malay states virtually to that of a British colony. When the British government published a White Paper on the constitution in January 1946, the Malay community was outraged and two months later 42 Malay organisations – soon to form themselves into the United Malays National Organisation (UMNO) – met to devise a campaign to defeat the proposals. The Malays' objections to the Malayan Union were clear. They feared that the transfer of jurisdiction from the Malay rulers to the British Crown and the changed conditions of citizenship would result in Chinese domination.

The protests over the proposed Malayan Union were so vociferous that Britain was forced to think again. In its place, a federal scheme was drawn up and, after lengthy negotiations with the Malay rulers, UMNO and other parties, the Federation of Malaya came into being in 1948. The new Federation consisted of all nine Malay states of the peninsula as well as Penang and Melaka, united under a federal government in Kuala Lumpur, headed by a British high commissioner, with the Malay rulers remaining sovereign.

Communism and the Emergency

An additional problem for the British at this time was the growing strength of the Malayan Communist Party, formed in 1931, the roots of which had been nourished from China. The propaganda of the Malayan Communist Party became very much more effective in the immediate post-war period with high unemployment, rapid inflation and shortages of essential foodstuffs such as rice – generally caused by the unstable economic and political conditions. The party had built up its credibility and prestige as a patriotic resistance movement during the Japanese occupation which it exploited in the post-war years.

Legalised for the first time in its history, the Malayan Communist Party took advantage of a British administration that wished to encourage a democratic labour movement. Through membership of the governor's Advisory Council in Singapore it was given a share in policy making and it exerted influence on constitutional development through such organisations as the All-Malaya Council of Joint Action and the Malayan Democratic Union. The party was effective in building up support through the then infant labour movement and created the General Labour Union in Singapore in 1945 with branches in Malaya. Early in 1946 these labour unions were incorporated into a Communist-dominated Pan-Malayan Federation of Trade Unions which supported widespread strikes on the rubber estates.

However, as economic conditions improved and wartime shortages disappeared, support for the Communist Party diminished. Another factor was the absconding in 1947, with the party's funds, of its secretary-general, Lai Teck. A year later, a Communist youth conference held in Calcutta, sponsored by the Soviet-controlled World Federation of Democratic Youth, came out in favour of militant action which was followed by risings in Burma, Indonesia, Indochina and then Malaya.

Arms that had been hidden after the Malayan People's Anti-Japanese Army was disbanded at the end of the war were made available and the uprising – aimed at economic disruption – began in earnest with the murder of three British planters in Perak in mid-1948, followed by a wave of attacks on European planters, their estate workers and tin miners.

The British poured in heavy troop reinforcements and, under the command of General Gerald Templer, forced the guerrillas onto the defensive. The British initiated a closed village policy under which 500 "new villages" were set up into which scattered settlements of Chinese squatters were moved under curfew conditions to prevent them giving assistance to the guerrillas. Regulations issued under the Emergency banned the Communist Party and the Malay Nationalist Party along with associate organisations supposedly tainted by their involvement with the Communists. By 1953 the worst fighting of the Emergency had subsided, although the uprising dragged on for over 10 years, officially ending in 1960. Almost exclusively Chinese, the Communist guerrillas used a combination of persuasion and intimidation to exact supplies and information from mainly rural Chinese communities, although their core political support came from the urban poor and rural squatters. The Communists found little support among Malays.

The impetus to independence

The Emergency gave an impetus to plans for independence. In preparation for this, the British increased Malayanisation in the civil service and introduced increased representation of Malayans and Singaporeans in both the legislative and executive councils. Municipal elections were held in Singapore in 1949 and, although the councils in Kuala Lumpur continued to be wholly nominated bodies, in 1951 non-official councillors were nominated as "members", or ministers in charge of specific departments.

Under this system, Dato Onn bin Ja'afar was appointed member for home affairs. He tried to achieve racial harmony by opening UMNO to non-Malays, but when he failed to get enough support Dato Onn resigned from the party and established the Independence of Malaya Party with the aim of securing independence within seven years. Dato Onn's party was heavily defeated at the Kuala Lumpur municipal elections in 1952 by an alliance between UMNO and the Malayan Chinese Association which had been formed in 1949 as an anti-Communist party of Malayan Chinese. This temporary marriage of convenience became a lasting one which, in 1954, was joined by the Malayan Indian Congress.

In the same year the Communists were in disarray and retreat, the economy was booming and political tensions were easing. Britain declared that it would grant independence as soon as the Emergency was over. In 1955, as a step towards this, the administration introduced a new constitution which, in the elections of that year, gave largely elected legislative councils responsibility over many functions. The Alliance, by now led by UMNO president Tunku Abdul Rahman, gained all but one of the elective seats and promptly offered an amnesty to the Communist rebels, pointing out that as independence was now being gained by constitutional means, there was no point in continuing their struggle. No agreement was reached, however, and the Emergency dragged on for another four years, albeit in a desultory way.

The Alliance was pledged to achieving independence within the shortest possible time. An Independent Constitutional Commission began its work in June 1956 and submitted its proposals to the British government early the following year. The Federation of Malaya Agreement was signed in August 1957 and independence came at the end of the same month with Tunku Abdul Rahman as Malaya's first prime minister.

Several new parties emerged after independence but in the state elections of 1959, the Alliance won all but two states, Kelantan and Terengganu in the north, which went to the new Pan-Malayan Islamic Party. The two new left-wing parties, the People's Progressive Party and the Socialist Front, were unsuccessful.

The formation of Malaysia

Tunku Abdul Rahman outlined his proposals for a wider federation, comprising Malaya, Singapore and the Borneo states in a speech given to a group of foreign correspondents at the Adelphi Hotel in Singapore in 1961. The situation in Singapore was causing concern in Malaya where it was felt that with Britain's proposals to give Singapore independence in mid-1963, leftist groups might well capture power and strengthen the position of the Malayan Communist Party. The Malayan government was also concerned about the situation in Sabah and Sarawak where Britain had done little to safeguard the interests of the indigenous people. Negotiations with Singapore dragged on for two years. It was important for UMNO to bring the Borneo territories into any larger federation, as a merger with Singapore without them would mean the Chinese outnumbering the Malays.

Generally welcomed in Malaya and Singapore, elsewhere the Tunku's controversial proposals aroused a mixed response, one of anger from the Philippines, with its claims of sovereignty over parts of Sabah, and from Indonesia because of complex ideological, political and economic factors. It was agreed that the views of the people of Sabah and Sarawak and those of the Sultan of Brunei would have to be ascertained and a joint Anglo-Malayan Commission of Inquiry, headed by Lord Cobbold, a former Governor of the Bank of England, visited Borneo and reported that the majority of people in Sabah and Sarawak favoured the formation of Malaysia. Brunei, however, declined to join the new federation. Malaysia came into being with the London Agreement of 1963 and two years of tension followed. The Philippines broke off diplomatic relations and all trade, travel and communications links between Indonesia and Malaysia were severed. Armed confrontation took place both on the peninsula and across the land frontiers in Borneo. Hostilities with Indonesia were brought to an end by an agreement signed in Bangkok in 1966 and the Philippines gave its formal recognition of Malaysia the same year.

With increasingly strained relations between the state of Singapore and the central government of Malaysia, Singapore split from Malaysia and became an independent state in 1965. The Borneo states, Sabah and particularly Sarawak, having been more closely linked to Singapore, now began to resent their assimilation into Malaysia and had to be placated with a certain amount of autonomy. Particularly resented was the influx of officials from the peninsula who had to be pulled back and replaced by local recruits.

Post-independence

Rich in natural resources and with a good infrastructure, Malaysia was poised for growth. The major shortcoming that Singapore's defection exacerbated was Malaysia's under-developed commercial services.

The expansion of agriculture was the priority of the First Malaysian Plan, 1966-70, during which period land under oil palm was doubled and there was large-scale replanting of rubber. Although the period was one of growing prosperity, it was recognised that indigenous Malays were not taking an effective part in the country's growing commercial activities and held only 1.5 per cent of the assets of private companies in the country. While this was the cause of resentment on the part of Malays, it was balanced by Chinese resentment at Malay cultural nationalism, the planned imposition of Bahasa Malaysia as the national language and the decision to enforce the language as the medium of instruction in all schools.

Polarisation and tensions increased as the May 1969 elections approached with new, more radical political parties on the scene, including the People's Action Party, the People's Progressive Party and the Malaysian People's Movement. The Alliance won the election but lost 10 per cent of the popular vote. Victory celebrations by the Malaysian People's Movement, a multi-racial party that had replaced the Socialist Front, and by the Democratic Action Party, sparked two days of rioting in Kuala Lumpur in which several hundred people were killed and property destroyed. Parliament and the constitution were suspended and a state of emergency declared. A National Operations Council took over the government and, in 1970, an advisory National Consultative Council was established.

It was felt by Chinese leaders as well as by Malays that racial tensions would ease if steps were taken to bring Malays up to the economic level of the other groups. A new ideology was sought, one that would put more emphasis on the restructuring of society, eliminate racial differences and maintain national unity and particularly to improve the lot of rural Malays. A national ideology was introduced which laid down five principles of national harmony and the discussion of "sensitive issues" was outlawed. The New Economic Policy was launched and incorporated into the Second Malaysian Plan 1971-75. After a poor start to the plan period with weakening trade and a fall in the rubber price, the economy picked up, helped by investment from the UK, the US, Japan and particularly Singapore.

Parliament was reconvened at the beginning of 1971 and the following year the People's Progressive Party was persuaded to join the Alliance, leaving the opposition parties weakened and relatively ineffectual. In the federal elections in 1974, the Alliance (the National Front) won all but nine seats. In the general election of 1978, the Alliance won a clear mandate for its policies including the new Third Malaysian Plan.

Economic prosperity in the 1970s allowed the Malaysian administration to make considerable progress towards achieving the objectives under the New Economic Policy. At the same time Malaysia established a more independent foreign policy, helping to found the Association of South East Asian Nations (ASEAN), recognising Communist China in 1974 and identifying itself with the non-aligned countries of the Third World. Issues of the 1980s have been primarily concerned with the challenges of establishing heavy industry and having to face the economic realities of lower prices for her raw materials. With strong economic recovery at the end of the decade helped by improved commodity prices and soaring manufacturing exports, the outstanding challenge for Malaysia remained that of forging its different communities into a more united nation.

Chapter Two

Geography, population and natural resources

Malaysia covers an area of about 330,433 square kilometres on the Malay peninsula and the states of Sabah and Sarawak in the north-western coastal area of Borneo Island. These two parts of Malaysia are separated by about 528 kilometres of the South China Sea. Peninsular Malaysia, comprising 132,828 square kilometres, extends for 740 kilometres from Perlis in the north at the border with Thailand, to the Straits of Johore, adjacent to the island republic of Singapore, in the south. Sabah and Sarawak on the island of Borneo comprise 197,605 square kilometres and have their frontier with Indonesia's Kalimantan.

Peninsular Malaysia

In Peninsular Malaysia a mountainous spine known as the Main Range, or Banjaran Titiwangsa, runs from the Thai border southwards through two-thirds of the peninsula, effectively separating the eastern part from the western. Much of Kelantan, Terengganu and Pahang in the north-east is also mountainous and contains the highest peak in the peninsula, Gunung (mount) Tahan (2,187 m). Peninsular Malaysia consists of the states of Johor, Kedah, Kelantan, Melaka, Negeri Sembilan, Pahang, Perak, Perlis, Pulau Pinang (Penang), Selangor, Terengganu and the Federal Territory of Kuala Lumpur, also known as Wilayah Persekutuan. Because of the mountainous nature of the peninsula, there are many rivers and nearly all the states take their names from the principal river in each. The longest river in Peninsular Malaysia is the Sungei Pahang (475 km).

Sabah and Sarawak

The states of Sabah and Sarawak on the island of Borneo are also fairly mountainous. The Crocker Range in Sabah, which separates the narrow lowlands of the north-west coast from the interior, contains Gunung Kinabalu which, at 4,175 m, is South East Asia's highest mountain. The highest peak in Sarawak is Gunung Murud (2,425 m) and nearby Gunung Mulu (2,371 m) contains one of the largest natural caves in the world. The longest rivers in Sarawak and Sabah are the Rajang of Sarawak and in Sabah the Kinabatangan, each of about 560 kilometres in length. The Rajang is navigable by small coastal steamer for about 160 kilometres.

Climate

The climate of Malaysia is governed by the north-east and south-west monsoons which blow alternately throughout the year, the north-east from November to April bringing heavy rainfall from the South China Sea and the south-west from May until October bringing drier weather. The north-east monsoon is responsible for the heavy rains which hit the east coast of the peninsula, frequently causing widespread floods, particularly between December and February and similarly bringing their wettest periods to Sabah and Sarawak. Temperatures can vary between 20°C to 30°C, with an average of 26°C throughout the year, and the humidity is high.

People

Malaysia's population is currently 17 million and is growing at a rate of about 2.3 per cent per annum. The plurality of Malaysia's population is its most salient characteristic, giving it a diversity remarkable anywhere in the world. While the events influencing this situation have largely occurred over the last 150 years, Malaysia's almost unique racial mix really began to develop thousands of years ago. The population comprises about 55 per cent Malay and other indigenous people, most often referred to as the Bumiputera community, 34 per cent Chinese, 9 per cent Indians and 2 per cent others. The official language is Bahasa Malaysia, but English is also widely spoken.

Approximately 83 per cent of the population lives in Peninsular Malaysia which has a population density of 83 persons per square kilometre, compared with 13 and 10 persons per square kilometre in Sabah and Sarawak respectively. With the exception of the aboriginal inhabitants, the Orang Asli, Malaysia's Bumiputera, Chinese and Indian communities are distributed relatively evenly throughout the country, both on the peninsula and in Sabah and Sarawak. In all, the decennial 1980 census identified 68 different population groups, 33 of them Bumiputera, 11 of them Chinese and nine Indian. A separate classification broke down Malaysia's aboriginal inhabitants, the Orang Asli, into 19 different tribes. The population is young, with over 39 per cent being in the 0-14 years age group and about 57 per cent within the working age of 15-64.

One problem in this ethnic diversity is that inequalities in income distribution are still closely identified with ethnic groups. Although gains have been made in reducing inequality, disparities continue to be wide and the differences can be traced to two factors: the concentration of the indigenous population in agriculture and the relatively small share in the ownership and control of the existing stock of financial capital by the Bumiputeras relative to other Malaysians and foreigners.

The Malays

The Malays form the predominant ethnic group in the Malay peninsula, a substantial minority in Sarawak and a smaller group in Sabah. The conventional view of Bumiputeras focuses on the simplicity of rural life for farmers and fishermen in the closely-knit community of the kampong where life revolves around the local surau, the village mosque. While this life still exists, Malays have also taken their place in all walks of the country's business life, in industry and commerce and particularly in government service. Islam and its laws govern the Malays' life, but the laws are less dogmatic than those practised in West Asia, and allow Malays to coexist with their non-Islamic fellow countrymen.

Islam

While Islam is the official religion, Malaysia is not an Islamic state. Although the constitution recognises the government's obligation towards Islam, it also pledges to uphold freedom of worship and to allow non-Muslims to practise their own religion. Since the early 1970s there has been an Islamic resurgence in Malaysia, apparent in a number of ways: the growing number of women who wear Islamic attire; the increasing popularity of Islamic forms of greeting; and the use of Arabic in everyday conversations. This is reflected in more overt concern about dietary rules, relating not only to pork and the slaughtering of animals in the prescribed manner, but also to the the use of gelatine in chocolates, cakes or tomato and other sauces. This sensitivity extends to medicines manufactured from substances derived indirectly from the pig.

There is no pan-Malaysian Islamic head in Malaysia. Political power goes hand-in-hand with spiritual prestige and has done so for centuries. Thus the hereditary ruler of each state is also the Islamic head of that state. The head of Malaysia's monarchy, the Yang di-Pertuan Agong (also head of Islam of his own state, as well as Melaka, Penang, the Federal Territory, Sabah and Sarawak), has the authority to fix uniform dates for nation-wide religious events such as the beginning and end of the fasting month of Ramadan. A National Council for Islamic Affairs was established in 1968 by the Conference of Rulers to act as a liaison between the state administrations and coordinate pan-Islamic affairs.

The Chinese and Indians

The Chinese form about a third of the population of Malaysia, and the majority of Chinese immigration occurred in the nineteenth century. Unrestricted immigration of both Chinese and Indians took place until 1931 when controls were introduced and ended altogether on the outbreak of the Second World War. The Chinese community is prominently active in Malaysia's commercial life, and its religious loyalties are divided between Buddhism, Confucianism, Taoism and Ancestor Worship.

Large-scale migration from the Indian sub-continent to Malaya followed the extension of British rule to the west coast Malay states in the 1870s. As early as 1901 the Indian population in the Straits Settlements was approximately 120,000 and by 1947 it had grown to almost 600,000 in Malaysia and Singapore. Today, Indians account for about 11 per cent of the population.

Like the Chinese, the Indians came to Malaysia hoping to make their fortune, although most of the Tamils ended up as indentured labourers on the rubber estates. The next largest group are Indian Muslims, and there are small communities of Christians and Sikhs each representing less than 3 per cent of the total Indian element. The north Indians, with the exception of the Sikhs, were mainly merchants and businessmen. The Sikhs were recruited for the para-military and police units which formed the nucleus from which the modern police and military forces of Malaysia are derived. The Sikhs continued to be identified mainly with military and security occupations, but after 1930 there was a marked increase of Sikhs in the professional and commercial fields.

Natural resources and agricultural commodities

Tin, rubber, timber, oil, palm oil and natural gas have each assumed importance in Malaysia's development story, although their respective positions have undergone considerable changes over the years. Tin and rubber were for a long time the twin pillars of the Malaysian economy. Rubber remains a crucial export, but crude oil has supplanted tin. However, oil is a rapidly depleting resource and will cease to play much of a part as a major commodity by the turn of the century, when rubber and palm oil will be vying for position as the premier commodity export. In recent years, natural gas has emerged as a major export and by 1992 will be the main fuel source for power generation in Malaysia. Nominally, petroleum was the top export earner among Malaysia's commodities at the end of the 1980s, but the combined revenue from all timber products exceeded that of petroleum.

Effective commodity pacts are crucial for Third World producers and present pacts relating to the Malaysian economy are in disarray with the exception of those for coffee and rubber.

Oil

The earliest official recorded oil find in Malaysia was at the village of Miri in Sarawak, by the British resident of Baram District in 1882, although the people of Sarawak and Sabah had long known of the existence of oil seepages, or "earth oil" as it was then called. The commercial exploitation of oil began at the turn of the century. In 1909, the Anglo-Saxon Petroleum Company, forerunner of the present day Sarawak Shell, won the first petroleum concession when it was given the sole rights to explore for petroleum resources throughout Sarawak. Oil was struck at Miri in 1910. Daily production started at 80 barrels and increased to a peak of 15,000 barrels in 1929. Post-war production never returned to pre-war levels and the Miri field was closed down in 1972. Miri was Malaysia's only onshore field and in just over 60 years, it produced over 80 million barrels of oil.

Advances in petroleum recovery technology allowed attention to be diverted to offshore areas of Malaysia by the mid-1950s. Marine seismic surveys were carried out off the coast of both Sabah and Sarawak in the mid-1950s with the discovery of oil in the Patricia and Temana fields. The first offshore oil field to go into operation was West Lutong, off Sarawak, which went into production in 1968 with 3,000 barrels per day (bpd). By 1973, a total of 19 oil fields had been discovered in Malaysian waters and four brought into operation with total production of 90,000 bpd. Meanwhile, exploration efforts had been gathering momentum in Peninsular Malaysia with Esso and Conoco awarded concessions off the east coast of the peninsula. The first field declared commercially exploitable off Peninsular Malaysia was the Seligi field, about 275 km off the coast of Terengganu, the richest so far discovered in Malaysia, which went into production in 1988. Measuring only 12 km by 8 km, the Seligi field has estimated recoverable oil reserves of 1.2 billion barrels. Being developed over a period until 1994, Seligi will eventually have 177 oil wells and 20 gas injection wells.

The figure for Malaysia's estimated recoverable oil reserves has increased from 0.9 billion barrels in 1977 to the present 3 billion barrels which ranks the country 22nd in terms of international reserves. Substantial contributions to the economy began with the 1974 oil price increases. In 1973 oil accounted for 4 per cent of total export earnings, but by 1980 had emerged as Malaysia's chief foreign exchange earner. Crude oil production currently stands at 560,000 bpd, with exports of around 330,000 bpd. At current production levels, it is estimated that Malaysia's present reserves will be depleted in 15 years, although exploration prospects are considered relatively good. Principal markets for Malaysia's crude petroleum exports are Singapore, Japan and South Korea.

Natural gas

In the search for oil, significant reserves of natural gas were discovered by both Shell and Esso: by Shell in the central Luconia province off Sarawak in 1969, and by Esso in its contract area off Terengganu in Peninsular Malaysia. Today, Malaysia is ranked 15th in the world by gas reserves of 53 trillion cubic feet (1.1 trillion cubic metres), with an estimated life span of present reserves of over 100 years, even with increased production levels up to the year 2000. Indonesia and Algeria are the world's largest suppliers and Japan is the largest consumer. Under a long-term contract, Malaysia ships about 6 million tonnes of liquefied natural gas (LNG) a year from Sarawak's Bintulu field to Japan, worth almost M$2 billion in 1988. LNG presently provides 18 per cent of Malaysia's energy needs, but by 1991 the share is expected to rise to 29 per cent and to 40 per cent by the year 2000. This will be achieved by a gas grid covering Peninsular Malaysia with supplies from the east coast fields.

Natural gas will also be used as feedstock in the petrochemical industry, initially in an MTBE/propylene and polypropylene plant being built on the east coast and scheduled for start-up in 1992. The two plants will save an estimated M$6 billion in imports and earn an estimated M$1 billion in exports within a 15-year period after completion.

Under the M$1.3 billion Phase 11 of the Peninsular Gas Utilisation scheme, scheduled for completion in 1991, LNG will be piped to Malaysia's west coast power stations and as far south as Singapore which, subject to the two countries agreeing on a price, will buy 150 million cubic feet of gas a day. Piped gas will be supplied to industries and households along the new network.

Tin

Tin has been mined continuously in Malaysia for 1,500 years. Until the mid-nineteenth century, Malays had been mining about 500 tonnes of tin annually using traditional methods. Discovery of the huge Perak fields raised output to 40,000 tonnes annually by the turn of the century. From then until the mid-1980s, Malaysia was the world's largest producer with annual output peaking at almost 80,000 tonnes in the 1970s. But its position as a principal producer has been declining since (to 29,000 tonnes in 1988), putting it in second place after Brazil (40,000 tonnes in 1988) and by the end of the century will probably have dropped to fourth place.

The collapse of the International Tin Council in 1985 and the dissolution of its Secretariat ended 60 years' of continuous work within the industry to monitor production and stabilise prices. A free-for-all followed and with huge buffer stocks held by most producers, prices collapsed, dropping by half from M$29 per kilo in 1985 to M$15.50 the following year. Prices crept back up in the late 1980s, breaking the M$20-per-kilo barrier to record a three-year high in mid-1989.

Vigorous purchasing of buffer stocks had fuelled the 1985 price levels. When the council's support buying abruptly ceased in October of that year, world tin stocks were estimated to be 100,000 tonnes. Towards the end of the 1980s, they were estimated at 40,000. A figure of 20,000 tonnes is considered necessary for a healthy market. The Association of Tin Producing Countries, of which Malaysia is a member, and which represents countries responsible for about 90 per cent of world production, has restored a measure of equilibrium in the market. Most analysts forecast a steady improvement in prices, but the delicate market balance can only be maintained if producers stick to their voluntary quotas. Both China and Brazil, for example, produce large surpluses.

In Malaysia the "tin crisis" led to the widespread closure of gravel pump mines, the most expensive to operate, and cuts of almost half in the number of miners. Overall, the 450 mines operating in 1984 were reduced to just under 200 by 1986, but of the 353 gravel pump mines only 120 survived. Employment in the industry dropped over four years from almost 24,000 in 1984 to 11,000 in 1988.

With the improving prices at the end of the decade, the industry in Malaysia sought help from the government which proposed to convert a sum of M$70 million, budgeted for loans to tin mines, into a rehabilitation scheme to assist gravel pump mines restart operations. Successful implementation of the scheme would increase production by 3,000 tonnes annually. While high-grade mining land in Malaysia has mostly been exhausted, due to advances in technology, mines can recover fine tin ore concentrated in deeper areas. Modern dredges can reach up to 45-60 metres, as against only 15 metres in former years.

The issue for Malaysia is whether to move further into downstream processing, beyond refining and marketing, to enhance the value added. Malaysia already has the world's two largest tin smelters, but a decision on further moves depends on how the price of tin advances. If the price continues to increase, users can switch to substitutes such as aluminium or plastic. Despite the establishment of a domestic tin-plate manufacturing plant which has been in production in Johor since 1982, Malaysia remains a net tin-plate importer, mainly from Japan. It is felt that if major impetus to growth in Malaysia is to come from the manufacturing sector, increased processing of domestically-produced raw materials should form an integral part of this goal. Malaysia's Industrial Master Plan forecasts export revenues from tin will grow to almost M$90 million by 1995, with demand coming from Japan, the major buyer, and the EC countries.

Malaysia Mining Corporation

Tin mining in Malaysia is dominated by Malaysia Mining Corporation Berhad (MMC), the world's largest integrated tin mining company. This was formed in 1981 out of the rationalisation and eventual merger of two UK mining groups, Malayan Tin Dredging (MTD) Group and London Tin Corporation (LTC).

MMC has its roots in Malayan Tin Limited which was incorporated in London in 1911. The tin mining activities of MTD Ltd were taken over by Malayan Tin Dredging (M) Bhd (MTD), which was incorporated in Malaysia in 1976. In 1980 MTD acquired 100 per cent of the capital of five other tin mining companies resulting in the emergence of the largest tin dredging group in Malaysia with the six companies owning and operating 20 dredges. The group also held interests in two tin operating companies in Thailand.

LTC operated as a fully integrated tin producing organisation involved in prospecting, mining, mines management, smelting and marketing of tin produced by its 18 operating dredges. The group also held significant interests in diamond exploration in Australia and the plantation industry in Malaysia. Its tin mining interests also extended to tin mining activities in Thailand and Nigeria. In 1976 LTC group was taken over by a Malaysian company, New Tradewinds Sdn Bhd, incorporated in May 1976. In December 1977, New Tradewinds Sdn Bhd (NTSB) changed its name to Malaysian Mining Corporation Berhad.

In 1981, Permodalan Nasional Berhad (PNB) acquired PERNAS' interest in MMC and in the same year merged with MTD. The 1981 merger created a new group called MMC, owning and operating 38 out of 55 dredges then operating in Malaysia and contributing some 22 per cent of the company's tin production in 1980. MMC is a public company with its shares quoted in Kuala Lumpur, Singapore and London. Its authorised share capital is M$70 million and its issued and paid-up capital is M$41,803,114, 56 per cent owned by the PNB Group.

Group activities

The group is engaged in mining operations in Malaysia producing tin and by-products in concentrate form, management of mines and marketing of tin metal, minerals and other commodities. It is also actively involved in exploration and engineering activities. In addition, the group has significant interest in diamond exploration in Australia and a joint-venture tin smelting company in Malaysia.

Mining. In Malaysia, the MMC Group possess 38 dredges of which 20 are currently in operation, producing between 11,000 and 12,000 tonnes of tin concentrates annually. The management of these operations is controlled by PERNAS Charter Management Sdn Bhd (PCM), a wholly-owned subsidiary of MMC Berhad since 1981. PCM has been appointed general manager for 13 active and one dormant mining company which together own a fleet of 39 dredges and one large open-cast mine.

Diversification. Whilst tin mining will continue to be the group's core activity for some time, MMC has also diversified into the mining of other base and precious metals, reflecting the Malaysian economy's general diversification. Other mining activities include the barite joint venture in Sungei Pedah, which is operating satisfactorily, and the company's gold mine at Pulai, Kelantan, which commenced operation in December 1988. The latter is a joint venture between the Kelantan State Economic Development Corporation and MMC with shareholdings of 51 per cent and 49 per cent respectively. Meanwhile PCM is also involved in providing mining and technical services to overseas clients. In Australia, MMC's involvement is through its 46.3 per cent associate Ashton Mining Limited. The latter has a 38.2 per cent stake in the Argyle Diamond Mines Joint Venture, the world's largest producer of diamonds, where production is estimated to be around 25 million carats per annum valued at A$150 million.

Exploration. The MMC exploration division has developed a team of highly skilled and experienced professionals, technicians and support personnel. The division has the capability to provide comprehensive technical services which range from initial exploration to pilot plant stage. Core exploration activities have been principally confined to the search for placer tin deposits which form the mainstay of the mining industry in Malaysia. The exploration division has been entrusted with the task of identifying and investigating areas with potential for exploitation of other base and precious metals.

Precious metals. The last five years have seen intensified efforts by MMC into exploration for precious metals such as gold, silver and platinum in Malaysia and other parts of the world. MMC Resources Corporation was established in Vancouver in 1988 to explore for potential precious metal prospects in North America. Exploration is also being carried out in Indonesia, China and other countries. In 1988 the division achieved success in the preliminary hydrometallurgical studies for base and precious metals in Mengapur, Pahang, as well as the completion of reserve evaluation of gold deposits at Sungei Tadoh, Kelantan. In Terengganu, two areas, one at Sungei Pelong and the other at Sungei Kerak (Kampung Rusila) have shown potential for gold mineralisation.

Marketing. MMC has a strong marketing and trading arm in its subsidiary MMC Marketing Sdn Bhd (MMCM). This trades in tin and allied minerals such as ilmenite, zircon, monazite, zenotime and struverite, coal, ferrous and non-ferrous metals, petroleum and petroleum based products and timber and timber products. It conducts its trading worldwide from its trading office in Kuala Lumpur. In order to assist its activities, servicing offices in London and Tokyo have been established and agents appointed in major consuming activities. MMCM's knowledge of Malaysia's import and export requirements have positioned it as an international company fully capable of providing specialised services in the area of Malaysian countertrade activities, especially in natural resources.

Downstream activities. MMC is also actively involved in downstream activities. Tin concentrates from MMC's mines are refined into tin metal before it is used to make tin plate, solder alloys and chemicals. This activity is undertaken by Malaysian Smelting Corporation Berhad, MMC's associate company.

MMC will continue to explore new areas in the future and together with its expertise and international marketing network, MMC will be able to attain its goal of becoming a broad-based international mining corporation. As a leading producer of tin in the world, MMC is committed to safeguarding the long-term viability of this versatile material which remains of substantial importance to the Malaysian economy.

Rubber

Rubber, introduced to Malaysia only 100 years ago, was the country's chief export earner between 1916, when it surpassed tin, and 1980, when it was overtaken by oil. Fuelled by the high demand of the burgeoning world automobile industry and by the First World War, rubber was planted throughout the country. In the 1970s, however, when profits from palm oil exceeded those from rubber, much of the land under rubber was converted to oil palm. Malaysia now contributes a third of the world's supplies of natural rubber and 70 per cent of the world's supply of latex concentrate, demand for which has soared because of its high content in rubber gloves and condoms, the production of which has accelerated because of concern over AIDS. About 1.9 million hectares of land are under rubber, mostly in Peninsular Malaysia, with the estates concentrated in the west, and two-thirds controlled by smallholder production.

Malaysia processes about 120,000 tonnes of its own rubber in domestic industries producing tyres and, more recently, rubber gloves with a capacity of over a billion pairs a year. However, although a major source of natural rubber, Malaysia is still an insignificant supplier of manufactured rubber products. The single most important constraint to the growth of the rubber-processing industry is the competition with Asian NICs, China, Eastern European countries and Malaysia's ASEAN neighbours. Many of these competitors have considerably larger domestic markets as well as a better industrial and export infrastructure.

A number of Malaysia's plantation companies are moving into downstream manufacturing. With increasing labour costs, future viability on the growing side will involve improved agronomic practices and tapping techniques. The target of the Industrial Master Plan is to increase domestic consumption to 300,000 tonnes by 1995 with an emphasis on expanding tyre production to the value of M$1 billion. However, projections indicate that Thailand is expected to overtake Malaysia as the world's leading supplier by the turn of the century.

Timber

Natural hardwood forests cover more than 50 per cent of the total land area of Peninsular Malaysia and even more in Sabah and Sarawak. The total forested area of Peninsular Malaysia is 6.4 million hectares, Sabah has 4.5 million hectares and Sarawak 9.4 million hectares – 76 per cent of its total land area. Forestry provides jobs for about 180,000 people in the country as a whole.

The exploitation of these timber resources is the single most controversial commercial activity in Malaysia. With a complete logging ban by Thailand and a ban on log exports in Indonesia and the Philippines, Malaysia is the only country in the ASEAN group still allowing logging on a large scale and a rapid depletion of the country's natural tropical forests. Malaysia does have a replanting programme, but critics – mainly European conservation groups – say the forest can never be renewed.

Malaysia intends to continue the present volume of logging of natural forest up to 1993 after which, over a two-year period, it will reduce production by about 40 per cent. The current forest plantations should give a yield of 0.19 million cubic metres in 1998 and from the year 2009 onwards, annual net production is targeted at 2.1 million cubic metres. Malaysia exports over 20 million cubic metres of timber a year, the bulk of saw logs going to Japan, Taiwan and South Korea. Production of saw logs from Malaysia's timber resources amounts to approximately 30 million cubic metres annually.

The timber sector emerged in 1987 as Malaysia's top-performing non-fuel commodity. Saw logs earned Malaysia approximately M$4 billion a year in the last two years of the 1980s but if export revenue from all timber products are introduced into the equation, the timber sector out-performed all other sectors, including petroleum.

Besides natural forests, commercially established forest plantations started in 1957 in Peninsular Malaysia with the planting of teak in the northern states of Perlis and Kedah. With the increase in domestic consumption, the government initiated a fast-growing tropical timber replantation programme, the Compensatory Forest Plantation Project, involving the planting of species like acacia mangium, gmeline arborea (yamane) and albizzia falcataria (batai) with the aim of establishing 188,000 hectares of forest plantation on the peninsula within 15 years. Timbers of these can be respectively used as pulp biomass, saw logs and blockboard. In addition it is estimated that an average of 1.66 million cubic metres of rubberwood logs will be available annually during the 1988-2005 period.

The Malaysian government claims it has one of the best forest management programmes in the world, but concedes there are still cases of intensive logging. Critics argue that there is no real proof that forests will regenerate and that the methods used to log them "economically" are very destructive.

Palm oil

Oil palm was introduced to Malaysia as an ornamental plant in 1875. Estates were developed between the 1920s and 1950s, but palm oil had little economic significance until the 1960s. Today, with almost 2 million hectares of land under oil palm, it is a vital element in the economy, contributing more than 10 per cent of GNP, and a crucial factor in the

Exhibit 2.1

Export of forestry products 1988 (1987 figures in parentheses) (M$m)

Saw logs	3,990	(4,280)
Sawn timber	1,900	(1,700)
Plywood	674	(486)
Mouldings	410	(314)
Veneer	119	(102)
Chipboard	19	(na)
Furniture	94	(56)
Others	17	(na)
Total	7,233	

Source: Malaysian Timber Industry Board

Exhibit 2.2

Production and export revenue of Malaysia's major commodities

	1975	*1985*	*1988*	*1989**
Petroleum ('000 bpd)	98	446	4,164	562
Export revenue (M$m)	727	8,698	6,128	5,750
Palm oil ('000 tonnes)	1,258	4,133	4,164	5,400
Export revenue (M$m)	1,320	3,951	4,538	4,464
Rubber ('000 tonnes)	1,478	1,469	1,611	1,624
Export revenue (M$m)	2,026	2,872	5,256	4,772
Saw logs ('000m^3)	19,164	30,957	20,555	33,700
Export revenue (M$m)	670	2,771	4,007	3,904
Tin ('000 tonnes)	64	37	49	30
Export revenue (M$m)	1,206	1,648	911	1,000
LNG ('000 tonnes)	–	4,600	6,300	6,440
Export revenue (M$m)	–	2,300	1,885	1,870
Cocoa beans ('000 tonnes)	17	103	210	220
Export revenue (M$'000)	35	410	709	738

* Forecast

Source: Economic Report, Ministry of Finance, 1988/89 and Bank Negara Annual Report 1988 (for 1988 figures)

livelihood of the more than 60,000 rural families in government land schemes and 250,000 agricultural workers in estates and smallholdings. Unlike rubber, palm oil is an estate crop with about half of the country's production under private estate management and 30 per cent under the Federal Land Development Authority (FELDA).

Following a decline in 1987, production of palm oil grew by 10 per cent in 1988 to around 5 million tonnes and is expected to pass the 10 million tonne mark by 1999. Palm oil is forecast to corner the major share in the world's oils and fats market by the year 2007.

Malaysia is currently the world's biggest producer but could eventually be overtaken by Indonesia, where production is projected to increase from 1.38 million tonnes in 1985 to 5.2 million tonnes in the year 2000 and 7.1 million tonnes in the year 2007.

Cocoa

Cocoa became a commercial crop in Malaysia in the 1950s when African cocoa suffered a virus disease. Commercial-scale cocoa was first grown in Terengganu. In the early days the crop was very susceptible to disease, but the situation improved with extensive research and the introduction of new germ-plasm. It was found to grow well on the west coast of the peninsula and in the Tawau area of Sabah.

In the mid-1970s Malaysia was still an insignificant producer with just 50,000 hectares under cultivation, whereas today 357,000 hectares are planted. There has been a spectacular increase in Sabah, which produces 60 per cent of the Malaysian crop on hectarage that has increased from less than 15,000 to almost 200,000 in little more than a decade. Of total production, almost 80 per cent is grown on estates and the rest by smallholders. Because it can be integrated with other crops, such as coconut and fruit trees, cocoa is considered an ideal smallholder crop.

Malaysia's production of 210,000 tonnes in 1988 made it the third largest producing country with 11.2 per cent of world production after the Ivory Coast (31.5 per cent) and Brazil (16.5 per cent) and slightly ahead of Ghana. However, with depressed prices because of a long-term world glut, cocoa is no longer such an attractive crop and growth in the foreseeable future will not compare with the 23 per cent annual rises in output achieved in the first half of the 1980s.

Cocoa prices slumped from a peak of M$10-12 per kilo in 1984 and have been fluctuating between M$3 and M$4 per kilo. Over-supply is the problem and, with the prospect of a record surplus – in excess of 200,000 tonnes – at the end of the 1980s there are no signs of an improvement in price. The Netherlands and West Germany are the biggest buyers of Malaysian cocoa, each taking about a third of production.

Pepper

Almost all of Malaysia's pepper is grown in Sarawak, with a little coming from Sabah and Johor. The total cultivated area in 1988 amounted to 8,622 hectares, controlled by approximately 40,500 smallholders. Production is expected to increase annually by about 17 per cent. A world surplus towards the end of the 1980s resulted in a drop of earnings for Malaysia from M$159 million in 1987 to M$150 million in 1988, despite exports rising from 14,000 tonnes in 1987 to 17,000 tonnes in 1988. The low price of pepper is expected to continue into the early 1990s because of increased production, primarily in India. Malaysia grows about 14 per cent of the world total supplies.

In the area of research and development, efforts are being directed towards yield and quality improvements. Apart from the development of high yielding strains, research efforts are also being undertaken to improve agronomic practices and post harvest technology.

Chapter Three

Domestic politics and the political system

System of government

Malaysia is a federal parliamentary democracy with a constitutional monarch. It is made up of the 11 states of Peninsular Malaysia and the Federal Territory of Kuala Lumpur (the capital) which comprise West Malaysia, and the states of Sabah and Sarawak on the island of Borneo, which comprise East Malaysia. Closely modelled on the Westminster model, the present constitution with a parliamentary and cabinet system has been effective since independence in 1957 with relatively few amendments.

The monarchy

Executive powers are formally vested in Malaysia's head of state, the Yang di Pertuan Agong, or king. He is a constitutional monarch with ceremonial duties and limited discretionary powers who serves for a term of five years. Under a unique system of monarchic, rotational and elective principles, the office rotates among the rulers of nine of the 13 states of the federation. The present holder of the office is Sultan Azlan Shah, who took office in 1989.

The executive

The effective head of state is the Perdana Menteri (prime minister) who is appointed by the king and is normally the leader of the majority party in the House of Representatives. Members of the cabinet are appointed by the king, on the prime minister's advice, from either of the two Houses of Parliament. These are the Dewan Rakyat (House of Representatives) and the Dewan Negara (Senate). The structure of government creates a strong central authority, although each state retains a chief minister or Menteri Besar and certain powers at local level. There are some 24 government ministries in all, the functions of which are summarised at the end of the chapter.

The legislature

The House of Representatives has 177 members elected from single-member constituencies. After a review in 1984 the number of constituencies was increased from 154 to 177. The full term of the House of Representatives is five years, but the king has the power, never yet used, to dissolve parliament on the advice of the prime minister. Parliament normally meets for about 11 weeks a year. The last general elections in Malaysia were held in 1986. The present parliament is Malaysia's seventh.

The Senate, the less powerful of the two houses, is based on Britain's House of Lords and has 69 members, two elected by each of the 13 state legislatures, 40 appointed by the king (acting on the advice of the prime minister) and three representing the Federal Territories of Kuala Lumpur and Labuan. Senators, who serve for a period of three years, are usually prominent older figures in public life.

A simple majority in both houses is sufficient to carry legislation and the Senate has the delaying power for one month over money legislation and one year over other legislation.

Malaysia also has a Majlis Raja Raja (Conference of Rulers) which meets three or four times a year and comprises the 13 rulers of the states of the federation, including the nine hereditary royal rulers and the governors of Penang, Melaka, Sabah and Sarawak. Its prime duty is the election of the king and his deputy, and the Conference of Rulers acts as a third house of parliament on amendments to certain sections of the constitution, particularly where it applies to the position of Malays, and it is the supreme authority on Islamic religious matters.

The states

Distribution of powers between the state and federal governments is set out in the Ninth Schedule of the federal constitution, under which the federal government retains responsibility for external affairs, defence, internal security, civil and criminal law, citizenship, finance, commerce and industry, shipping, communications, health and labour.

State responsibilities centre on land, agriculture, forestry, fishing, Muslim law, and extend over areas like education, social welfare and urban planning in which there are concurrent state and federal responsibilities. Federal law always takes precedence where inconsistencies arise. Each state has a unicameral legislature, for which elections are held every five years.

Administrative machinery exists in each state, under the control of the state government's Executive Council (Exco), chaired by the chief minister. The district level is important in the actual implementation of policy, and below district level are the mukims, each administered by a penghulu.

The parties

The principal political force in Malaysia from the struggle for independence until 1973 was the "Alliance", a coalition of the United Malays National Organisation (UMNO) which was formed in 1946, the Malaysian Chinese Association (MCA) and the Malaysian Indian Congress (MIC). In Malaya's first national election the Alliance won 80 per cent of the popular vote and Tunku Abdul Rahman, the architect of Malayan independence, became chief minister. The Alliance was committed to free enterprise, although exercising guidance through the Malayan Five-Year Development Plans, first introduced in the 1956-60 period.

While the Alliance remained dominant in Malaysian politics during the 1960s, the aftermath of the 1969 election had far-reaching effects. The Alliance vote fell by 10 per cent, and hundreds of people were killed in a wave of racial demonstrations and counter-demonstrations. Parliamentary democracy was suspended from mid-1969 to mid-1970 and a National Operations Council was created to restore order. Tunku Abdul Rahman, who had become prime minister after Malaysia had gained full independence, stepped down in 1970 in favour of Tun Abdul Razak. Normal parliamentary government was restored in February 1971, following a declaration of principles of national harmony, the Rukunegara, and the announcement of the New Economic Policy designed to give greater economic equality to Malays.

The Alliance evolved into the Barisan Nasional (National Front), a broader coalition of 13 parties, which was successful in the 1974 general election winning more than 70 per cent of the popular vote and 135 of the 154 seats in the House of Representatives. Following the death of Tun Abdul Razak in 1976, the premiership passed to deputy prime minister Dato Hussein Onn who continued the social and economic development programmes started by his predecessor in the wake of the communal disorders which had been blamed on bitterness over the country's division of wealth along racial lines. The Third Malaysian Plan which started in 1976 continued the emphasis on policies to bring about a more equitable distribution of income and reduce rural poverty.

When Hussein Onn retired in 1981, deputy prime minister Datuk Seri Dr Mahathir Mohamad took over as leader of the dominant UMNO and as prime minister. In the 1982 elections, the UMNO-led National Front won an overwhelming victory, securing 140 of the 154 seats in the House of Representatives. In the state assembly elections held at the same time in Peninsular Malaysia, the National Front retained control of all 11 state governments, winning 282 out of 312 seats. The National Front achieved a convincing victory again in the parliamentary elections in August 1986, winning 148 of the 177 seats. Losses of seats by the MCA at the election reflected two years of leadership problems that included the jailing of its then leader, Tan Koon Swan, in Singapore in 1986.

The split in UMNO

The 1980s saw the emergence of serious differences within the ruling coalition. At the triennial UMNO elections in April 1987, Tengku Razaleigh Hamzah, the former Trade and Industry Minister, and Datuk Musa Hitam, former deputy prime minister, buried past rivalries and joined forces in a challenge to the party leadership. The election was won by the existing party leadership but the results were very close. A petition to the High Court claiming the election results were invalid on the grounds of irregularities led to the finding that UMNO was an illegal organisation because some of its branches had not been correctly registered at the time of the party elections. Razaleigh tried to take over UMNO but was outmanoeuvred by the prime minister who launched UMNO Baru, the "new" UMNO.

The present split in UMNO is thought unlikely to remain, simply because most Malaysians would like to see a reunified party. A lasting division would theoretically allow the Chinese and Indian parties a balance of power, something that they would not wish. Nor do these minority parties like the present embarrassment of being forced to take sides. Permanent divisions within UMNO would have grave implications for the large number of businesses which are controlled by the party.

A reconciliation between Mahathir and Musa early in 1989 was seen as the possible basis for a lasting compromise. Musa rejoined UMNO (Baru) on the tacit understanding that, among other things, the original UMNO constitution would be restored. A reconciliation would leave Razaleigh and his dwindling number of supporters in increasing isolation. Victory by the new opposition force, the Angkatan Perpaduan Ummah (APU) – a loose grouping of Razaleigh's supporters and the Party Islam – in a June 1989 by-election pointed, however, to a continued period of political sparring. Mahathir's next important test is the 1990 party leadership contest.

Mahathir's open-heart surgery in February 1989 clouded the political outlook as there is no obvious successor to him. General elections are due to be called before 1991. Depending on his health, there is no doubt that Mahathir would prefer to remain in office at least for another year in order to groom a successor, host the Commonwealth heads of government meeting scheduled for October 1989 and participate in the construction of the successor to the New Economic Policy (NEP), Malaysia's social and economic blueprint.

The opposition

Opposition parties have been a feature of the Malaysian political system since independence. Although Communist parties have been illegal since the Emergency involving Communist guerrillas, a variety of other opposition parties have flourished. The Pan-Malaysian Islamic Party derived its strength chiefly from the Malay majority northern states and made gains in 1969 as disillusionment spread amongst Malays, although it was drawn into coalition with the Alliance in 1972. In that year the Alliance also managed to incorporate the left-wing People's Progressive Party.

The Democratic Action Party (DAP) was the only major force to remain outside this realignment in the early 1970s, but in 1977 the Pan-Malaysian Islamic Party was expelled

The installation of the Sultan of Perak, now King of Malaysia. The monarchy is an important symbol of unity for Malaysia's 13 states

from the National Front over differences relating to the state of Kelantan. The 1978 election saw the Pan-Malaysian Islamic Party losing to the National Front, although the DAP drew support from amongst the Chinese population.

In the present parliament, the DAP is the principal opposition party, while the Pan-Malaysian Islamic Party holds only one seat. The DAP continues to draw most support from urban Chinese communities, although it seeks to present itself as a non-racial alternative. The party faced a particularly challenging moment in late 1987, when its leaders were among those arrested in the clampdown on opposition figures and, at the time, responded by moderating its stance somewhat.

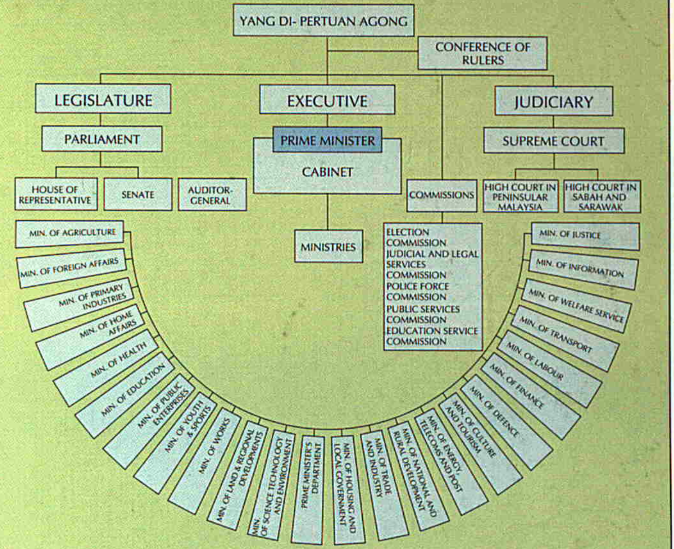
One development that would complicate the opposition picture would be the emergence of a secessionist movement in Sarawak and Sabah. No evidence of organised secessionist groups exists, but the issue is a sensitive one given the high concentration of Malaysia's valuable reserves of oil, LNG, and timber in these states. Christian Dayaks and Kadazans – who form a significant proportion of the population of the two states – have given their support to opposition parties at state level.

The judiciary

The Supreme Court is the highest judicial authority in Malaysia with the power to interpret the constitution and to adjudicate in disputes between states or between states and the federal government. The Supreme Court replaced the Federal Court and with the ending of appeals to the Privy Council in London on 1 January 1985, it is now the final court of

Exhibit 3.1

Organisation of the government of Malaysia



Source: Government of Malaysia

appeal in the country. The bulk of the Supreme Court's work consists of hearing appeals from the High Court.

The Lord President of the Supreme Court, the two Chief Justices, and the judges of the High Court are appointed by the king. The maximum number of judges is currently set at 27 for Peninsular Malaysia and eight for Sabah and Sarawak. Below the Supreme Court are the two High Courts of Peninsular Malaysia and Sabah and Sarawak, below which are subordinate courts. The courts experienced a testing time early in 1988, when they were drawn into confrontation with Mahathir after UMNO was declared an illegal organisation in the High Court.

In June 1989 parliament passed a bill removing the High Court's ability to review any government actions under the Internal Security Act or the drug laws.

Principal ministries and agencies

Coordination between ministries is assisted by the cabinet and cabinet committees. Three councils established by the government assist in this – the National Action Council (MTN), the National Economic Council (MEN) and the National Security Council (MKN) – among which the MTN is the highest body.

Prime Minister's Department
The Prime Minister's Department coordinates the general policies of the government and has 13 separate divisions: Administration and Finance, Cabinet, Ceremonial, Economic Planning, Federal Translation Bureau, Implementation Coordination Unit, International Conferences, Islamic Affairs, Malaysian Administrative Modernisation and Manpower Planning Unit, Management of Government Buildings, National Family Planning Board, Nuclear Energy Unit and the Socio-Economic Research Unit.

Ministry of Agriculture
The MOA's function under Malaysia's New Economic Policy is to improve incomes in rural society and to increase agricultural productivity for domestic consumption and export. Because of this, the ministry's activities are focused on smallholders with the aim of improving crop production through better services such as irrigation and drainage, research, agricultural inputs, credit and marketing. An important development strategy of the ministry is the Integrated Area Development Programme where services are concentrated on particular projects.

Ministry of Culture and Tourism
The MCT's role is to develop tourism as one of the nation's primary industries by the establishment of a national policy. Under the Fifth Malaysian Plan (1986-90) the tourist industry is being allocated US$210 million to carry out these objectives compared to only US$54 million under the previous five year plan. Culture and tourism are allied under one ministry in Malaysia because, as a predominantly Muslim country, it is deemed important to maintain Islamic cultural values whilst encouraging the inflow of visitors.

Ministry of Defence
The MOD is the central agency responsible for formulating and obtaining policy decisions of the government on defence matters and for ensuring their implementation by the Malaysian Armed Forces. Since the withdrawal of British troops from Malaysia and Singapore in the late 1960s, the primary objective has been the attainment of self-reliance in defence and, to this end, the three arms of the Malaysian armed forces have undergone rapid expansion and modernisation.

Ministry of Education
Education has been a major priority of the New Economic Policy. The MOE is responsible for the maintenance and development of all forms of education. Significant developments in education in Malaysia have been the full implementation of Bahasa Malaysia as the medium of instruction in Peninsular Malaysia (Sabah and Sarawak to follow suit by 1990) and the Malaysian Examination Council's assumption of the administration of the higher school certificate examination from the University of Cambridge. Also significant has been the decision to return to the basics in education with the introduction of a new curriculum in primary schools.

Ministry of Energy, Telecommunications and Posts
This ministry advises the government on all electronic matters and distribution of

electricity. It operates postal and telecommunications services. The ministry was established in 1981 primarily to supervise and coordinate the burgeoning postal and telecommunications services, which have now been privatised under the Malaysian Telecommunications Company. The present emphasis is on the expansion and improvement of services and the expenditure of US$3.5 billion is targeted for this under the current development plan.

Ministry of Finance

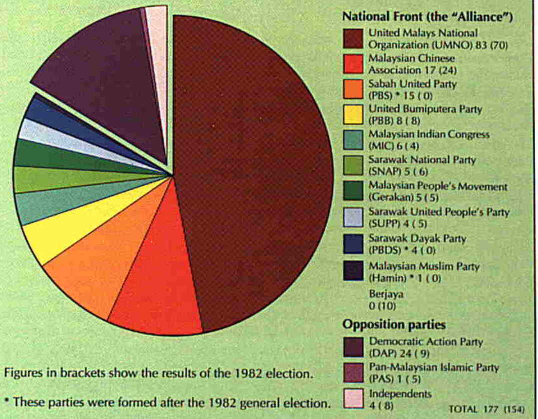
This is the overall controlling organisation for all banking and financial matters. It establishes fiscal and monetary policies and governs relations with international financial institutions, taxation, capital issues and stock, the national savings and savings banks, the insurance industry, business registration, currency, the maintenance of provident funds, state and public authority loans, and government tenders and purchases. The central bank, the Bank Negara Malaysia, comes under the aegis of the Ministry of Finance.

Ministry of Foreign Affairs

The MFA coordinates economic and regional cooperation, including matters concerning Malaysia's relationships with UN agencies, the Colombo Plan, ASEAN, ASPAC, etc. It is responsible for diplomatic, consular and trade agencies and foreign affairs including treaties, agreements and conventions with other countries. The ministry is also responsible for activities involving the pilgrimage to Mecca by Malaysian Muslims.

Exhibit 3.2

1986 general election: political composition of the House of Representatives



Figures in brackets show the results of the 1982 election.

* These parties were formed after the 1982 general election.

Ministry of Health

The MOH is responsible for all health and medical services. The government is presently encouraging the development of Health Maintenance Organisations, a prepaid group practice by which the payment of a set premium per month, on the basis of enrolment for a year, guarantees the provision of medical outpatient and inpatient care for the ensuing year. Malaysia is presently dependent upon overseas suppliers for its requirement of high-technology medical equipment.

Ministry of Home Affairs

The activities of the MHA cover all aspects of internal security, the police, immigration, citizenship and naturalisation, passports, visas and entry permits, border security, anti-corruption activities, intelligence matters, the control of newspapers and other publications, film censorship and registration of births, marriages and deaths.

The Ministry of Housing and Local Government

Divided into two main departments, the Department of National Housing and the Local Government Division, the former is concerned with the provision of an increased supply of low-cost homes and to provide greater opportunities for Malaysians to own houses. Emphasis is also placed on the modernisation of villages. The ministry supervises the activities of local authorities in Malaysia and is responsible for town and country planning.

Ministry of Information

The MOI operates and coordinates all government mass media activities through its three departments of broadcasting, information and films. It operates the national news agency, Bernama, provides civic and community services, monitors broadcasting and publishing and controls exhibitions. It publishes a number of titles on a regular or ad hoc basis on national development issues in cooperation with other government ministries.

Ministry of Justice

The MOJ is responsible for censuses in Malaysia, the economic and functional classification of government transactions, the winding up of companies, societies and trade unions, the administration of debtors' and bankrupts' estates and is responsible for official archives – business and economic, government and royal.

Ministry of Labour

The MOL's major objective is to restructure and promote the balanced distribution of manpower in accordance with the New Economic Policy, to develop good industrial relations between employers and workers, to provide manpower data and monitor the supply and demand characteristics of the labour market, to provide training facilities in industrial skills and to maximise the utilisation of manpower resources.

Ministry of Land and Regional Development

The main objectives of this ministry are to plan, coordinate and implement the land development and utilisation policy at federal and state levels, to obtain maximum benefit from land utilisation, at the same time ensuring a balance in development between regions and improving the economic conditions for those living in under-developed regions. Another function of the ministry is to minimise ecological and environmental damage.

Ministry of National and Rural Development

Established in 1983, the ministry is responsible for the planning and implementation and evaluation of programmes and strategies for national and rural development in the context of the New Economic Plan. Thus its aims are to improve living standards, increase

Parliament House: at the heart of Malaysia's consensual tradition of democracy

employment opportunities and maximise the use of national resources. It does this through adult education and community development and the provision of basic facilities such as roads, water and electricity supplies.

Ministry of Primary Industries

The MPI is responsible for the research, development and marketing of Malaysia's primary products such as rubber, palm oil, palm kernel oil, coconut oil, tobacco, pepper, pineapples, cocoa, timber, tin, copper and other minerals. This is aimed at achieving increased benefits in terms of income to producers, particularly to smallholders, increased contributions to gross national product and employment and enhancement of Malaysia's foreign exchange earnings.

Ministry of Public Enterprises

Twelve major agencies concerned with industrial development operate under the MPE. They include the Development Bank of Malaysia, Food Industries Malaysia Berhad, Malaysia Industrial Development Finance Berhad, Malaysian Shipyard and Engineering Sdn Berhad, the National Padi and Rice Board, the State Agricultural Development Corporations and the State Economic Development Corporations. The role of the ministry is to monitor the activities of these agencies and to ensure increased Bumiputera participation.

Ministry of Science, Technology and the Environment

The ministry is responsible for the formulation and implementation of policies and programmes in science and technology and for creating an integrated approach to ensure that developments are in line with the needs of the country, which it does through research activities and cooperation with foreign countries and institutions. It is also charged with establishing standards for industrial products and ensuring that local and imported products are of a sufficiently high standard.

Ministry of Trade and Industry

The functions of the MTI concern copyright, export incentives, external trade promotion, freight rates, hire purchase, GATT, import and export control, international trade including trade and commodity agreements, pioneer industries legislation, shipping insurance, trade commissioners, trade exhibitions and weights and measures. Four important statutory bodies are associated with the ministry. They are the Malaysian Industrial Development Authority (MIDA), the National Film Development Corporation, the National Productivity Centre and the Tourist Development Corporation.

Ministry of Transport

The MOT's activities are primarily concerned with the activities of its four departments of civil aviation, marine, road transport and railways and its four statutory authorities: Malaysia Airlines (the national carrier), the Malaysian Highway Authority, the Malaysian International Shipping Corporation Berhad and the Port Authorities of its five major ports. Transport is a sector which is at the forefront of privatisation in Malaysia. The airline was privatised in 1986 and the shipping corporation the following year. The government is also considering privatisation of Malayan Railways and major ports and airports.

Ministry of Welfare Services

The MWS is responsible for welfare services at federal level, and at state level there are state welfare directors. Responsibilities include the coordination and supervision of voluntary organisations, the protection of children and young persons, relief and rehabilitation of victims of natural and civil disasters, welfare of the handicapped, rehabilitation of juvenile offenders and the welfare of refugees.

Ministry of Works

One of Malaysia's oldest ministries, established in 1956, it was reorganised in 1975 dropping its other functions of Post and Telecommunication, and again in 1978 losing its function of transport which went to the new Ministry of Transport. Three bodies fall under the ministry: the ministry itself, the Public Works Department and the Malaysian Highway Authority.

Ministry of Youth and Sports

Formerly the Ministry of Culture, Youth and Sports, the new ministry is concerned with assistance to sports, coordination of sports and youth organisations, the promotion of youth involvement in economic development, the provision of training facilities and the training of youth leaders, and the provision of training schemes for unemployed young people. The ministry is also responsible for the country's main stadia.

Chapter Four

Foreign relations and regional cooperation

Membership of international bodies

Membership of ASEAN is the cornerstone of Malaysia's foreign policy, although there is disappointment that, more than 20 years after the economic bloc was formed, there has been little substantial progress towards a common market. Malaysia's partners in ASEAN are Thailand, Indonesia, Singapore, the Philippines and Brunei, most of whom compete head-on in export markets and for foreign investment. Although much has been achieved in political unity, there is little cohesion in development strategies and economic policies. The competition between the six states is thought likely to continue to stand in the way of closer unification in the 1990s.

In world affairs, Malaysia maintains a non-aligned posture and is a member of the Non-Aligned Movement. It maintains diplomatic relations with most Communist countries, including the Soviet Union and the East European countries, and China, and has good relations with non-Communist countries. Malaysia's position as host of the Commonwealth heads of government conference in October 1989, has mellowed Prime Minister Dr Mahathir Mohamad's hitherto unenthusiastic attitude to the Commonwealth, but he is known still to be seeking more tangible signs of Malaysia's membership.

Malaysia is also a member of the Islamic Conference Organisation, although membership is believed to be governed more by domestic considerations than by a desire to play a greater role in the international Islamic movement. Concessions on policy in line with Islamic Conference policy are relatively easy for Malaysia, yet they help contain pressure from the Islamic parties at home. Membership also improves trade, and other ties with West Asian countries, particularly Iran, have been strengthening.

Malaysia's foreign policy has tended to develop increasingly as "economic diplomacy" with the growing need to establish good relations with countries prepared to open their markets to Malaysia's commodities and other exports. Nevertheless, in defence matters it remains tied to the five-power treaty involving the UK, Australia, New Zealand and Singapore. Under the terms of this, Australia bases air force units at Butterworth for part of the year, where it has recently decided to upgrade facilities. Major arms purchases are made from Western powers, although suggestions of building multilateral military cooperation between ASEAN members have made little progress, since Singapore and Thailand are believed to continue to favour bilateral agreements with the US.

Mahathir's high-profile and sometimes controversial views have done much to give Malaysia a hugely increased recognition in international affairs. It has played a leading role in trying to solve the problem of Vietnamese refugees. Almost 300,000 refugees have arrived on Malaysia's shores since 1975 (13,000 in 1988 alone), 230,000 of whom have been settled in third countries. This recognition of Malaysia as one of the leading spokesmen of the developing world will be heightened by its role as host at the Commonwealth heads of government conference.

ASEAN

While it has been effective as a catalyst of political unification, ASEAN has yet to prove itself as a viable economic grouping. Competition for export markets and foreign investment between the six member countries is seen as impeding their economic growth. In important commodities like tin, Malaysia is in competition with other producers such as Thailand and Indonesia and past disagreements have left a legacy of wariness.

When ASEAN was formed in 1967, it was realised that political cooperation alone would not show practical results, and so the organisation was conceived as a regional grouping for political, economic, social and cultural cooperation. Progress has been painfully slow in the crucial areas of trade liberalisation and industrial cooperation. The original target date of 1990, by which time it was hoped to establish ASEAN as a limited free trade area, will pass without any significant achievement towards that goal.

ASEAN has spawned many committees and sub-committees, but the lack of success in regional economic cooperation is a story of protracted negotiations, exasperation and frustration. The economic recession of the mid-1980s exposed the group's fragile economies and heightened competition for market share in the industrial economies. Intra-ASEAN trade, which presently represents about 20 per cent of the trade of ASEAN member countries' total overall trade, has been slow to develop.

As long ago as 1977, when the ASEAN foreign ministers met in Manila, they agreed on a framework for promoting greater cooperation in trade and industry through the ASEAN Preferential Trading Arrangement (PTA). This proposed to liberalise trade through the granting of tariff preferences, long-term quantity contracts, preferential terms for the financing of imports, preferential procurement by government agencies, and the liberalisation of non-tariff barriers in intra-regional trade.

The effects of the PTA scheme in terms of increasing intra-regional trade have been minimal. One problem has been a tendency for the items offered in lists of tariff preferences to be inappropriate. The Philippines, for instance, includes snow ploughs in its list of preference items, and Thailand offers a 40-50 per cent margin of preference for more than 100 log items, most of which the other ASEAN countries cannot produce.

ASEAN industrial cooperation is focused on three basic schemes: the ASEAN Industrial Projects (AIPs), the ASEAN Industrial Complementation (AIC) scheme and the ASEAN Industrial Joint Ventures (AIJVs). While the notion of industrial cooperation is commendable and while the schemes – agreed on in 1980 – are still too recent to be subjected to any meaningful evaluation, they have been bogged down in extensive pre-implementation discussion. It was hoped, for example, that the AIC scheme would help to foster the manufacture of an ASEAN motor car, but the long-delayed and ambitious project has been abandoned as four of the five members have their own independent automative industries. Schemes that have become operational, such as two urea projects in Malaysia and Indonesia, are both losing money.

As ASEAN countries, including Malaysia, become individually impatient over the protracted delays, the tendency is to take short-cuts into bilateral arrangements with their neighbours. At another level, private sector cooperation, frustrated by ASEAN bureaucracy, moves ahead more efficiently and quickly. Sime Darby, for example, has established subsidiaries and projects throughout ASEAN.

While in principle economic cooperation could be extended to achieve maximum benefits in commodities, energy, agriculture and tourism, short-term national benefits, rather than long-term regional prospects, take priority. Domestic political problems have also hampered cooperative efforts. More particularly, with the ASEAN members producing very similar commodities, they compete for world trade. Additionally, there is the link to former colonial powers, which means that the Philippines retains strong trading links with the US, Indonesia with the Netherlands and Malaysia with the UK.

Achievements through ASEAN cooperation in energy have been similarly elusive. While at official level significant progress has been made in delineating a framework of cooperation, actual results have been meagre. In agriculture, attempts are focused on establishing uniform prices and agreements whereby members have the first right of refusal of food deficit commodities at preferential rates. Transport is one of the areas with the greatest potential. The economies of the ASEAN countries are outward-looking and heavily dependent on seaborne trade, yet the share of external trade carried by ASEAN-registered shippers is less than 20 per cent. National airlines do, however, occupy a leading role in tourism development, although member countries have rejected the notion of an ASEAN airline and, again, commercial and national interests have superseded regional ones.

In tourism, cooperation has been more fruitful and the Visit ASEAN Year in 1992 is projected to attract 24 million visitors. ASEAN has benefited from assistance provided by the United Nations Development Programme (UNDP) in the form of market studies and from EC cooperation in the form of research. ASEAN members have been unable to make significant progress in eliminating travel barriers, a step that would have the greatest effect in liberalising intra-ASEAN tourism.

Mahathir believes the early priority of ASEAN has been achieved:

> ... in its first 20 years, the main thrust of ASEAN has been political. This is as it should be and we have no need for regrets. We should remember that it was political problems between us as neighbours that first brought us together. We had been kept separate by our former colonial masters (except Thailand) so much so that we really knew nothing of, and were only ready to mistrust, each other. But the resulting political problems forced us to negotiate and eventually to appreciate the futility of confrontation.

He regards political cooperation within ASEAN as crucial to the economic development both of Malaysia and the region as a whole. It has been marked by the ending of the confrontation with Indonesia and a reduction in the tension engendered by the Philippines' claim to Sabah.

Mostly friendly neighbours

Malaysia's post-independence differences with its immediate neighbours have all but vanished. The only outstanding problem, and one that has prevented complete normalisation with the Philippines, is the latter's historic claim over Sabah in east Malaysia. Despite pledges by President Corazon Aquino, and before her, President Marcos, to remove it, a qualified claim to Sabah is still written into the Philippines' constitution. A Bill dropping the claim was approved by the Philippines House of Representative in 1987, but was amended by the Senate. Malaysia has said it will only sign a Treaty of Friendship and Cooperation and the Agreement on Border Control after the claim is dropped unconditionally. Until that happens, the two countries are unable to move ahead on other issues such as the limits of their territorial waters and common efforts against smuggling and piracy. Both the Philippines and Malaysia also claim interests in the Spratleys, a scattered chain of tiny islands in the South China Sea, which are also claimed by China and Vietnam. Interest in the Spratleys centres on the possible presence of hydrocarbons.

Mistrust between Malaysia and Singapore has gradually dissipated in the 25 years since Singapore parted from Malaysia in 1965. Improved relations culminated in the signing of a memorandum of understanding by leaders of the two countries in June 1988. Further testimony has been joint military exercises and Singapore's support in Malaysia's successful bid for a non-permanent seat on the United Nations Security Council. Nevertheless, there is the likelihood of occasional strains resurfacing, partly over ethnic issues, although the strong economic links between the two countries ensure that strenuous efforts are made to minimise differences.

Historically, Malaysia's most serious regional confrontation was with Indonesia, although over the years relations steadily improved and are now completely normalised.

After Malaysia and Indonesia became independent, it was assumed that the two countries would be closely drawn to each other, not only because of their geographical proximity, but because they are closely related by race, language, religion and culture. However, it was not the case. While Indonesia became a republic, for example, Malaysia retained its monarchy. More significant was Indonesia's leaders' scorn over Malaysia's relatively easy path to merdeka (freedom), while Indonesia had to fight the Dutch for independence. Indonesia's President Sukarno opposed the formation of Malaysia because he perceived the new nation as "neo-colonialist", serving the interests of Western powers, particularly Britain. Contrary to expectations of a closer relationship, relations deteriorated to such an extent after independence that all trade, travel and communications between the two countries were severed.

Indonesia and Malaysia are still involved in a prolonged exercise to chart their common border. It has taken the two countries 13 years of negotiation to settle the precise demarcation of only one-third of the 1,500 km border on the island of Borneo. The present differences arise out of the vague border definitions set by the former colonial administrations. Border agreements between Britain and the Netherlands were not always clear, and further confused by different conventions adopted in 1891, 1915 and 1982. Another, more sensitive, issue is that of the thousands of migrant Indonesian workers in Malaysia, many of whom work illegally on plantations.

Similar border discussions between Malaysia and Thailand, which began in 1973, were completed in 1985 and beyond the occasional fishing dispute and minor trade squabbles, Malaysian-Thai relations are sound, developing, according to Mahathir, into a "brotherly relationship" rather than just good neighbours. There are outstanding minor irritants: Thailand would like Malaysia to drop the tax charged on items that the 500,000 Malaysians who cross the border into southern Thailand each year have to pay. Malaysia would like Thailand, an importer of edible oils, to buy more palm oil. Ten years after the two countries set up a joint authority to exploit oil and gas in their overlapping continental shelf areas nothing has been achieved.

Relations with the West and fears over "Fortress Europe"

Malaysia fell out with Britain at the beginning of the 1980s. Simmering discontent on the part of Malaysia with what it felt was Britain taking its former colony for granted, culminated in a "Buy British Last" policy that was initiated by Mahathir after the UK introduced full-cost study fees for all foreign students. With the largest contingent of foreign students in Britain, this had hit Malaysia particularly hard. Relations were normalised after the prime minister made a private visit to London in 1983 and Britain is again Malaysia's largest trading partner in Europe, taking a role as an important arms supplier.

Relations have always been cordial with the US, a major investor and trading partner, which also sees eye-to-eye with Malaysia on many international and Third World problems. Mutual confidence is evidenced by the record proposed US investments of M$500 million in 1988 and current total investment of M$15 billion, the bulk of which is in the petroleum industry. It came as some relief to Malaysia in April 1989 when the US chose to renew Malaysia's General System of Preferences (GSP) status, despite allegations of violations of human and workers' rights in the country.

Malaysia has indicated its apprehension over the EC's proposal for a single European market by 1992. The European Community ranks as Malaysia's fourth largest export market after Japan, Singapore and the US, with the EC's share of Malaysian's aggregate exports about 14 per cent in 1987, an increase of 23 per cent over the previous year. At present, Malaysia is already affected by EC trade barriers. Under the GSP, for example, the Community allows a duty-free import quota of 86,000 cubic metres of plywood from

Kuala Lumpur played host to the 1989 Commonwealth Heads of Government conference, a token of Malaysia's growing prominence in world affairs

Malaysia, against actual imports of twice that amount. Export volume over the duty-free quota is subject to a high tariff of 11 per cent. Similarly, the EC tariff system discriminates against higher value added refined palm oil which is subject to a 12 per cent tariff, compared to 2.5-4 per cent for crude palm oil.

These restrictions strengthen the belief in Malaysia that the single European market will have negative effects on developing countries in Asia. In theory, the EC is supposed to have a common trade policy towards outside countries. In practice, however, under Article 115 of the Treaty of Rome, member states can take their own protective measures against dumping. Malaysia, like other developing countries, fears that these inconsistencies will be harmful to future trade. These fears were voiced by Mahathir on an official visit to Belgium. Saying that Malaysia was not seeking any special relationship with the EC, but simply a chance for fair trade and market access, Mahathir said: "We need to know and make preparations should the proposal become a reality in 1992. We don't want the EC to make irreversible decisions which may harm the economic interests of developing countries." Malaysia has excellent relations with Canada and New Zealand, but there have been occasional flare-ups with Canberra over Australian media attention to human rights issues in Malaysia.

China

China's support for Communist guerrillas in Malaysia made relations impossible in the immediate post-independence period. They improved subsequently and diplomatic relations were established as long ago as 1974, when China agreed to stop supplying arms and money to the banned Communist Party. However, as China insists on a right to provide "spiritual" support, Malaysian defence planners still consider China the greatest external threat to regional stability. Malaysia still imposes travel restrictions for the five million ethnic Chinese Malaysians, although these were slightly eased in 1985 to allow Malaysians over 60 years of age to visit relatives in China. Further relaxation of the restrictions are focused on dropping the age limit to 40. China's continued links with the Communist Party of Malaysia contribute to this somewhat cool atmosphere.

About 5,000 Malaysians now travel to China each year to visit relatives or attend trade fairs, and direct trade now accounts for fully 90 per cent of trade. In the past, the bulk of Sino-Malaysian trade has passed through third countries. Malaysia is eyeing China as a future major market and the two countries signed an agreement on the avoidance of double taxation in 1987. China has a 20 per cent advantage in total annual trade of about M$2 billion. China and Malaysia signed a mutual air traffic rights agreement in 1989 and flights were due to start later in the year. The two countries have also initialled a maritime transport agreement.

Japan

The South East Asian region is important to Japan as a source of raw materials and the area through which its strategic oil imports pass. Malaysia's relations with Japan have been tempered by an awareness of Japan's economic preponderance in the Asia-Pacific region and, among older Malaysians, by memories of the occupation during the Second World War. Nevertheless, Japan was at the centre of Malaysia's "Look East" policy, launched around the time of the cooling in relations with the UK. The policy urged Malaysia to model itself on Japan, South Korea and Taiwan, although Mahathir always takes pains to point out that the policy does not imply favouring Japan or South Korea with contracts.

Rather, it is argued, "Look East" was about the excellence of work ethics and management style and skills. It has involved large numbers of Malaysian students going to Japan, at the same time as efforts have been made to adopt Japanese work practices more widely. Japan has invested heavily in electronics manufacturing in Malaysia, but ASEAN countries are now losing out to the more strategically placed advanced economies of the US and Western Europe. Nevertheless, Malaysia is a major beneficiary of the US$2 billion ASEAN-Japan Development Fund.

West Asia

As with the Commonwealth, Malaysia has evinced occasional disappointment with the lack of tangible achievements of the Islamic Conference Organisation. Having had to face accusations that Malaysia is becoming more "fundamentalist", closer ties with Islamic nations are a sensitive issue. In the Middle East, referred to as West Asia, Malaysia's closest ties are developing with Iran. With a population of 50 million, Iran represents a sizeable market for palm oil, rubber, timber and other products. The two countries signed a memorandum of understanding to strengthen bilateral ties during a visit in 1989 to Kuala Lumpur by Iran's Foreign Affairs Minister who said that trade between the two countries had the potential to increase to US$200 million a year from the present US$8 million. A most favoured nation agreement will be signed in 1989.

Malaysia recognised Palestine after the declaration of independence by the Palestine National Council in Tunisia and its office in Kuala Lumpur is to be upgraded to full embassy status.

Chapter Five

The structure of the economy

The region

The performance of the Malaysian economy cannot be understood apart from that of the Asia-Pacific region as a whole, with the fortunes of which it is inextricably linked.

For three decades economic growth in the the Asia-Pacific region has been faster than anywhere else in the world. Since the mid-1970s, when worldwide growth began to falter, the slowdown in the region has been much less marked than in other regions. Declining commodity prices and debt problems had only limited effects in retarding developing countries in the Asia-Pacific region, where average economic growth increased in 1982-87, although at a slower rate. Thus Malaysia has benefited from association with a healthy regional market.

The region's share of exports and imports began to out-perform overall world trade in the mid-1970s and has accelerated since then. Exports began to outpace imports significantly in 1984, which was an achievement almost entirely attributable to the vigorous growth in the volume of manufactured products. The sharp expansion of exports was accompanied by increased investment and stronger domestic consumption. Malaysia has shared in this growth, seeing its manufactured exports rise during the 1980s to M$26.9 billion in 1988, accounting for almost half of total exports.

As the region's importance in the world economy has grown, so too has it become the target of increased foreign investment, particularly from Japan, Taiwan and the US. Malaysia is seen as a logical destination for this investment, given the General System of Preferences (GSP) which it enjoys in relation to the crucial US market. Imports into Japan are also increasing rapidly, much of the rise being accounted for by Japanese investment in export-oriented manufacturing in the region, although at present it is the Asian NICs that are benefiting more from Japan's increased imports, rather than the developing countries.

Exhibit 5.1

GDP by origin (1978 prices) (M$bn)

	1986	*1987*	*1988*	*1989**
Agriculture, forestry & fishing	12.4	13.3	13.8	14.4
Mining & quarrying	6.4	6.4	6.9	7.3
Manufacturing	12.1	13.7	15.8	17.4
Construction	2.4	2.1	2.1	2.2
Electricity, gas and water	1.0	1.1	1.2	1.3
Transport, storage and communications	3.8	4.1	4.3	4.5
Wholesale and retail trade, hotels and restaurants	6.1	6.4	6.9	7.5
Finance, insurance and real estate	5.0	5.4	5.7	6.1
Government services	7.3	7.5	7.8	8.2
Other services	1.4	1.4	1.4	1.5
Less: Imputed bank service charges	1.9	2.2	2.5	2.8
Plus: Import duties	1.8	1.7	1.9	2.0
GDP at market prices	57.8	60.9	65.3	69.5

Source: Bank Negara

* Forecast

The Peninsular Gas Utilisation Project is set to transform energy supplies and pave the way for an expanded petrochemicals industry

is the Asian NICs that are benefiting more from Japan's increased imports, rather than the developing countries.

Within the region, it is apparent that Thailand and Malaysia are moving closer to NIC status, ahead of the Philippines and Indonesia. Both Thailand and Malaysia have experienced high rates of economic growth, steadily climbing per capita income and strong inward foreign investment from inside and outside the region.

A two-commodity economy

When Malaysia gained independence in 1957, the country was the world's largest producer and exporter of rubber and tin, accounting for a third of total world supply of both products in that year. Since then, Malaysia has been transformed from a colonial producer of raw materials into one of the most progressive, prosperous and fastest-growing countries in Asia, with a modern, diversified economy in which agriculture, industry, mining and the service sector all play important roles.

The first problem faced by Malaysia's post-independence government was the over-reliance on rubber and tin. Declining demand and wide price fluctuations caused economic instability and the first priority for the new government was to diversify the production base. One instrument in this was the First Malayan Five Year Development Plan (1955-60). This sought to reduce dependence on rubber by the introduction of alternative cash crops, to develop secondary industries and to increase the area of rice cultivation.

The 1960s saw diversification start to take place with a broadening of the commodity base and the establishment of more import-substitution industries, although agricultural expansion remained a priority. Real gross domestic product (GDP) rose by an annual average rate of about 5 per cent with inflation of less than 1 per cent annually.

The New Economic Policy

The inter-communal unrest in 1969 was the trigger for a major reorientation in economic policy and the launch of the New Economic Policy (NEP) in 1970. The rationale for the policy was in a 1970 government survey showing that 42 per cent of Malay households in Peninsular Malaysia fell within an income bracket of less than M$200 per month, compared to only 10.4 per cent of Chinese households. Nine percent of Chinese had household incomes of M$400 or more compared to 4.3 per cent of Malay households. While Malays held the political weight, the Chinese controlled the country's commercial activities.

The NEP sought to redress the economic imbalances. It was designed to eradicate poverty and to enhance the economic standing of Malaysia's indigenous population, collectively known as Bumiputeras. It set the target of 30 per cent ownership of equity in Bumiputera hands by 1990, with 40 per cent held by other Malaysians and 30 per cent by foreigners. The policy was embodied in the Second Malaysia Development Plan (1971-75), in which state investment was to play an important part in rural industrialisation through agricultural processing. One important aim of the NEP was to avoid racial conflict in the future by tackling rural poverty and ending the identification of economic function with race.

In spite of the two oil price shocks and higher inflation which averaged 6 per cent during the 1970s, the end of the decade saw a period of rapid growth, averaging 8 per cent per annum, and an even more broadly-based economy assisted by the exploitation of oil and gas and a growing manufacturing sector. By the end of the decade Malaysia also had in place a relatively sophisticated financial system. The mining sector suffered a decline in the mid-1970s, but at the end of the decade it had largely recovered.

The major impetus for Malaysia's rapid growth in the 1970s was the export of natural resources. More than 70 per cent of exports were derived from primary commodities, especially petroleum, rubber, timber, palm oil and tin. Only after 1980 did the share of manufactured exports exceed 20 per cent of all exports. However, the exports of manufactured goods increased more than 15-fold (in nominal terms) during 1970-83, against a six-fold increase in total exports during the same period.

Recession and recovery in the 1980s

The 1980s have been characterised by a continuing boom in exports of manufactured products. These overtook the traditional commodities sector at the end of the 1980s to pass the 1995 target of the Industrial Master Plan and take the lead in economic recovery. Other new characteristics of the economy have included increasing liberalisation and sophistication in banking and financial services; privatisation and soaring foreign and domestic investment in a more diversified economy; a far more manageable foreign debt; and increasing downstream manufacturing of its own raw materials.

Malaysia's long period of high growth came to an abrupt halt in 1985-86 when a sharp fall in commodity prices (oil and palm oil prices were halved) sent the economy into recession. Real output was stagnant during 1985-86, but the worsening of Malaysia's terms of trade (the prices of her exports compared to the prices of imports) caused nominal GNP to fall by a combined 11.5 per cent in 1985 and 1986. Per capita GNP fell from M$5,500 in 1984 to a low of about M$4,300 but has since recovered to around M$4,815 in 1988. The brunt of this drop in income fell on the rural areas in which commodity production and the Bumiputera population are concentrated, thus accentuating already existing imbalances in income levels between the ethnic communities.

Counter-cyclical infrastructure spending policies to combat declining commodity prices and higher interest rates were partially successful but could not be sustained. A period of austerity and severe cut-backs took place and sharp deflation followed. Planned expenditure under the Fifth Malaysian Plan was cut by 25 per cent.

Recovery began in late 1986 and gained strength during 1987, although it was a year in which the government had to face considerable problems because of mismanagement and allegations of corruption. The government had to rescue three banks and 24 deposit-taking cooperatives that were in trouble because of fraud or mismanagement.

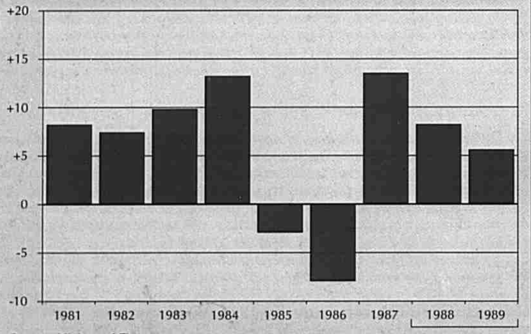
Helped by improved commodity prices, foreign investment and strong growth in the manufacturing sector, Malaysia's economy rebounded in 1987 and continued even more strongly in 1988. Tight control of spending and the recovery's boost to revenues reduced the federal deficit from 11.3 per cent of GNP in 1986 to 7.8 per cent for 1988. Private investment has recovered strongly from the recession, and is now expected to be one of the main motors of economic growth.

A forecast by the deputy governor of the central bank, Bank Negara Malaysia, Lin See Yan, in mid-1989, predicted that growth would be 8 per cent in 1989, falling only marginally from 8.1 per cent in 1988. Consumption and private investment were seen as the main motors of growth, with investment being reflected in higher manufacturing output and tourism expansion. Farm sector output growth was expected to slow, although total unemployment was forecast to fall to 7.75 per cent. In the medium term, unemployment is expected to remain above 6 per cent until 1992.

As Malaysia emerged from the recession it also became clear that a transformation to an industrial economy had taken place with manufacturing overtaking agriculture for the first time.

Exhibit 5.2

GNP at market prices, annual rates of change



Source: Ministry of Finance

Manufacturing

Manufacturing grew at 10 per cent per annum from independence until 1980, declined to an average of 5.2 per cent in the 1981-85 period, and picked up after the recession to reach 15.5 per cent in 1988. The focus of early post-independence industrialisation was on import-substitution products such as foodstuffs, construction materials and chemicals; in the 1970s it was on resource-based processing and by the 1980s had extended to electrical equipment, electronics, textiles and natural rubber products.

Rapid industrialisation has been dominated by the production of electronic components, telecommunications equipment, electrical equipment and machinery, and textiles and apparel. Malaysia is now the world's third largest producer of semiconductor devices after the US and Japan, and the world's largest exporter. A strategy for the development of heavy industry has now been abandoned in favour of resource-based,

Exhibit 5.3a

Gross fixed capital formation, current prices (M$m)

	Public	*Private*
1981	9,293	11,466
1982	11,378	11,367
1983	13,455	11,758
1984	12,046	13,345
1985	10,854	12,270
1986	8,599	10,266
1987	7,442	10,838
1988[e]	8,846	12,764
1989[e]	10,821	14,383

[e] Estimate

Source: Ministry of Finance

Exhibit 5.3b

Capital expenditure by sector/industry[1] (M$m)

Sector/industry	*1985*	*1986*	*1987*	*1988*[2]
Rubber	36.4	20.5	18.0	27.7
Oil Palm	121.2	116.4	87.7	137.2
Logging	23.2	6.7	39.9	131.3
Mining[3]	8.8	5.2	14.4	11.6
Manufacturing	631.5	613.2	655.4	769.0
Food	92.1	112.5	56.9	66.5
Textiles	3.7	2.5	5.2	15.4
Petroleum refining	76.5	72.0	123.4	96.7
Non-metallic mineral products	22.7	30.3	3.5	9.9
Electrical products	152.8	155.4	219.2	313.1
Transport equipment	27.4	63.4	39.4	29.6
Other manufactured products	256.3	177.1	207.8	237.8
Construction	6.2	7.5	3.4	1.2
Wholesale and retail trade	128.3	185.8	106.6	120.4
Hotels	–	1.4[4]	6.3	8.6
Banks and other financial institutions	251.6	235.9	176.5	163.2
Insurance, real estate and business services	18.0	7.3	8.3	8.4
Transport	266.3	116.4	248.1	315.1
Total	1,491.5	1,316.1	1,364.5	1,693.7

[1] Based on the survey of 220 large companies by the Department of Statistics
[2] Expected expenditure
[3] Excluding petroleum and gas
[4] Second half of 1986 only

Source: Ministry of Finance

consumer-and export-oriented industrialisation. However, the fact that the semiconductor industry (concentrated around Penang) remains heavily export-dependent reveals the limited extent to which Malaysia has succeeded in building up related industrial assembly operations.

Manufacturing growth has been against the backdrop of the Industrial Master Plan (IMP). This was drawn up by experts from the United Nations Industrial Development Organisation, and identified the industrial sector as the engine of growth for the future. It fixed a target for industrial output to represent 23.9 per cent of GDP by 1995. The 10-year plan, 1986-95, was controversial in that it envisaged that Malaysia could step away from its reliance on agricultural commodities with their painful price swings, and move rapidly into industrialisation, with heavy industry playing a significant role.

Heavy industry failed to live up to expectations. The Heavy Industries Corporation of Malaysia (HICOM) has been responsible for coordinating investment across strategic industries, such as iron and steel and cement, but also in autos (see Chapter 11). HICOM has not been wholly successful, for which several explanations have been put forward. One is that it has tried to exploit cheap and readily available energy resources – such as natural gas – even where this has involved using experimental processes or reliance on other high-quality inputs. At a more fundamental level, it has been suggested that Malaysia faces a problem in trying to telescope the multi-staged development which South Korea went through in developing both basic industries and advanced manufacturing simultaneously.

This has been more successful in electronics, where it was not so necessary to build up an industrial base before establishing manufacturing operations. Manufacturing has soared way beyond the IMP's expectations, reaching the plan's 1995 target of GDP contribution

Exhibit 5.4

Exports of manufactured goods (M$m) (% share of all manufactured exports in brackets)

	1970		*1980*		*1985*		*1988*	
Total	612	(100)	6,101	(100)	12,111	(100)	26,917	(100)
Food; beverages and tobacco	112	(18)	475	(8)	594	(5)	1,374	(5.2)
Textiles, clothing and footwear	40	(7)	806	(13)	1,289	(10)	2,407	(9.0)
Wood products	88	(14)	467	(8)	363	(3)	923	(3.4)
Rubber products	17	(3)	84	(1)	113	(1)	872	(3.2)
Chemicals and petroleum products	197	(32)	361	(6)	1,412	(12)	1,850	(6.9)
Non-metallic mineral products	20	(3)	61	(1)	150	(1)	452	(1.7)
Iron and steel and metal manufactures	26	(4)	161	(3)	300	(2)	1,187	(4.4)
Electrical and electronic machinery and appliances	17	(3)	2,832	(46)	6,028	(50)	15,164	(56.3)*
Other machinery and transport equipment	68	(11)	407	(7)	1,031	(9)	503	(1.9)
Other manufactures	27	(5)	447	(7)	831	(7)	1,863	(6.9)

*The breakdown of total exports in 1988 of M$15,164 million was:
Electronic components: M$8,711 million (32.3)
Electrical appliances: M$1,069 million (4.0)
Other electrical machinery: M$5,384 million (20.0)

Source: Ministry of Finance Economic Report 1988/89 and Bank Negara 1988 Annual Report

***Far left*: Dr Mahathir, Prime Minister**

***Left*: Dato' Paduka Daim Zainuddin, Finance Minister and architect of Malaysia's post-recessionary structural adjustment**

in 1988. It had already overtaken agriculture as an export earner in 1987, its contribution increasing from 31 per cent of exports by value in 1984 to 48 per cent in 1988 and reaching 24.2 per cent of GDP in that year.

The shift to a manufacturing economy has been reflected in the structure of imports. This has been marked by a decline in food products as import-substitution industries got under way and, latterly, by the import of intermediate inputs and capital goods in line with the rapid expansion of industry. Whereas 47 per cent of imports in 1961 were of consumption goods, this proportion fell to 24 per cent in 1988, while that of intermediate goods rose from 28 per cent to 44 per cent.

Raw materials for manufacturing which constituted about half of all intermediate imports in the 1970s now represent about three-quarters of the imports of intermediate goods, with 49 per cent representing components for the electronics industry. The shift in the structure of manufactured exports has also been an important indicator of the underlying transformation of the economy, revealing a dramatic rise in the proportion of sophisticated products since 1970 and the remarkable jump in exports of electrical and electronic machinery.

From a country that relied almost entirely on rubber and tin for its foreign exchange earnings at independence in 1957, Malaysia has seen tremendous diversification and is more able to resist the shocks that the swings of the world economy can bring to bear so disruptively on developing nations.

Nevertheless, the manufacturing base remains relatively narrow because of the overwhelming reliance on electronics and textiles. Moreover, the sector is unhealthily over-dependent on one market – the US. Exports of electronic components and equipment represent more than half of the total export revenue from manufacturing. Half of the output of the electronics and textiles industry goes to the US market, making the economy very sensitive to any swings in the US economic cycle. But when total export figures are examined, dependence on the US is not so great.

However, narrow as both the product and distribution bases may be, manufacturing development has allowed the country to diversify from its traditional reliance on raw materials. Malaysia is now taking its first steps in the downstream manufacturing of its commodities; foreign investors and a number of plantation companies have turned to tyre and rubber glove manufacturing, with a huge demand for the latter because of AIDS. A huge project on the east coast near Kuantan will transform Malaysia's abundant supplies of

Offshore oil and gas have been crucial export earners

natural gas into feedstock for a polypropylene plant that will save M$6 billion in imports over a 15-year period, and foreign firms – particularly Taiwanese and South Korean – are believed to be interested in integrated projects linking oil and natural gas with petrochemicals. In the agricultural and forestry sectors there are plans to use palm oil production for conversion into diesel fuel and to expand production of hardwood furniture by using rubber trees which have reached the end of their productive life. Furniture production is a labour-intensive industry which is likely to prove popular with the government.

Commodities and agriculture

Nevertheless, Malaysia continues to be vulnerable to volatile commodity prices. Commodities, both agricultural and mineral, are still a vital part of the export picture. Malaysia is the world's largest producer of rubber and palm oil and a leading producer of tropical hardwoods, cocoa and pepper. In 1988 agriculture accounted for 21 per cent of the GDP, 31 per cent of employment and 48 per cent of export earnings.

While Malaysia remains the world's largest supplier, the tin industry has become progressively less important in the economy since 1957. The sector saw the reopening of mines as the tin price firmed in 1988, taking employment in the industry to over 11,000. In the short term, however, there were fears that the rapidly increasing price of tin in 1989 might cause over-supply and a return to low prices. Finance ministry projections envisaged a rise in output of nearly 10 per cent in 1989.

Exhibit 5.5

Structure and value of exports/imports 1988 (M$m)

	Exports	%
Agriculture	18,513	33.4
Rubber	5,256	9.5
Saw logs	4,007	7.2
Sawn timber	1,844	3.3
Palm oil	4,538	8.2
Palm kernel oil	634	1.1
Other	2,234	4.1
Minerals	9,250	16.7
Tin	911	1.6
Petroleum	6,128	11.1
LNG	1,885	3.4
Other	326	0.6
Manufactures	26,917	48.5
Other	803	1.4
Total	55,483	100.00

	Imports	%
Consumption goods	10,246	23.6
Food	2,344	5.4
Beverages and tobacco	217	0.5
Consumer durables	3,386	7.8
Other	4,299	9.9
Investment goods	12,677	29.2
Machinery	3,864	8.9
Transport equipment	1,433	3.3
Metal products	2,865	6.6
Other	4,515	10.4
Intermediate goods	20,057	46.2
For manufacturing	15,151	34.9
For construction	1,129	2.6
For agriculture	1,042	2.4
Crude petroleum	410	0.9
Other	2,325	5.4
Imports for re-export	433	1.0
Tin ore	43	0.8
Natural rubber	90	0.2
Total	43,413	100.0

Source: Bank Negara

Malaysia also produces significant quantities of oil and gas. Although exploration prospects are bright, oil reserves will be depleted within 15 years given current production levels. But present gas reserves have an estimated lifespan of over 100 years. Under a long-term contract, Malaysia exports LNG to Japan worth about M$2.6 billion a year.

While the commodity outlook remains volatile, agricultural growth has been steady with output rising at an annual rate of 6.9 per cent since independence and with strong diversification into other products. Timber and palm oil have become increasingly important, rising in export revenue terms from 1.7 per cent to 8.4 per cent and from 5.4 per cent to 11.2 per cent respectively in 1988. By comparison, those from rubber and tin declined as a share of the total from 69.1 per cent in 1960 to 11.5 per cent in 1988.

The Bornean state of Sarawak is the most densely afforested in Malaysia, and an important source of timber exports

Debt and the balance of payments

Malaysia's large trade surpluses have traditionally been offset by service deficits, leading to a deficit in the current account. These deficits widened in the global recession of 1981-82 as the trade account deteriorated. The current account was in deficit in 1983, but remained in surplus from 1984 to 1987, before moving into deficit in 1988 when the services deficit was M$10.1 billion (equivalent to 12 per cent of GNP). Recent efforts have focused on reducing this deficit, both by improving the earnings of Malaysian transport services and by limiting the growth of foreign debt.

Public sector borrowing policies have been reversed, and the emphasis on all development is now on minimising the additions to external debt. Parastatals have been encouraged to reorganise and restructure their borrowing to reduce costs. During the period of heavy borrowing, foreign exchange reserves fell to a low of M$10 billion and the external debt rose to M$51 billion at the end of 1986 – equivalent to more than 70 per cent of GDP. Debt remained at this level during 1987, although by 1988 policies had successfully reduced both the total of debt (to M$47.3 billion) and the debt/GDP ratio (to 56 per cent). One complicating factor in the debt outlook for Malaysia has been that the ringgit's depreciation against major international currencies, in which debt is denominated, adds to the total debt.

The foreign debt situation has therefore eased considerably since the early 1980s. Liquidity from the export boom and improving commodity prices allowed the government to make a pre-payment of M$2.4 billion in 1988, the third consecutive year for such pre-payments. The decline in the debt total in 1987 was the first decline since 1973 and in sharp contrast to the rapid accumulation of 30 per cent annually during the 1981-86 period. The debt service ratio improved from the 1986 level of 19 per cent of exports – close to the cautionary barrier of 20 per cent set by the IMF and the World Bank – to 16 per cent in 1987 and 13.3 per cent by the end of 1988. Reserves rose and at the end of 1988 they had reached M$18 billion, sufficient to finance about five months of imports.

Multilateral agencies

As a developing country, Malaysia has been the recipient of foreign aid since independence. Between 1958 and the end of 1987 Malaysia received a total of US$2.13 billion in direct and guaranteed loans from the World Bank, with a total of 74 projects receiving assistance up to 1987, and a further four that year. The bulk of funds has gone to infrastructure (41.3 per cent) and agriculture (32.3 per cent). A tighter fiscal stance has delayed disbursement of funds in recent years because locally-funded components of projects have been held back. Success in speeding disbursement in 1988 meant, however, that net transfers involving the World Bank were positive for the first time since 1984. But in the medium to long term, Malaysia's growing prosperity is likely to reduce the role of the World Bank in funding projects.

Asian Development Bank (ADB) lending between 1966 and 1987 totalled US$1.36 billion, predominantly to provide the foreign exchange element for agricultural projects. Of the 63 loans approved, 22 are still under implementation and, since 1984, the flow of funds associated with the ADB has turned sharply negative. Islamic Development Bank (IDB) funding has played a smaller part in development – providing only US$75 million between 1975 and 1987.

Foreign investment

Malaysia's major sources of foreign investment in 1988 were the same as those for neighbouring Thailand, but the amounts less: US$200 million from Japan, US$150 million from Taiwan, and US$93 million from the US. Malaysia was also the focus of substantial investment from Singapore (US$63 million), Hong Kong (US$50 million) and the UK (US$35 million). As Thailand's infrastructure becomes stretched and land prices rise, foreign investment started to swing more in Malaysia's favour.

The policy environment

Fiscal policy

Government fiscal policy has entered a phase of marked retrenchment in recent years, during which the state has sought to expand the role of private capital in the development of the country, while cutting the losses of parastatals. A sharp deterioration in government revenues in 1986 triggered a crisis, when revenue fell by some 7.6 per cent, producing a deficit in the current expenditure. The government responded with a series of austerity measures, which fell particularly on development expenditure. Cuts have reduced the overall budget deficit to its lowest level since 1980, although the cost has been felt in unemployment remaining around 10 per cent.

Development expenditure was cut from a peak of M$11.3 billion in 1982 to M$5.1 billion in 1988, at the same time as public sector pay. Meanwhile, the federal revenue position improved after two years of decline. This was boosted by a stronger economic performance and rose by over 18 per cent in 1988 to M$21.5 billion for the year. Against operating expenditure of M$21.4 billion, this gave a modest surplus of M$143 million, a sharp reversal from a deficit of M$2.1 billion in 1987.

Monetary policy

On the domestic front the Bank Negara has sought to manage interest rates judiciously and provide adequate monetary growth and sufficient liquidity to compensate for the sharp contraction in government spending. A regime of relatively low interest rates has been a feature of Malaysian policy, with the commercial banks' base rates being reduced steadily since 1986, falling to their lowest effective level since 1972. Bank lending expanded rapidly during 1988, across a wider range of activities than the narrowly based property lending boom of the 1980s.

Against a background of rumours and lack of confidence in the banking system, and the recognition that it must lend only to tradeable and productive sectors, Bank Negara adopted a two-pronged "pump priming" approach which involved a reform of the Export-Credit Refinancing Scheme and the establishment of an investment fund aimed at channelling funds at low cost to promote export financing and spreading the benefits on a backward linkage basis to the suppliers of exporters.

The M$1 billion New Investment Fund was successful in financing productive capacity in priority sectors – agriculture, mining, manufacturing and tourism. Aimed at providing cheaper funds at a time of tight liquidity and high interest rates, it was an emergency measure that will be terminated once the NIF allocation is fully utilised.

The central bank has also had to repair the damage done to the financial system by the deposit-taking cooperatives (DTCs), 24 of which with over half a million members and M$1.5 billion deposits were unable to meet depositors' withdrawal demands. More than M$680 million had been lost through fraud and mismanagement. Bank Negara "froze" the 24 DTCs and put a rescue package into operation.

Partly because of this experience, an important aim of monetary policy at the end of the 1980s has been to promote a more efficient and competitive banking system and to broaden and deepen the money and capital markets by introducing new instruments and stimulating competition. After the problems of the DTCs and with a number of banks, the central bank has been obliged to intervene on a number of occasions. To establish a sounder financial system, a major review of banking legislation was completed in 1988 and was due to be presented to parliament in 1989.

Exchange rate policy

On the external front, Bank Negara has overseen a policy of "clean floating", which has seen the ringgit depreciate steadily since 1985. The Malaysian government's policy is not to intervene to support the continued weakening of the ringgit except against speculation. Between 1985 and 1988 its value fell 32.6 per cent against the currencies of Malaysia's major trading partners. However, the rate of depreciation has been checked, and the currency fell only 6.2 per cent in 1988 (although it recorded a sharper fall against the US dollar). While this is seen as having had benefits for the export sector, in making Malaysian goods more competitive, there is concern about the potential inflationary consequences of a floating currency.

Inflation, wages and employment

Unlike the developing countries of Latin America, Malaysia has never suffered from excessive inflation. During the 1980s inflation has been held consistently below 10 per cent, hitting 5.8 per cent in 1982, but falling to below 1 per cent during the recession of 1985-86.

Currently, there is no national minimum wage law covering the manufacturing sector. Generally wages and salaries are determined by market forces, but in many establishments are also negotiated by collective bargaining.

Basic wage rates for unskilled workers in manufacturing industry range from about

M$6 per day upwards according to type of industry and location. Basic wage rates for semi-skilled workers range from M$7 to M$10 per day, again depending on type of industry and location. Skilled workers are paid much higher rates, ranging upwards from M$15 per day depending on work ability and experience. However, skilled workers fresh from training institutions are paid between M$8 and M$10 per day.

The labour force

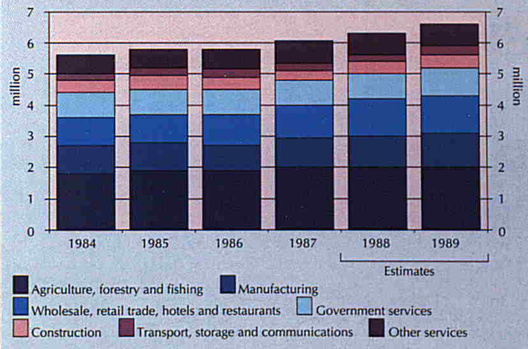
Malaysia's labour force was estimated at about 6.8 million in 1989, with unemployment at around 7.9 per cent. The country has a young population with 38 per cent of people below the age of 15 and the proportion of working age (between 15 and 64) comprising 58.4 per cent of the total. The bulk of new entrants to the labour market are educated at least up to lower secondary level and are conversant in the national language of Bahasa Malaysia and in English.

An increasing number of the more highly educated are joining the workforce and an average of 12,000 degree and diploma holders graduate each year from Malaysian universities, colleges and other technical and industrial training institutions in the country to become professionals and technologists or to go into management. This supply of professionally qualified personnel is augmented by the hundreds of Malaysians who return home every year after completing their studies in universities and colleges abroad, particularly from the UK, the US, Canada, India, Australia and New Zealand. There is presently a large over-supply of university and college graduates.

In the last decade there has been a rapid expansion of vocational and technical schools, polytechnics and industrial training institutions. Most training institutions are run

Exhibit 5.6

Employment by sectors



Source: Ministry of Finance

by government agencies. The Ministry of Labour operates five industrial training institutes, with an additional five due to come on stream before the end of 1990. In addition, the ministry operates a Centre for Instructor and Advance Skilled Training and has programmes of skills upgrading courses, in-plant training and trade instructor training. The industrial training division of MARA (Trust for the Indigenous People) operates nine vocational training institutes and the Ministry of Education operates 46 vocational schools and nine technical schools.

With effect from 1988 a double deduction is allowed on operational expenses in the manufacturing sector on "approved training" undertaken by manufacturing companies. Under a National Industrial Training and Trade Certification Board (NITTCB) programme, 52 trade standards have been established covering a wide range of industries. All students trained at public and private industrial training institutions sit for the NITTCB examinations.

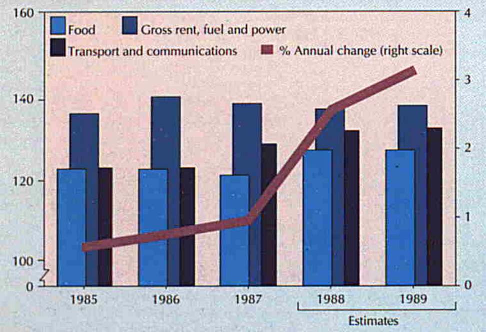
NEP and industrial intervention

Criticism of the NEP has focused on its "unfair" aspects – the special privileges that indigenous Malays receive in education, employment and loans – and on it being a disincentive to domestic and foreign investment. Another source of criticism is that its implementation has been stymied by administrative problems in interpretation of the policy. In some instances, even after central government authorisation from MIDA, for example, for a project with a degree of flexibility on employment, a state government might then insist on employment of a full quota of Malays.

NEP was created at a time of high economic growth, but in the wake of the economic downturn the government was forced to take a more pragmatic view of the NEP's

Exhibit 5.7

Consumer price index



Source: Ministry of Finance

implementation. In any case, while there had to be some kind of target, it was generally accepted that there were bound to be some modifications. With some exceptions, companies have not been forced into restructuring along the lines of the original target of 30/40/30 foreign/non-Bumiputera/Bumiputera ownership. Similarly, employment ratios have been relaxed. In recent years Prime Minister Mahathir has emphasised in speeches that it was more important to provide employment and opportunities than to concentrate on ownership structure.

PERNAS

One major company to have emerged from the NEP is the diversified Perbadanan Nasional Berhad (PERNAS). This was formed in 1969 with the primary objective of increasing Bumiputera participation in the commercial and industrial sectors in line with the NEP. A public limited government-backed investment holding company, PERNAS had an initial paid-up capital of M$11 million. Today, the authorised and paid-up capital have increased to M$1 billion and M$751 million respectively. As a public limited company, PERNAS' operations are geared towards making profits which provide the means for the company to achieve its primary socio-economic objective of raising the level of Bumiputera participation in business.

From its initial activities in the fields of trading, insurance, construction and mining, over the years PERNAS has diversified its interests to include hotel and property development, engineering, manufacturing, plantation, leasing, banking and shipping. In 1981 and 1982, in line with its objectives of establishing and developing profitable companies for eventual transfer to Bumiputera ownership, shares of PERNAS group companies with an estimated market value of M$1 billion were transferred to another Bumiputera trust agency, the National Equity Corporation or Permodalan Nasional Berhad (PNB).

PERNAS is involved in a broad spectrum of the country's economic activities. Through its group of wholly-owned and subsidiary companies more than M$1.5 billion has been invested in banking and finance, hotel and property, manufacturing, plantation, shipping and trading.

Financial services and insurance

The banking and finance sectors today represent by far the largest investments of PERNAS. With a recent further equity acquisition, PERNAS now has an 87 per cent equity stake in United Malayan Banking Corporation Berhad, Malaysia's third largest bank. In the insurance sector, PERNAS holds a 25 per cent share in Malaysia National Insurance Sdn Bhd (MNI), Malaysia's largest general and life insurance company, and 56 per cent of the equity in Union Insurance Malaysia Sdn Bhd, which provides general and marine insurance. PERNAS Insurance Brokers Sdn Bhd is one of the largest insurance brokers in the country.

Hotel and property

PERNAS' most recent ventures into the hotel industry are the construction of the 300-room Pelangi Beach resort on the legendary Langkawi Island, and another five-star international class hotel, the 600-room Istana Hotel located in the heart of Kuala Lumpur's Golden triangle. PERNAS has also acquired a 70 per cent interest in Holiday Inn, Johor Baharu, through C.T. Hotel Sdn Bhd.

Manufacturing

PERNAS' major investment in the manufacturing sector is Malayawata Steel Bhd, an integrated steel mill in which PERNAS holds a 46 per cent equity stake. Through its joint venture with Sime Darby Bhd in PSD Holdings Sdn Bhd, the group is involved in automobile tyre manufacturing; auto batteries and component parts; bituminous products; and manufacture of industrial, mechanical electrical and electronic equipment. PERNAS' other investments in the manufacturing sector include safety glass manufacturing, sugar refining and industrial chemical products.

Plantations
Through PERNAS Securities Sdn Bhd, PERNAS owns 24,902 acres of agricultural land in the states of Johor, Sabah and Terengganu that are planted with oil palm, rubber and cocoa. By 1990 PERNAS will have increased its plantation holdings to 70,000 acres and, in line with its plan of becoming a major plantation owner, has set a target of 150,000 acres to be achieved by 1995.

Shipping
PERNAS' involvement in the shipping industry began with the incorporation of Perbadanan Nasional Shipping Line Bhd (PNSL) in 1982. To date PNSL has 12 vessels in its fleet with a total tonnage of 266,724 dwt and is expected to play an active role in the expansion of the nation's economy as well as in reducing the outflow of foreign exchange.

Trading
PERNAS Trading Sdn Bhd is engaged in general trading, import and export business and countertrade. Its products range from chemicals, fertilisers, paper products, building materials, cements, steel bars and computers to cosmetics. In the wholesaling and retailing of household products PERNAS, through its subsidiary PERNAS Edar Sdn Bhd, has the responsibility for training and enhancing Bumiputera participation in the retail business. As suppliers, PERNAS Trading and PERNAS Edar are expected to play a major supporting role for Bumiputera contractors and retailers in terms of ensuring adequate supplies and maintaining reasonable price levels.

PERNAS has placed heavy emphasis on human resource development among its 9,400 employees, a quarter of whom are executives and professionals. Training programmes include local and overseas training in areas such as engineering, computer science, insurance, hotel management accountancy, business management and shipping. PERNAS has spent M$5.4 million on scholarships and staff training and developed a number of successful Bumiputera managers and entrepreneurs. Some of those who have left PERNAS are now holding key positions in various industries and financial institutions.

For foreign investors, PERNAS represents a potential partner that is not only a corporate giant in terms of group assets but one that is uniquely placed in the Malayan economy reflecting the important part which the company has played in the government's industrial policy. With its domestic and international affiliations, PERNAS is in a strong position to help prospective investors enter smoothly into a new business development.

Through its transfer of its profitable companies, PERNAS has contributed substantially towards the attainment of the corporate asset ownership targets under the NEP. Until the national target of equity ownership by the Bumiputera community is fully achieved, PERNAS' role will continue to be sizeable.

Economic policy into the 1990s

Prime Minister Mahathir expects the country to graduate to NIC status by the year 2000 when industrial production is expected to account for 80 per cent of GDP. On the road to this goal, the policy that will replace the NEP when it expires in 1990 is crucial to the future of domestic and foreign investment. However, the view of the Malaysian Institute of Economic Research's (MIER) executive director Dr Kamal Salih is that to become a NIC in the 1990s is very different and much tougher than in the previous three decades. This is

The tin industry has seen a revival of employment and activity, but projects are still conditioned by the volatile behaviour of world prices

the real test of Malaysia in the 1990s – whether it can emulate the success of the "Four Tigers" and join the first rank of developing nations in the Asia-Pacific region.

Before the NEP's 20-year life draws to a close at the end of 1990, a 150-member National Economic Consultative Council (NECC) will mould recommendations for its replacement. Discussions included calls for research to establish more accurate and up-to-date information on poverty and corporate ownership. The council is made up of half Bumiputera and half non-Bumiputera members and is composed of politicians and trade unionists, bankers and farmers, academics and businessmen.

Unpopular as the NEP has been with some sections of the community, it was a necessary step and its success is apparent in Malaysia's growing and visible Malay middle class. It is estimated that the achievement of NEP is about 10 per cent short of its target of having 30 per cent of corporate wealth in Malay hands by 1990. The results of a survey carried out by the Kuala Lumpur Stock Exchange towards the end of 1988 showed that Malays owned M$4.5 billion, or 25.3 per cent, of the paid-up capital of 218 public listed companies as at the end of 1987 and constituted 9.2 per cent of the total number of shareholders. A National Outlook Conference in December 1988 organised by MIER drew mixed opinions. While deep disagreement exists on the corporate equity target, there has been success in employment restructuring with the notable exceptions of the lucrative professions such as medicine, accountancy and law.

Foreign investment after 1990

Following the 1986 relaxation in the foreign investment code, Prime Minister Mahathir sees that any new policy will "have to continue to encourage new investments, both from foreign and domestic sources". Precise rules and concessions do, however, remain to be worked out. The interpretation of the NEP and lack of cohesion in implementation have for long been a source of anxiety and anger for foreign businessmen. Traditionally, meetings about NEP at the Malaysian International Chamber of Commerce and Industry in Malaysia have seen West German and Japanese businessmen pushing for a strict set of rules to follow, while British members preferred flexible implementation. Indications are that foreign investors will press above all for clarity in new rules.

Foreign investment will remain highly important to Malaysia in the 1990s, and rules will be framed with this in mind. According to the foreign interests representative on the NECC, their priorities include the absence of any overhanging threats in the form of unexercised options for the state to take a stake or set participation ratios, and equality of treatment once a foreign business has restructured. To a foreign investor, an unexercised option with no time limit to it hanging over a business venture is a major uncertainty. The foreign investor would like to know that once certain acceptable steps have been taken, perhaps at some short-term costs and discomfort, the option will not be exercised again. Having complied with restructuring targets, equality of treatment for a foreign business is crucial to convince overseas shareholders of the benefits of divesting a proportion of ownership.

Malaysia's traditional concern with social consensus means that any new policy will have to be seen to be creating a careful balance between the interests of capital and labour in the drive to become a NIC. An industrialisation process conducted with regard exclusively for the interests of capital is seen as risking the emergence of a militant labour movement as in South Korea where workers have not shared equally in the fruits of the country's economic growth.

Chapter Six

External trade and trade relations

Regional perspective

As the Asia-Pacific region's share of the global economy has increased, so too has the region become increasingly important in world trade. In the 1960s the region's share of world exports and imports hovered around 14-15 per cent. While the world economy slowed in the 1970s, Asia-Pacific exports and imports outpaced overall world trade. Its share passed the 15 per cent mark in 1980 and is rising towards 25 per cent. The acceleration has been particularly marked on the export side. The Asia-Pacific region did not become a net exporter until the early 1980s and it is only since 1984 that exports have significantly outpaced imports.

Trade performance in the individual countries of the region has varied widely, as have the trading profiles of the countries. As a group, the nations of the region fall into two categories, those that are primarily exporters of manufactured goods and those which export raw materials and commodities. The expansion of manufacturing output means that Malaysia is now in the process of leaving the second category (Australia, Indonesia, New Zealand, the Philippines and Thailand) to join the first (China, Hong Kong, Japan, South Korea, Singapore and Taiwan). In 1988 the manufacturing sector not only strengthened its position as the leading source of export earnings with M$26.9 billion, but accounted for almost one half of total Malaysian exports.

The Asian Development Bank calculated that the combined exports of the region rose by 11 per cent in 1988, with Thailand recording a rapid increase of 38 per cent and Malaysia a much more modest 7 per cent. Imports into the region had grown by 23 per cent, again with Thailand recording the highest growth of 49 per cent, followed by Malaysia (19 per cent) and the Philippines (10 per cent).

Yet the region's manufactured export growth has been achieved through increasing penetration of the US market. This has been particularly true for the region's developing countries. From 1980 to 1986 these countries increased their total exports to the world by 36 per cent, but exports to the US jumped by 104 per cent in the same period. In contrast, their intra-group exports grew by 38 per cent, their exports to Western Europe by 16 per cent and their exports to Japan actually declined. While the Asia-Pacific share of US imports has soared, US exports to the region have grown only marginally, causing increasing tensions over trade issues. Sustained growth of 3 per cent in the industrialised world is thought necessary for Malaysia to maintain growth of manufactured exports.

The balance of trade

Between 1960 and 1984, Malaysia had an overall trade surplus position with the rest of the world every year except 1982 when the only deficit, of M$915 million, was recorded. During the second half of the 1970s and the early part of the 1980s, annual trade surpluses were large, ranging between M$3.4 and M$7 billion. This was due to the coming on stream of crude petroleum from off-shore wells since 1976 and liquefied natural gas since 1983.

Malaysia is trying to diversify into new markets in the Asia-Pacific region, as well as Africa, the Middle East and Australia. With Singapore, the US and Japan absorbing more than half of its exports, each of Malaysia's other trading partners, with the exception of South Korea, account for export shares of less than 5 per cent. The balance of trade recorded a substantial surplus of M$13.2 billion in 1987, although this fell slightly to M$11.5 billion in 1988 and is expected to decline further in 1989.

GSP

Malaysia does not take full advantage of General System of Preferences (GSP) benefits that are available from 25 countries, including notably the European Community (EC), the US and Japan. GSP provides for duty-free entry of goods from developing countries. Of the total export value of M$25 billion in 1987 with the preference-giving countries, only M$4.2 billion (16.7 per cent) worth of trade was transacted through the GSP. On a regional basis, GSP availability is extremely high for EC countries, the third largest export market, at 97 per cent of total dutiable exports, but falls to 21 per cent for the US, the second largest market, and to 16 per cent for Japan. One of the reasons for low availability in trade with Japan and the US is the high proportion of exports of electronic components, many of which, because of the low level of value added, are not eligible. However, there are significant volumes of other manufactured items being exported where Malaysia is not taking advantage of GSP benefits.

The direction of overseas trade

Japan

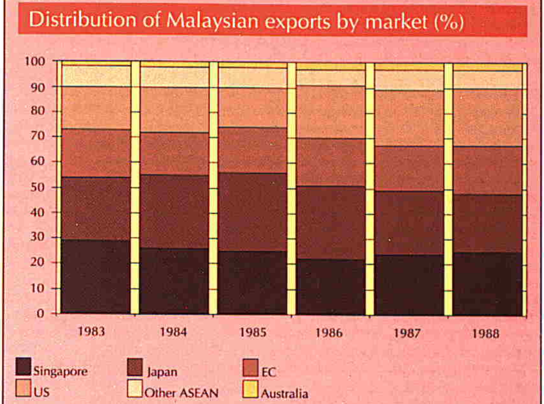
From Japan's perspective, trade with Malaysia is relatively insignificant, representing 2-3 per cent of its total international trade. Seen from a Malaysian perspective, however, the story is different. Japan is Malaysia's leading trade partner, accounting for almost 20 per cent of all exports, worth M$9.5 billion, and 23.4 per cent of imports, worth over M$10 billion. Japan took the position of being Malaysia's largest single customer in 1984, but this was reclaimed by Singapore in 1988, with imports worth M$10.7 billion.

Unlike trade with the US, exports to Japan remain skewed towards primary commodities which make up 80 per cent of Malaysia's exports to the Japanese market. This presents a problem, since Malaysian manufacturers continue to find Japan a difficult market to penetrate, yet relentless research in Japan is reducing demand for Malaysia's raw materials. Consequently, the share of aggregate Malaysian exports going to Japan has been shrinking, declining from 24.4 per cent in 1986 to 19.6 per cent in 1987 and 17.2 per cent in 1988.

Saw logs account for a quarter of Malaysian exports to Japan, LNG for 20 per cent and crude petroleum for about another 20 per cent, although this proportion fluctuates markedly in line with oil price movements. Japan buys more than half of Malaysia's saw log exports (but only one-twelfth of sawn timber exports) and, under a long-term contract, it buys all of the LNG exported by Malaysia. Exports of manufactured goods to Japan consist largely of electronic components mostly made by Japanese plants in Malaysia. The Japanese market has proved to be almost impenetrable for other Malaysian manufactured products, which Japanese buyers say lack the quality of those of the Asian NICs – Hong Kong, Taiwan, South Korea and Singapore.

Would-be exporters from Malaysia are also hindered by the complex procedures involved in gaining access. Imported food products, pharmaceuticals and electrical equipment are subjected to a host of stringent regulations and entry procedures that are cumbersome and costly. Another barrier is in Japan's discrimination against processed goods in favour of raw materials. The duties on saw logs and cocoa beans, for example, are

Exhibit 6.1



Source: Economic Report 1988/89 and Bank Negara Annual Report 1988

far lower than those levied on plywood and cocoa butter.

However, Japan agreed to implement tariff cuts and make concessions on tropical products under the Uruguay GATT round, and this is seen as bringing benefits to Malaysian exporters. The concessions cover 179 products imported at an annual cost of US$3 billion. The main item of interest for Malaysia is canned pineapple for which quantitative restrictions and tariff cuts were agreed and are due to be implemented by Japan in mid-1990. Lower tariffs will also be applied from the same time on fresh bananas, plywood, wooden moulding and furniture, particle board, rubber tubes, pipes and hoses, palm oil, kernel oil and cocoa powder and paste.

Representation has been made on numerous occasions and at every level to try to secure improved access for Malaysian goods in Japanese markets. Some progress has been made, but Malaysia needs an expansion of technical assistance programmes to help bring her products into line with Japanese standards, help in marketing, and the further removal of discriminatory duties that penalise value-added products. Malaysian food and fruit processors are getting some help under a three-year project from the Japan External Trade Organisation (Jetro) and the Japan Food Industry Centre. Malaysia is also the first country to receive assistance from a new worldwide initiative being carried out under the auspices of Japan's agriculture ministry which has allocated M$400,000 for Malaysia.

One problem is that while the Japanese can share their experience and teach Malaysians the necessary processing skills, the technology needed to upgrade the products to a standard acceptable to the Japanese is extremely expensive. There have been some successes. Dunlop is selling tyres worth about M$10 million a year to Japan. Another rubber products company is selling 100,000 sets of car mats annually. Textile products have also enjoyed some success, as have mangosteens, which have a target of 10 million pieces by 1995. Yet here, again, the problem of quality remains to be overcome. The fruit made its debut in Japan a full year behind schedule because of problems in getting the produce up to standard. Only 100 of every 1,000 pieces of fruit brought in by farmers was of sufficiently good quality.

The problems in penetrating the Japanese market are reflected in the difficulties which Malaysian firms have in selling to Japanese firms established in Malaysia. For while Japan is the biggest foreign investor – investment totalled ¥56 billion in 1988 – local input remains low. In both the electronics and electrical industries, in which the bulk of investment is concentrated, Japanese manufacturers would like to see as much local content as possible because of the cost factor of sourcing from their home plants and elsewhere. In the electrical industry, Malaysian supplies have seen some success. A survey showed that about 50 per cent of parts are purchased in Japan, mainly compressors and electronic parts, with almost 30 per cent coming from Malaysia and the balance from other ASEAN countries. However, in the electronics industry, 73 per cent of purchases come from Japan, with Malaysia supplying only 3.5 per cent. In the transport equipment industry, about 80 per cent of parts come from Japan and 20 per cent is sourced locally.

Almost 50 per cent of the Japanese manufacturing companies surveyed cited the low level of technology as being the main barrier to increasing the use of local components and material. Another 19 per cent cited delays in delivery, 14 per cent the differences in production systems and another 14 per cent put the blame on high cost. Local suppliers, however, complain that the Japanese are too demanding, wanting a high consistent quality and a low price. With small profit margins and a high chance of supplies being rejected on the grounds of poor quality, Malaysian sub-contractors lose interest. They are also unhappy with the requirement of Japanese manufacturers for them to disclose full details of their operations, including the cost of labour and inputs.

United States

Exports to the US soared for the third year running in 1988, growing by more than 28 per cent. The US now ranks as Malaysia's second largest market, accounting for 17.3 per cent of all exports. Significantly, the US accounts for half of Malaysia's total exports of electronic components and almost half (42.5 per cent) of the exports of textiles and textile products. Malaysia is thus heavily dependent on the US market for the continued success of its fastest growing exports, and highly sensitive to any hint of restrictions on exports.

Exhibit 6.2

Malaysia's trade partners

	Imports from Malaysia (M$m)			*Exports to Malaysia (M$m)*		
	1975	*1985*	*1988*	*1975*	*1985*	*1988*
Japan	1,337	9,272	9,541	1,707	7,006	10,171
US	1,489	4,891	9,613	909	4,627	7,680
UK	2,137	5,504	7,990	1,731	4,397	5,803
W. Germany	554	979	1,934	852	1,202	2,131
Netherlands	1,169	3,234	3,577	505	1,704	2,022
ASEAN	2,234	9,805	13,491	1,289	6,823	8,152
Singapore	1,874	7,357	10,698	722	4,828	5,730
Australia	172	650	1,354	665	1,234	1,802 *
China	128	399	1,090	356	621	1,266

* A significant element of Australia's exports to Malaysia is tin (14,000 tonnes worth M$100 million in 1987) which is smelted in Malaysia for re-export. The inclusion of tin exports here causes some distortion of the overall trade picture.

Manufactured exports to the US consist almost entirely of electronics and textiles. The US buys half of Malaysia's electronic components and almost half of the country's textiles and textile products. Malaysia has taken increasing advantage of US GSP benefits, exporting goods worth M$900 million under the scheme in 1987, which represented a 50 per cent increase over the previous year. With the removal by the US of GSP advantages granted to the Asian NICs, Malaysia is in a more competitive position.

It was of considerable relief to Malaysian trade officials when, in April 1989, the US announced that Malaysia would continue to enjoy the benefits of its GSP programme. The US trades union confederation, the American Federation of Labor and Congress of Industrial Organisations, had petitioned to exclude Malaysia from the list alleging it had engaged in "large-scale human rights violations". The decision to target Malaysia and five other countries (Syria, Burma, Haiti, Liberia and Israel) was based on petitions from labour unions, human rights and lobbying groups. The threat of trade sanctions has, therefore, not faded entirely into the background.

Europe

Trade between the ASEAN and EC countries grew by 55 per cent between 1980 and 1987, and ASEAN exports to the Community increased by 46 per cent during the same period. The EC's share of Malaysia's aggregate exports hovers around 14 per cent. Within the EC, the accession of Spain, Portugal and Greece has altered the composition of the Community in a manner unfavourable to Malaysia and other Third World exporters. Unlike the original EC members, whose products were complementary to Malaysia's, the exports of the new low-cost producing countries compete head-on with Malaysia's manufactured goods. Spain, Portugal and Greece are expected to expand textile and electronics manufacturing and, with duty-free entry into Europe, will enjoy a tremendous advantage over Malaysia.

EC members are expected to press for tougher external barriers to compensate for increasing competition in the internal market. While the bigger Japanese, South Korean and Taiwanese manufacturers are following the example of the US and are responding to possible protectionism by increasing their investments in Europe, Malaysian companies do not have the investment clout to do so. Malaysia's response has been to step up its lobbying activities in Europe and to try to attract European manufacturers to Malaysia to produce for the Japanese market. Encouraging European investment will, it is hoped, serve to strengthen trade links with the continent.

Malaysia's main trading partners in Europe are the UK, West Germany and the Netherlands. At independence, Britain was Malaysia's major trading partner. By the 1960s it had slipped to second place, dropping to fourth place in the 1970s and seventh place in the 1980s. Relations – and trade – deteriorated sharply at the beginning of the 1980s with Malaysia's "Buy British Last" policy, initiated in retaliation for what Prime Minister Mahathir perceived as a negative British attitude towards Malaysia and which culminated in a row over increased education fees for the thousands of Malaysian students in the UK.

After visits to each other's countries by Prime Ministers Mahathir and Thatcher in the mid-1980s, relations were normalised and today Britain is a major investor in Malaysia with investments of around M$10 billion. Two-way trade is about M$4 billion annually, approximately equally shared, but in invisibles, such as insurance and banking, Britain has a large surplus. With the signing of a contract for the supply of M$5 billion worth of military equipment to Malaysia over a 10-year period from 1988, Britain's surplus will increase considerably. Aircraft and missile systems will be supplied on a countertrade basis with Malaysia paying in oil and other commodities.

Britain remains Malaysia's biggest EC trading partner and is a major purchaser of agricultural commodities such as rubber, sawn timber and palm oil. Malaysia is Britain's biggest supplier of electronic components and sells a wide range of manufactured and semi-manufactured articles. Malaysia has also done well in textile products and fabrics with Britain becoming its third biggest customer. The big prestige sale as far as Malaysia is concerned is that of the Proton Saga car, 1,000 units of which were sold in less than a month after they went on sale in Britain early in 1989. Proton's UK agent has revised its annual sales target to 8,000 units.

Malaysia's second biggest trading partner in the EC is West Germany. Rubber, palm oil, tin and timber account for about half of West Germany's imports from Malaysia, with another quarter represented by electrical components. Finished goods have yet to make much of an impact in West Germany or on its European neighbours. More than 90 per cent of West German exports to Malaysia are accounted for by machinery.

West German investment has also begun to play more of a part in the economy. Although slow to start, the range of investment grew more diversified towards the end of the 1980s. From only four projects with total equity of M$3.3 million in 1971, investments grew to 87 projects worth a total of M$80 million at the end of the 1970s and more than doubled to almost 200 projects worth over M$200 million by the end of 1988. Total trade in 1988 was about M$3.5 billion with Malaysian exports accounting for M$1.9 billion. Trade between the two countries is forecast to grow by 10 per cent annually until 1990.

ASEAN and Singapore

Malaysia's trade with its ASEAN neighbours has been in its favour for two decades and exports to markets in ASEAN account for about a quarter of Malaysia's exports. However, because of their long historical and close geographical connection, Singapore accounts for 70 per cent of Malaysia's total ASEAN trade and is the leading buyer of Malaysian exports. It relies on Malaysia for its water supplies and, after the completion of Malaysia's peninsular gas utilization scheme in 1991, Singapore will buy 150 million cubic feet of gas a day. With its highly-developed refining and processing sector, Singapore is the leading customer for Malaysian raw materials which it processes and re-exports. More than 40 per cent of Singapore's Malaysian imports are in the form of raw materials. It buys a third of Malaysia's crude oil (6.4 million tonnes in 1988), is the leading single importer for rubber and sawn timber products and one of the biggest buyers of palm oil. As a supplier of food products, Malaysia is best placed to serve Singapore which intends gradually to phase out the farming industry.

Singapore broke away from the Malaysian federation in 1965 and tensions have arisen from time to time. Today, however, relations between the two countries are better than ever. Singapore's industrial policy is to reduce and eventually eliminate labour-intensive and low-technology manufacturing, allowing these functions to move overseas. The southern state of Johor is likely to become a particularly important focus for investment by Singaporean manufacturers.

The bulk of Malaysia's export revenues from trade with its other ASEAN neighbours comes from its sales of crude oil (to Thailand and the Philippines), and iron and steel to most of the ASEAN nations. With a gradual lowering of trade barriers between the ASEAN countries, a marked increase in trade is forecast for the 1990s. To encourage further intra-ASEAN trade, economic ministers of the six-member group (Malaysia, Indonesia, Singapore, Thailand, the Philippines and Brunei) meeting in 1987 agreed to pare the exclusion list of the ASEAN Preferential Trading Arrangements (PTA) over a five-year period so that, by 1993, 90 per cent of the items traded among ASEAN countries will have been removed from the list. Under the scheme, Malaysia exports a wide variety of manufactured items.

All other items will be automatically given a 25 per cent margin of preferences (MOP) and new items that come under the PTA will have a minimum MOP of 25 per cent. (The MOP is a reduction or "discount" on the existing tariff rate for a product. For example, if the tariff Malaysia imposes on a product is 10 per cent, a MOP of 25 per cent means that it

Malaysia's membership of international Islamic organisations is important for trade relations as well as reasons of cultural identity can be imported from an ASEAN country at a tariff of 7.5 per cent.) Under the same agreement and over the same period, the ASEAN content requirement under the Rules of Origin will be reduced from 50 per cent to 35 per cent. By the end of the period, each country will have reduced its exclusion list from 2,000 to 3,000 items to about 400. In Malaysia's case it will be 370 items, or about 9 per cent of total traded items.

South Korea, Hong Kong and Taiwan

As bilateral trade with three of the "tigers" of South East Asia – South Korea, Taiwan and Hong Kong – grew rapidly at the end of the 1980s, Malaysia had an increasingly comfortable surplus, but exports are again hampered by the lack of sophistication of Malaysian products, particularly consumer items. Malaysian exports to Hong Kong, for example, represent only slightly over 1 per cent of the colony's burgeoning imports. Malaysia's total trade with South Korea of M$1 billion in 1980 had increased to almost M$4 billion in 1988, with a surplus in Malaysia's favour of M$1.35 billion. The bulk of exports to South Korea are commodities – petroleum, palm oil, natural rubber and wood products – while imports consist mainly of steel products, textiles, chemical products, fertilisers and machinery. South Korea has promised to buy liquefied natural gas (LNG) from Malaysia when its long-term contract with Indonesia expires in 1995.

Taiwan is another potential customer for Malaysia's LNG with plans to triple its use of natural gas by the year 2000. Taiwan also has a long-term contract with Indonesia, but is looking for other suppliers because of increasing domestic demand. Taiwan anticipates demand to increase from 500,000 tonnes in 1990 to 3 million tonnes in the year 2000. Its own gas reserves will be exhausted by about the year 2005. Taiwan's Chinese Petroleum Co has already constructed a terminal capable of accommodating 2 millions tonnes of LNG annually.

Electrical components replaced timber as Malaysia's main export to Taiwan after the opening of 10 Taiwanese electronic companies in Malaysia which export a major part of their production back to Taiwan. Other exports are electrical machinery and apparatus, chemicals and wood products. Trade between the two countries grew at about 4 per cent annually in the early 1980s, but soared by almost 40 per cent in 1987 and almost 50 per cent in 1988 to reach about M$3.6 billion and was forecast to grow a further 30 per cent in 1989.

Malaysian exports to Hong Kong, worth M$2 billion in 1988, were double the level of imports and were composed primarily of electronic products, industrial machinery and parts. Total trade between the two countries increased from M$1 billion in 1983 to M$3 billion in 1988, with a 75 per cent surge of manufactured exports in 1988.

Australia

At the beginning of the 1980s, imports from Australia were double the level of Malaysia's exports. Towards the end of the decade, exports and imports were running neck-and-neck with total trade increasing at a very healthy 38 per cent in 1988 over the previous year. Although a small market (Australia's population is the same as that of Malaysia), business between the two countries is well diversified. Australia takes a package of Malaysia's commodities such as natural rubber, palm oil, cocoa and petroleum (the single biggest earner), as well as other raw materials like cork and timber. There has also been a big jump in the export of Malaysia's building materials, including lime, cement and prefabricated construction materials, the value of which increased from M$300,000 in 1985 to almost M$20 million in 1988. About M$25 million worth of electrical goods, such as air conditioners, televisions, radios and telecommunications equipment, contributed to the M$1.3 billion worth of Malaysian goods exported to Australia in 1988. Cane and wood furniture have found a ready market there. So too have textiles, garments and footwear, despite high tariffs ranging from 35 per cent to 55 per cent. Sales of fresh, chilled, frozen, salted and dried crustaceans and molluscs have shot up to be worth M$25 million in the same year. The 50,000 migrants from Malaysia who have settled in Australia may be responsible for the latter category, but they are also given credit for establishing many of the business linkages that have been established between the two countries.

Australia gives preferential tariff treatment for developing countries like Malaysia. This is 5 per cent across-the-board, but Australia is still viewed as a relatively high tariff country. A predominantly agriculture-based economy, Australia is expected to continue to restrict market access in order to speed up industrialisation, but has announced that tariffs will be no higher than 10 per cent by 1992 and all import quotas will be eliminated by 1995.

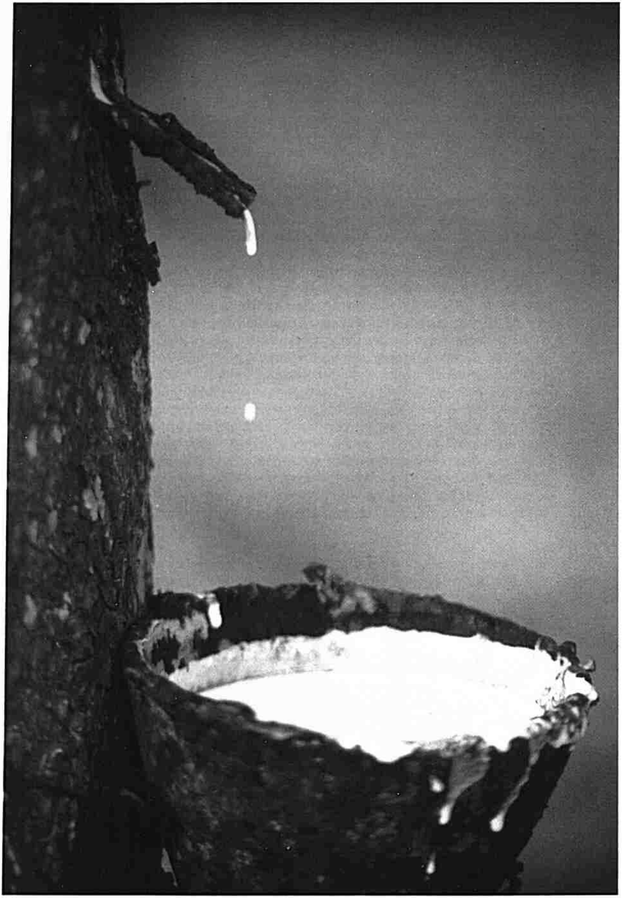
China

Trade with China was severely constrained until diplomatic relations with China were resumed in 1974. But even after then, trade was strictly regulated by the Malaysian government. Importers not only had to be registered with PERNAS Trading Bhd, a quasi-government company, appointed to oversee trade between the two countries, but had to apply to the Ministry of Trade for licences on an item-by-item basis. To get round these requirements – the most stringent Malaysia applied to any country – Malaysian importers continued to deal most often through third countries, mostly Hong Kong and Singapore, through which all trade was conducted before 1974.

China and Malaysia signed a bilateral trade agreement at the beginning of 1988. As a precondition to the signing of the agreement, China had demanded that the licensing requirement be withdrawn. This finally occurred two years after a visit to China by the prime minister in 1985.

As a result of the agreement, which reduced duties on rubber and palm oil from 30 per cent and 20 per cent to 10 per cent and for furniture and woodware by half, total trade between the two countries doubled from M$1.15 billion in 1986 to M$2.35 billion in 1988. Exports to China, however, still represent only 2 per cent of Malaysia's total exports. Although visits by Malaysians to China are still strictly controlled, about 1,500 business visitors a year travel there, mostly to attend trade fairs. China buys iron and steel from Malaysia and considerable potential exists for sales of timber products for construction.

Rubber's key role as one of Malaysia's "Big Three" commodity exports is likely to be enhanced by downstream diversification into rubber processing



Chapter Seven

The evolution of the financial system

When independence came to Malaysia, the banking system was geared to an economy dominated by the exchange of rubber and tin for food and other consumption goods as well as a certain amount of capital equipment. Predominantly British banks – commonly referred to as "exchange banks" – financed Malaysia's exports of tin and rubber, accounting for 86 per cent of total export revenues, and imports of food and manufactured goods, which accounted for 70 per cent of the total import bill.

With a third of Malaysia's trade being channelled through Singapore, which was also the location of the headquarters of the Currency Board system that had been in operation since the early 1900s, the banks in the Federation of Malaya were obliged to maintain around a third of their assets on deposit with the banks in Singapore and London. As a result, only about a third of the assets of the commercial banks in Malaysia was in the form of domestic loans and advances at the time of independence, a situation which meant that the secondary markets in Kuala Lumpur remained largely undeveloped.

In a pre-independence (1955) report the World Bank recognised that Malaya had:

> ... reached a stage of development where this largely external orientation of the economy has been and is being modified by such factors as a wide and growing volume of monetary transactions and of local capital and enterprise; a settled labour force; indigenous banking facilities at least as important as those afforded by overseas banks; and a need, as the inflow of new private external capital has declined, to depend increasingly on internal savings for further investment in the development of Malaya's resources...These changes in the economy call for a modification of the present currency system to permit a measure of deliberate management of the money and credit situation, with the object of fostering a more favourable climate for the further development of domestic enterprise. As the instrument for this management we recommend the establishment of a central bank of Malaya.

The central bank

The central bank of Malaysia (Bank Negara Malaysia) was consequently established in 1959 with the traditional functions of the currency authority – to issue currency and keep reserves safeguarding the value of the currency; to act as the government's banker; and to control banking and monetary policy. Malaysia's central bank has, however, always seen a somewhat broader role for itself, including responsibility for growth, price stability and living standards. From the outset, the bank was keenly aware of the need to initiate, foster and accelerate the process of developing a sound monetary and diversified banking system that would not only serve the vital needs of the country, but would also enable the bank to carry out effectively its responsibilities and functions in the field of monetary management.

The central bank identifies four main phases in the evolution of money and banking since independence. The pioneering years between 1957 and 1967 were marked by the establishment of the central bank, during which years the currency issuing powers remained vested with the Currency Board. Then came the phase of adaptation and growth from 1968 to 1973, culminating in the separation of all common financial links with Singapore and the floating of the ringgit in 1973. From 1974 to 1978 were the years of consolidation, before what the bank sees as its "drive towards maturity" between 1979 and today.

During this 30-year period money in the banking system increased from less than US$1 billion to over US$52 billion today.

The pioneering years

At the end of 1959 there was a total of 26 banks, of which only eight were Malaysian-incorporated banks. These Malaysian banks accounted for only 11 per cent of the 111 banking offices in existence at that time. During the post-independence period, the central bank actively encouraged the establishment of Malaysian-incorporated banks and two such institutions were established in 1960, with another in 1965. Today these three domestic banks – Public Bank Berhad, Malayan Banking and Bank Bumiputra Malaysia – are the three largest banks in Malaysia, accounting for 40.6 per cent of the total assets of commercial banks.

These early years also saw Bank Negara take over the issue and management of Treasury bills. Rediscounting facilities were offered and the first discount house was set up in 1963. With the development of an interbank market, this formed the basis for the evolution of a viable money market dealing mainly in short-dated funds and Treasury bills. In 1967, Bank Negara became the sole authority for issuing currency.

Adaptation and growth

The period 1968-73 was characterised by rapid economic growth at a time of diversification of exports and the emergence of domestic manufacturing industries based on import substitution. As part of this growth process, Malaysia saw the emergence of a growing number of finance companies, which accepted deposits from the public. In 1969 the increasing complexity of the financial system required that these were brought under the supervision of the central bank and at the end of that year 25 finance companies with 130 branches were authorised.

By the end of 1970 there were 38 commercial banks in Malaysia with a total of 336 branches. With the spread of banking into rural areas, significant advances were made in the monetisation of these non-urban sectors of the economy. In the corporate banking sector, the first merchant bank was established in 1970.

The years of consolidation

After 15 years of growth, which had seen remarkable advances in the establishment of a sophisticated banking system adequate to meet the needs of all sections of the community, it was time for consolidation. The central bank had become concerned over a number of trends. The first of these was the dilution of the capital base of the banking system. Secondly, it noted a deterioration in the quality of bank assets in certain segments of the system, coupled with a deterioration in the integrity and competence of the boards of management of certain banks and a general lack of professionalism in the banking industry. Lastly, it became concerned at the slow response of the system in providing modern and competitive banking services to meet the special needs of customers and in adopting modern banking techniques.

The authorities' response was embodied in refinements to the financial system in the 1979 budget, which introduced a range of reforms. The budget saw the abolition of administered interest rates for the commercial banks. This was an important step towards liberalisation, since the central bank had previously determined the maximum borrowing rates on bank deposits and the minimum prime lending rate for bank credit.

The structure of liquidity requirements was also reformed, including the composition of liquid assets, so that liquidity of the commercial banks and finance companies would better reflect the state of liquidity in the financial system. Two new monetary instruments were introduced, bankers acceptances and negotiable certificates of deposit. The intention of this was to develop the money market and raise the efficiency of the market in mobilising savings more effectively.

The new merchant banks were also brought within the ambit of the 1973 Banking Act to ensure they would undertake the functions for which they were established. This period also saw the establishment of a separate Malaysian Stock Exchange and an international exchange for the marketing of rubber in both physicals and futures.

Towards maturity

The period from 1979 onwards saw a further deepening and broadening of Malaysia's financial infrastructure, characterised in the early part of this period by high economic growth and increasing demand for new financial services and instruments. In 1979 and 1980 real GNP grew at an annual rate of 8.9 per cent and 17.6 per cent in nominal terms and higher levels of savings called for increased sophistication in the supply of financial services.

Part of the maturing process for the central bank was the experience which it gained during the economic slowdown in the mid-1980s and the subsequent recovery. The bank has also had to cope with the Bank Bumiputra scandal of the early 1980s and the embarrassment created by a M$22.2 million fraud at the central bank itself.

The economic slowdown which started in 1985 saw an unprecedented decline in commodity prices on a broad front. The recession and the collapse of share and property markets combined to depress banking profitability. As the pace of economic activity slackened and companies became unable to meet loan obligations, banks and finance companies were faced with an increasing number of bad debts and non-performing loans. Many institutions faced losses on a scale large enough for them to have to be rescued by the central bank. They included the United Asian Bank, the Oriental Bank, Supreme Finance, Perwira Habib Bank, Sabah Bank and First Malaysia Finance.

The consequences of the mid-1980s crisis are still being felt, leading the central bank to petition the High Court for an order to place the Cooperative Central Bank in receivership and wind up SEG Insurance. In these two cases, Bank Negara has changed its tactics from its previous practice of bailing out banks. Previously, Bank Negara pumped in M$670 million to recapitalise three insolvents banks and appointed new management. But

Exhibit 7.1

Banking system: income and expenditure (M$m)

	Financial year end					
	1986		*1987*		*1988**	
	M$m	%	*M$m*	%	*M$m*	%
Interest income	9,551	87.7	7,710	81.8	6,498	76.0
Other income	1,344	12.3	1,712	18.2	2,050	24.0
Total income	10,895	100.0	9,422	100.0	8,548	100.0
Interest expense	7,396	65.8	5,751	61.9	4,449	57.4
Staff costs	1,073	9.6	1,031	11.1	1,096	14.1
Bad debt provisions	1,657	14.8	1,410	15.1	1,014	13.1
Overheads	1,106	9.8	1,105	11.9	1,195	15.4
Total expenditure	11,232	100.0	9,297	100.0	7,754	100.0
Pre-tax profit/loss			125		794	

* Preliminary
Source: Bank Negara

in the case of the Cooperative Central Bank, a licensed finance company will acquire the assets and assume the deposit liabilities, and in the case of SEG Insurance, Bank Negara will close it and run off its liabilities.

A new era begins

The beginning of the 1990s marks the start of the final stage of evolution in banking and finance in Malaysia, drawing on the experience and lessons of the first 30 years. A number of reforms will take place in line with efforts to deregulate the financial system through the increased deepening and widening of banking activities.

From January 1989, steps designed to enhance competition, provide depth to the money market and further develop the capital markets have been in effect. The major thrust of these measures was the creation of a more active secondary market for trading of government securities with the appointment of 18 principal dealers who will be market makers. Open market operations are now conducted only through these dealers. Adjustments have been made to the system of issuing Malaysian government securities and the range of securities that discount houses can hold has been extended. In addition, guidelines have been established for the issue of private debt securities with the aim of providing investors with a wider range of instruments to raise funds. Statutory reserve and liquidity requirements have been adjusted to provide the banking system with increased liquidity.

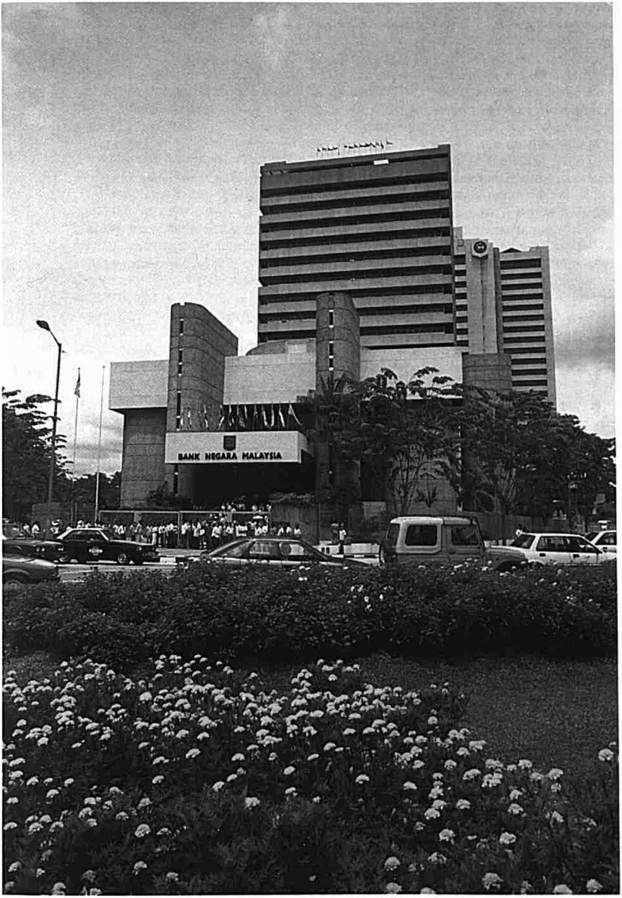
Tax incentives were introduced in the 1989 budget to help develop a more active market in corporate bonds and unit trusts and to promote the emergence of a viable market in property unit trusts. Plans are under way to launch the Phase II reform of the Export Credit Refinancing (ECR) Scheme on a national scale, together with the insurance and guarantee schemes. The Phase II reform aims to shift the emphasis from post-shipment to pre-shipment ECR to promote backward linkages in the export industries, as well as to extend the ECR to a wide range of indirect exporters. To augment the growing markets in commodity futures, the central bank is examining the feasibility of launching a financial futures market.

In this encouraging regulatory environment, profitability looks set to return to the banking sector following the problems of the mid-1980s, helped further by the general recovery in the economy. The increase in Bank Negara's own profitability, while not matching the banking system's six-fold increase in profits in 1988, was a healthy 32 per cent, amounting to M$951.5 million.

Profitability is also improving as a result of central bank supervision that includes ceilings of 5 per cent on wage increases and compulsory training and education. Expenditure in the banking sector fell by 3.9 per cent in 1988 despite a marginal rise in employment. An additional factor is the decline in interest payments on deposits. While the banking sector incurred losses of M$64 million in 1985 and M$224 million in 1986, pre-tax profits of M$794 million were recorded in 1988.

Public Bank Bhd, the country's third largest group, is expected to outperform the banking industry average with a net profit forecast of about M$58 million for its 1989 financial year, as against M$29 million for 1987. Malaysia's two largest banking groups, the government-owned Malayan Banking and Bank Bumiputra Malaysia, have, to some extent, sacrificed profitability in order to bring banking services to rural communities. Of a total of 895 bank branches throughout the country, 246 are located in small towns with a population of less than 10,000, and these are predominantly branches of state-owned banks.

Increases in productivity have kept any rise in overheads in check, and this also augurs well for the future. Malaysian banks' staff and overhead costs of 1.9 per cent of total assets are in keeping with international banks' operating costs standard of 2.3 per cent of total



Bank Negara: the central bank and guardian of the integrity of the country's financial system

assets. As an indication of increased productivity, assets of the banking system per employee improved by 14 per cent to M$2.4 million at the end of 1988 and revenue per employee rose a substantial 16.4 per cent in the same year to M$39,100. Total assets of the banking system increased by M$12.3 billion to M$125.8 billion. Flush with low-cost funds and aided by the recovery in the private sector investments, the loan portfolio of the banking sector rose by the end of 1988 to M$77 billion. Nevertheless, non-performing loans remain an area of concern. Provisions for interest in suspense and bad and doubtful debts rose by 70 per cent in 1986 and another 33 per cent in 1987 to M$9 billion – 12.7 per cent of total loans outstanding.

In all, liberalisation is helping to develop the capital market and give Malaysia a more significant role in the regional financial scene.

Chapter Eight

The commercial banks

The commercial banks in Malaysia have evolved considerably since independence. Before 1957, they were mostly British-owned and concerned principally with the finance of the export-import trade. After independence, the pattern of lending by commercial banks changed from that of the colonial era. Loans and advances were needed for agricultural diversification and for the new manufacturing industries, and a number of Malaysian institutions developed to meet this need. These banks faced a situation quite different in character to that which had prevailed before 1957. Bank loans to the manufacturing sector soared in the late 1960s and through the 1970s, but stagnated in 1987 because of the economic slowdown of the two previous years.

Malaysia now has 38 commercial banks – 22 of them domestic and 16 foreign-incorporated – which are the largest and most important group of financial institutions. The number of domestic banks overtook foreign banks in 1974 and at the beginning of 1989 there were 749 branches of domestic banks and 146 branches of foreign-incorporated banks, with many of the new branches located outside the urban areas.

After the years of expansion and consolidation in the 1960s and 1970s, the problems faced by the banking sector in the mid-1980s gave rise to a number of reforms. The failures of that period indicated that the quality of management was inadequate in many institutions. These shortcomings have been countered by a number of steps on the part of the banks themselves as well as government and central bank initiatives. One measure which has done much to improve the quality of personnel and the assessment of risk is the compulsory expenditure by banks of not less than 1.5 per cent of salaries on staff training and education.

As in other parts of the world, the impact of technology has transformed the range of banking services available to the public even in remote parts of the country. The huge expansion in the number and activities of commercial banks is seen by the increase of their resources from M$1.2 billion in 1960 to M$93 billion at the end of 1988. Total deposits, including NCDs, placed with the commercial banks rose at an average annual rate of 16.1 per cent from M$942 million in 1960 to M$61.1 billion.

Interest rates

Until the early 1980s, interest rates had been on a steady upward trend, but after October 1981, in line with the decline in international rates and the easing of liquidity in the domestic money market, interest rates generally moved downwards. The decline was marked in the case of shorter-term deposits, so that longer-term deposits became relatively more attractive. During the 1981-83 period, interest rates on one and three month deposits declined by 4.25 per cent and 3.25 per cent to 6.7 per cent and 7.25 per cent per annum respectively, while interest rates on nine to 12 month maturities declined by 2.5-3 percentage points to a range of 7.5-8 per cent per annum.

Bank liquidity came under pressure because of a heavy demand for loans towards the end of 1983 and during 1984, particularly in the property sector, prompting a rise in deposits rates. This took one to 12 month maturities up to a range of 10-10.75 per cent. In response to the downturn of the mid-1980s, the central bank exerted pressure to bring the rates down again. Following the improvement in domestic liquidity in 1987, interest rates on deposits declined markedly. The central bank issued guidelines to the commercial banks to adjust the margin of their lending rates for all loans to not more than 4 per cent above their Base Lending Rates (BLR). By the end of 1988, short-term fixed deposit rates of the commercial banks ranged from 3 to 4.25 per cent per annum and the savings deposits rate was 3.5 per cent. The two leading commercial banks reduced their BLR from 7 per cent to 6.75 per cent while the other commercial banks and finance companies made similar reductions in lending rates.

New directions

Among the new directions which commercial bank activity has taken is the financing of real estate development. This has shown a dramatic expansion over the past thirty years. The share of commercial bank credit extended to construction and real estate rose from an aggregate of 3.7 per cent of total loans and advances in 1960 to 35.5 per cent by late 1988, although growth in the property sector slackened following the sharp fall in property prices after 1984.

Bank Negara has monitored this expansion in property-based lending closely and measures taken through the revamped Export Credit Refinancing Schemes have encouraged commercial banks to redirect lending away from the over-exposed areas of real estate and property to the new priority sector of export financing. Other priority areas are manufacturing, agriculture, tourism and mining. Also of significance has been the lengthening of the maturing structure of bank credit.

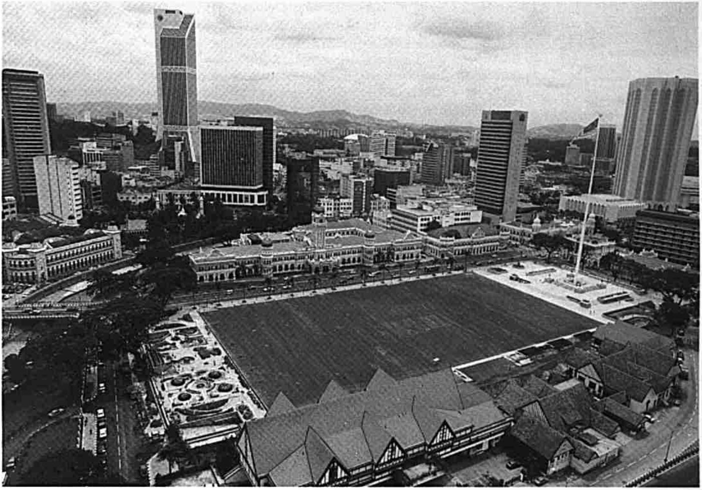
Credit to special groups

In line with the government's policy to give the Bumiputera community a stronger role in the economy – under the New Economic Policy – guidelines have been issued to banks every year since 1974 to ensure that a certain percentage of loans are channelled to Bumiputera borrowers. In 1988, this figure was set at 20 per cent.

The policy has been a success, and credit extended by the commercial banks to Bumiputera individuals and companies has increased since 1974 from M$537 million to M$16,083 million in 1988. This increase was equivalent to an average annual growth rate of 34.8 per cent. As a proportion of total outstanding bank loans at the end of the same period, credit to the Bumiputera community constituted 29.4 per cent of the total, as against 9.6 per cent at the end of 1974.

The policy has been applied particularly to protect small Bumiputera borrowers. A ceiling rate of interest – 8.5 per cent in early 1989 – is imposed on business loans not exceeding M$500,000. These "small" loans have, however, diminished in significance as Bumiputera entrepreneurs have become more involved in the commercial life of Malaysia, making it more relevant to look at loans of M$1 million or more. While Bumiputera borrowers in this category numbered 14 in 1971, there were over 2,000 at the end of 1988, accounting for 54 per cent of all loans outstanding from the Bumiputera community. There is, however, a higher-than-average failure rate in Bumiputera business ventures.

To ensure ready access to credit facilities, banks are required to channel a certain fixed percentage of loans to small-scale enterprises (defined as those with fixed assets not exceeding M$500,000). Guidelines are reviewed annually and following a redefinition in March 1988, the commercial banks are required to extend M$300 million of new loans to these enterprises, of which M$150 million must be extended to Bumiputera borrowers.



The changing shape of Kuala Lumpur's skyline has reflected the growing strength and confidence of the banking system headquartered here

Bank Bumiputra Malaysia Bhd

Bank Bumiputra Malaysia Bhd (BBMB) is Malaysia's principal "high-street" bank with new branches opening at the rate of 20 a year with a target of 40 new bank branches and 29 new finance branches by 1990. Much of the emphasis of the bank's expansion has been into the rural areas. The kampongs and fishing villages have been the prime beneficiaries of Bank Bumiputra's campaign to modernise rural life through full access to banking and other financial services. Bank Bumiputra has also been the innovator behind mobile banks that serve scattered communities without the conditions for a permanent branch. About 60 per cent of the bank's loans are to Bumiputeras, further underlying its commitment to the indigenous community.

This emphasis on rural activities has not limited development to a basic, unsophisticated service. On the contrary, Bank Bumiputra is the leader in Malaysia in banking technology with all its branches on-line, not only in Peninsular Malaysia, but also in the remote corners of Sabah and Sarawak. It has been the first bank to achieve this in Malaysia. The bank's new management, led by its tough executive chairman Tan Sri Dato Haji Basir Ismail, was installed in 1985, and has led a rapid expansion and at the same time renewed BBMB's commitment to its dual social/commercial role.

Another key area of activity for BBMB is the provision of financing for Malaysia's national development aspirations, through support for infrastructure and major projects in manufacturing, construction, agriculture and other sectors. With the largest assets of any Malaysian commercial bank – M$19 billion at the end of the financial year to 31 March

1988 – Bank Bumiputra has the financial clout necessary for such major projects. It ranks among the 500 largest banks in the world and the 200 largest in the Asia-Pacific Region.

Commitment to community development

When it started operations in 1965, the objectives of the state-owned bank were to provide a full mix of banking and financial services for all Malaysians. But it had a special remit to assist Bumiputeras in particular, to encourage the development and expansion of Bumiputera-owned and managed business, as well as to speed the flow of investment capital to rural areas with their larger concentration of indigenous Malays.

Because of its broader role in the development of Malaysian society, Bank Bumiputra has to give ground in profitability. While it is usually either ranked first or second (behind Malayan Banking Bhd) in terms of assets, it drops down the field (to 9th place in 1986) in terms of profits. Since taking over, however, chairman Basir has trimmed the bank's operations with two restructurings and, with only a modest increase in staffing levels, has opened dozens of new branches. Says Tan Sri Basir: "The social obligation is realised in terms of where we operate, including areas not served by other banks. There is a high initial cost and there is a period where we lose money, but over time the business then justifies the operation."

Nevertheless, Bank Bumiputra is back in the black and its painful loan problems of the early 1980s are fading into the past. As Malaysia's economy goes into top gear Basir and his team are confident of profitable years ahead. Pre-tax profits in the financial year ending 31 March 1988 were M$20.33 million, a 10 per cent increase over the previous year.

A very important part of the bank's success has been its achievements in the employment and training of Bumiputeras in banking and finance. Prior to Bank Bumiputra's establishment, the number of Bumiputeras employed by commercial banks was insignificant. Following its establishment, BBMB became the largest single source of employment for Bumiputeras in the banking industry. From a total Bumiputera staff of 68 at the time of incorporation, indigenous Malays now represent at least 30 per cent of Bank Bumiputra's total workforce.

"The growth in the number of Bumiputeras employed in the banking industry is most significant, considering that at the time when BBMB was established there was arguably not a single Bumiputera managing a branch office of any commercial bank", says chief general manager (planning and financial subsidiaries) Aris Othman. "To date, the management of the majority of the bank's branches is under the charge of Bumiputeras. What is gratifying is the fact that other commercial banks and financial institutions are also following suit."

BBMB has taken the lead in endowing Bumiputeras with experience and knowledge in commercial banking and the financing of domestic and international trade. The bank sharpens the skills of its staff with continuous in-service training as well as scholarships and loan awards for its employees to develop their education in the industry.

Specialised services

Bank Bumiputra provides specialised financial services through its subsidiaries: BBMB Kewangan Bhd, a finance company; Bumiputra Merchants Bankers Bhd; BBMB Finance (Hong Kong) Ltd; BBMB Heller Factoring Bhd; BBMB Leasing Bhd; BBMB Discount House Bhd; BBMB Securities Sdn Bhd; and BBMB Trustee Bhd. BBMB's merchant bank subsidiary, Bumiputra Merchants Bankers, is one of Malaysia's top five merchant banks and it is hoped that greater emphasis on its fee-based sources of revenue will strengthen its position further. BBMB has overseas branches in London, New York, Los Angeles, Tokyo, Hong Kong, Singapore and Bahrain.

In April 1989 the bank opened Malaysia's first wholly-owned bank overseas, South-East Asia Bank Ltd, in Mauritius, of which 20 per cent of the equity is held by Bank

Bumiputra, and the balance by individual Malaysian investors. The venture, which will help to develop Mauritian banking through the use of advanced computer software and sophisticated customer services, is part of Malaysia's increasing interest in the tiny Indian Ocean island nation which, through its incentives to investors and its export processing zone, has attracted Malaysian companies interested in setting up industrial activities there.

Innovation has also occurred in other product areas. In 1988 BBMB became the first commercial bank in Malaysia to introduce a 24-hour electronic banking service; it offers customers its competitive home loan deal with an almost instant evaluation by computer; it offers loans to graduates about to enter business; at the end of 1988 it introduced electronic funds transfer at point-of-sale (EFTPOS) so that holders of its Juwara card can pay for purchases at certain locations without using cash; it launched (to Malaysia Airlines) the country's first computer-linked direct banking facility through its Corporate Terminal Services, enabling the airline to have total and effective control over funds placed with BBMB and allowing the electronic transfer of funds.

United Malayan Banking Corporation Berhad

United Malayan Banking Corporation Berhad (UMBC) commenced operations in Kuala Lumpur in July 1960, the first locally incorporated bank to be established after the achievement of the country's independence in 1957. Reflecting the objective of its founder – which was to provide local savers and the local commercial community with a financial institution that best understood their needs – UMBC has expanded to become one of Malaysia's leading commercial banks.

While its correspondent banking affiliations link UMBC to the four corners of the globe, its widespread domestic branch banking network ensures that it has a close working relationship with Malaysian entrepreneurs and a first-hand knowledge of local business opportunities.

Growth record

The decade of the 1960s was a period of expansion. Deposits grew from M$34.3 million in 1961 to M$418.8 million in 1969 while loans and advances expanded from M$26.7 million to M$281.6 million. Total assets increased from M$40.6 million to M$475.7 million. In terms of branch network, 45 branches were established out of its current total of 71 – and those included branches opened in Singapore, Bangkok and Brunei.

From the start, UMBC sought to offer a comprehensive array of financial and finance-related services to the public. Its first subsidiary, United General Insurance Co Sdn Bhd (now known as UMBC Insurans Sdn Bhd) was established in 1961 while its first wholly-owned company, United National Finance Bhd (now known as UMBC Finance Bhd) was set up a year later in 1962. United National Finance (Singapore) Ltd (now known as UMBC Finance (S) Ltd) was incorporated in Singapore in 1969.

By 1970, UMBC's total assets had reached M$530 million. In 1973 it expanded into merchant banking activities with the setting up of Asian International Merchant Bankers Bhd (AIM Bankers) as an associate company. (AIM Bankers has since become a subsidiary).

In the 1980s the increasing sophistication of the Malaysian banking public necessitated the upgrading of UMBC's manpower development programmes, implementation of a stage-by-stage computerisation of its operations and diversification into new product lines and services. In 1980 the bank entered into a joint venture with American Express International Inc to launch the American Express-UMBC Ringgit Gold Card. This marked the bank's entry into the charge card business. Another agreement with American Express later gave UMBC the right to issue the Green Card, the first Malaysian bank to do so. In 1982 UMBC expanded into leasing activities.

Following the incorporation of the Malaysian stockbroking industry in 1987, UMBC Securities Sdn Bhd, the bank's latest wholly-owned subsidiary, began trading in January 1988. In the area of retail banking, UMBC's coparticipation with five other banks in Malaysian Electronic Payment System Sdn Bhd (MEPS) – the country's largest shared automated teller machine network – enhances the convenience and range of services.

UMBC is a member of the Perbadadan Nasional Berhad (PERNAS) Group, one of Malaysia's premier government conglomerates. Eighty-six per cent of the bank's paid-up capital of M$333.3 million is owned by PERNAS. This affiliation lends a strong backing to the bank's operational and expansionary activities and has been responsible for strengthening its position as one of the country's leading financial institutions.

UMBC has steadily augmented its traditional products and services with new packages directed mainly towards the middle-level market, including the educational and housing segments. Monitoring market response to these packages has been important and, thus far, response has been good, enabling UMBC to enlarge its niche in the highly competitive Malaysian middle market.

Domestic and international orientations

UMBC has a strong domestic base in a network of 62 branches spread out over urban and rural areas. Besides dispensing financial services, these also serve as information centres on local requirements. Each branch manager is expected to have a thorough knowledge of the social-economic characteristics of the branch's locality – its resource base, commercial and industrial sophistication, manpower availability, infrastructural support facilities and, of course, potential for further development, giving UMBC a solid knowledge of Malaysia and its people.

Outside the country, UMBC has seven branches in Singapore and one each in Bangkok and Bandar Seri Begawan (Brunei). Its Singapore network is licensed to deal in Asian Currency Units (ACUs). All these branches fall under the purview of the Overseas Branches Department. In June 1989 UMBC opened a Representative Office in London, its first expansionary move outside the ASEAN region.

The bank's experience in international banking operations places it in a favourable position to offer advice on foreign exchange and money market matters, investment options, foreign currency loans, trading contacts and exchange control regulations as well as giving information on the local and foreign business scenario.

UMBC's International Banking Division was originally set up as a small unit in 1968, and now employs 79 people, including a pool of experienced and capable foreign exchange and money market traders. In 1988 a total of M$47.9 billion worth of foreign exchange deals were made.

Although the volume of syndicated credits worldwide has shrunk substantially, UMBC participated in 25 syndicated foreign currency loans totalling US$110.5 million between 1980 and 1985. Recognising that borrowers now prefer securitised debt instruments in the form of Euronotes and Eurobonds, the bank is now expanding into the area of investment in and trading of international debt securities especially Eurodollar and US Treasury bonds.

UMBC sees its international banking activities as playing an important supportive role to its domestic banking operations. The future would see an even more expanded function for the International Banking Division, particularly in the area of forging stronger links between Malaysian and foreign entrepreneurs.

Group synergy

Group synergy through the coordinated delivery of services forms the nucleus of UMBC's business development strategy. The Group Marketing Coordination Unit was set up in 1987 as a joint committee to ensure complementarity in marketing efforts.

The UMBC Group comprises the bank and its subsidiaries as follows: UMBC Finance Berhad; UMBC Finance Ltd; UMBC Harta Sdn Bhd; UMBC Realty Sdn Bhd; UMBC Insurans Sdn Bhd; UMBC Nominees Sdn Bhd; UMBC Nominees Pte Ltd; UMBC Securities Sdn Bhd; and Asian International Merchant Bankers Berhad (AIM Bankers)

The services offered by the Group are wide-ranging. They embrace retail banking, consumer credit and general insurance, stockbroking, corporate finance counselling, and underwriting of public listed securities. This "one-stop" approach to customer service has long been one of UMBC's most-cherished objectives, although the needs of the banking public have to be reassessed from time to time and new services created commensurate with the demands of a nation on the threshold of becoming a Newly Industrialised Country.

For the corporate client, two subsidiaries of particular interest are AIM Bankers and UMBC Securities. AIM Bankers, one of the country's leading merchant banks today, has been continuously active in providing corporate and financial advice, and banking and investment services to meet the requirements of corporations and institutions. In August 1988 it led a consortium of merchant banks, major sharebroking houses and the Malaysian Industrial Development Finance Consultancy and Corporate Services Sdn Bhd (MIDFCCS) to underwrite a rights issue of 253,732,500 new ordinary shares of M$1.00 at par for Raleigh Bhd, a diversified Malaysian trading, property and manufacturing group. This was the largest underwriting consortium ever assembled for a single equity issue and the first time in the country that the underwriting for shares to be listed was structured in several tranches. Earlier, AIM Bankers was also the adviser and manager of a rights issue by Public Bank Bhd.

With a paid-up capital of M$20 million, UMBC Securities Sdn Bhd – the latest subsidiary in the UMBC stable – now ranks as one of the country's largest stockbroking firms. Making up for its "newness" is the prior experience of its key personnel in the areas of stockbroking, fund management and banking. While the company has been in operation for only little more than a year, it has been able to provide a broad spectrum of services to institutional and individual investors, locally and worldwide. These include share dealing, research and analysis, investment counselling for Malaysian and Singaporean stock, sub-underwriting, margin trading and financing, and nominee and custodian service. UMBC Securities is optimistic about its future. In the medium term, one of its expansion plans is to undertake research commission and contract research for both the private and government sectors locally and internationally.

Corporate plan

A five-year corporate plan is now being implemented by UMBC. Covering the period 1988 to 1992, the plan forms the focal point of the bank's operational activities and marketing programmes. Administrative and managerial machinery has, since the implementation of the plan in early 1988, been geared towards achieving objectives in five key areas, namely finance, marketing, human resources and organisation, technology and social responsibility.

The major objectives include achievement of a target gross return on shareholders' funds to be reached by 1992 (finance), provision of good and efficient services that are responsive to customers needs (marketing), cultivation of a high level of professional, dynamic and ethical management (human resources and organisation), utilisation of technology to yield competitive advantage (technology) and continuation of being a good corporate citizen (social responsibility).

In the areas of finance, in order to attain the target set for return on shareholders' funds, operational units are concentrating their efforts on attaining certain targeted growths or reductions in those financial parameters that have a bearing on investment return. In marketing, the strategies are, inter alia, improvement of service delivery and response time, development of new products and services, expansion of the deposit base, enhancement of international banking business and enlargement of group activities. In human resource management and organisation, the main strategies are the development of performance-oriented staff benefits and improvement of staff training and development. In the area of technology, emphasis is being given to automation of all services apart from developing an effective management information system.

Some of these strategies, such as computerisation, are on-going activities of the bank that were introduced or implemented long before the plan was unveiled. But incorporating these activities into the plan gives them a sense of formality and greater urgency. They can now be assessed in terms of a certain standard yardstick.

Senior executives admit that for a long while UMBC was viewed as one of the quieter banks – big but rather on the low-key side. In the medium term and beyond, however, they want to extend the bank's reach and further expand their niche in the market. They are confident that the Malaysian economy will continue to do well and there will be new financing requirements on the part of economic units. Although this will mean keener competition, that is a challenge that any non-monopolistic establishment must accept. In 5 to 10 years UMBC is likely to be a more dynamic, a more aggressive force, although retaining a distinctively Malaysian and pleasant personal touch.

Public Bank Berhad

A commitment to the public

Public Bank Bhd was incorporated in 1965, inspired by the idea of establishing a bank for the public with which the man in the street could identify. True to this spirit of a public bank, at its inception about 90 per cent of its shareholders were wage-earners. It depicts the truly multi-ethnic Malaysia with all major races participating in the share ownership of the bank.

Public Bank was established as a response to the call of the central bank to overcome the trade orientation of the banks and to redirect the system towards meeting the development needs of the country. Besides establishing its branches in the major cities, Public Bank also embarked on a plan to build a network of rural branches with the objective of promoting rapid monetisation of the less developed areas in the country and mobilising rural savings more effectively. This progressive and responsive side of the bank's work has, at times, been overshadowed by the physical size and financial strength of the institution.

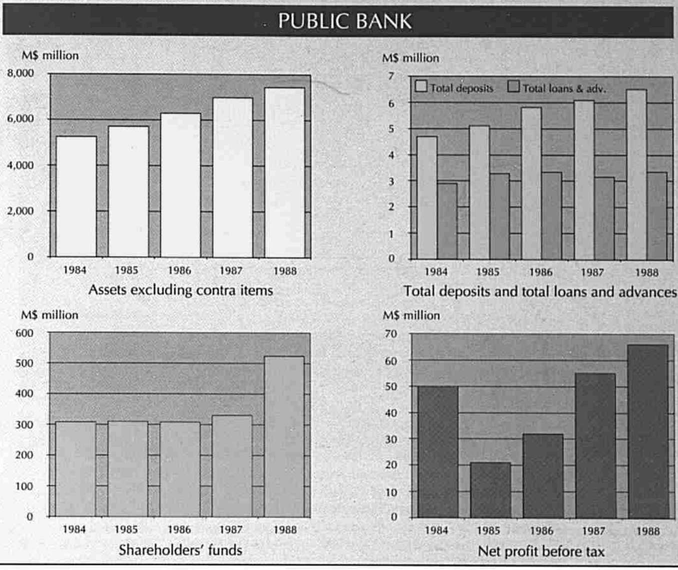
Public Bank has provided a courteous and efficient service while also being innovative in the development of new banking facilities and promoting the well being of its staff. In the community it has assumed a socially responsible role and adhered closely to national policies. Its shareholders have benefited from the bank's efforts in forging ahead and consolidating its position as a stable and progressive financial institution.

The high degree of Public Bank's sensitivity towards the needs of the communities is reflected in various social responsibility projects undertaken each year. These include scholarships for education, sponsorship of literary and journalistic awards, financial support for arts, culture, local handicrafts, community projects and sports. The bank is also a staunch supporter of government policies. Fully conscious of the importance of the New Economic Policy (NEP), Public Bank set up a special unit of Bumiputera and Rural Credit Division in 1972 to provide assistance to Bumiputera borrowers in the form of credit facilities, advisory and consultancy services. To conform to the requirements of NEP in terms of share-ownership, a restructuring of the Bank's equity was effected in 1980 raising the Bumiputera share to 31.2 per cent.

Financial strength

Public Bank was initially incorporated with an authorised capital of M$50 million and

Exhibit 8.1



a paid-up capital of M$12.75 million. Business operations of the bank commenced on 6 August 1966 and by 31 December 1966, shareholders' funds stood at M$12.82 million, group customer deposits at M$22.66 million, group loans and advances at M$4.29 million and group total assets (less contra items) at M$36.36 million.

Since then the growth of Public Bank has been rapid. As at 31 December 1988 the group's shareholders' fund had increased over 40-fold to M$514 million, customer deposits more than 266 times over to M$6 billion, loans and advances by more than 789 times over to M$3.4 billion and assets (less contra items) more than 202 times over to M$7.4 billion. Public Bank Berhad was granted "Approved Status" Bank by the Ministry of Finance of Malaysia in March 1982 which made it eligible to receive deposits from government departments, statutory bodies and other government agencies.

Today Public Bank is one of the best-known commercial banks in Malaysia. Amongst domestic banks, Public Bank is ranked second in terms of market capitalisation on the Kuala Lumpur Stock Exchange. As at 31 December 1988, Public Bank had a market capitalisation of M$1.14 billion.

Astute management

Public Bank has benefited substantially from the foresight of its founder, president and chief officer, Tan Sri Dato Teh Hong Piow. His anticipation that the central bank would eventually free its control on interest rates helped to stimulate Public Bank's exponential growth in the late 1970s and early 1980s. The strategy of quoting deposit interest rates as high as 2 per cent above the industry's rates pushed the Bank into a momentum of growth that has given it a standing to be reckoned with in the sector today.

Public Bank also anticipated that the central bank would introduce capital adequacy ratio requirements at the turn of the current decade. Such a move was seen as cutting into business expansion unless the banks concerned had the financial means to meet the new requirements. Public Bank made a rights issue of M$91 million at an opportune time during the stock market boom in 1982 to raise the bank's equity and this enabled Public Bank to be well poised for future expansion programmes. When the central bank advised against lending too much for the construction of high-rise buildings in the early 1980s, Tan Sri Teh instructed his staff to scale down loans in that sector. This helped the bank to limit its exposure to the many non-performing loans which surfaced during the property glut.

Policy-making by the board of directors was further strengthened with the addition of Tan Sri Dato Thong Yaw Hong as chairman in 1986, after his retirement from the civil service as Secretary-General of the Ministry of Finance in Malaysia. Tan Sri Thong's wealth of experience in macroeconomic and financial planning complements the board's strengths. The board is well-supported by a strongly-knit senior management team led by the president and chief executive officer who are committed to a participative style of management. This style is manifested through the annual management seminars where strategic business issues are discussed between head office and branch management and also through ad hoc meetings to address more current critical issues.

Service improvements

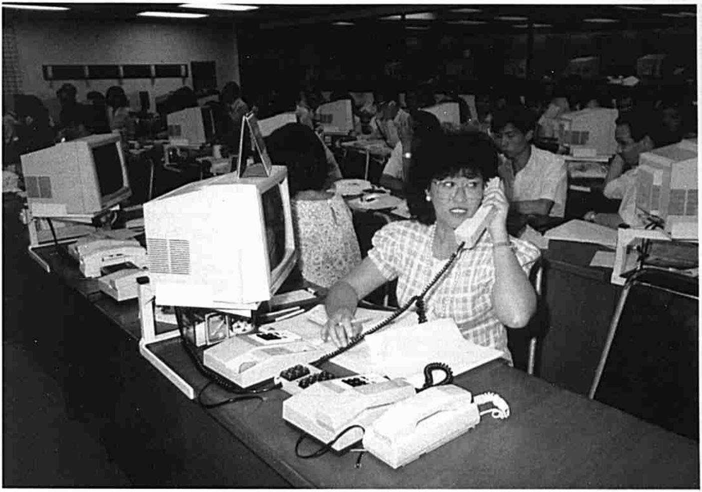
Public Bank embarked on a computerisation programme in 1979 and almost all its branches are now fully computerised on an on-line real-time basis. Banking services have also been extended beyond normal banking hours through the bank proprietary network of 68 automated teller machines (ATM) as well as through a shared ATM network of some 300 ATMs in the Malaysian Electronic Payment System (MEPS) of which the bank is a charter member.

Through its network of 70 branches and the ATM networks, the bank has extended the availability of its personal banking services to a wider cross-section of the community it serves. In the area of corporate banking, the bank has established worldwide correspondent banking relationships to facilitate foreign trade financing. The bank's ability to package financial facilities for its corporate customers has been enhanced through the activities of its Corporate Account Department in its head office. All these services are embodied in the slogan "Your Neighbourhood Friend".

Corporate mission

Public Bank is aiming to become the top commercial bank in the country by striving to be recognised as the most efficient, profitable and respected financial supermarket in the country. It has extended banking services to the suburban and rural areas with branches spreading throughout the 14 states in Malaysia within 22 years. It is now the third largest domestic bank in Malaysia in terms of issued and paid up capital at M$357 million. The bank has under its wings five wholly-owned subsidiaries, namely, Public Finance Berhad with 59 branches of its own, Public Nominees Sdn Bhd, Public Leasing and Factoring Sdn Bhd, Public Holding Sdn Bhd and Public Consolidated Holdings. The bank also has a representative office in Hong Kong.

Besides having a commercial bank, a finance company and a leasing and factoring



On-line linkages have become a common feature of operations among the leading Malaysian banks

firm, the group has also acquired its own stockbroking firm, PB Securities Sdn Bhd, previously GP Securities Sdn Bhd. This move by Public Bank is seen as one of its efforts in helping the government to upgrade the standard of the securities industry while at the same time reaping steady profitable returns. In line with its corporate mission to become a financial supermarket, the bank's proposed business expansion list includes merchant banking and insurance.

Given these foundations, the Public Bank group is well-positioned to mount energetic initiatives and seize new opportunities for further expansion. In particular, the group will widen the spectrum of its financial services to meet new demands and changing needs in all dimensions of trade, investment and export promotion in tandem with the growth of the Malaysian economy during the decade of the 1990s.

Foreign commercial banks

The first commercial bank to be established in the country was a branch of Mercantile Bank Ltd, then known as the Chartered Mercantile Bank of India, London and China. The bank's office opened in Penang in 1859. The Chartered Bank followed suit with an office in Penang in 1875 and 10 years later was joined by the Hong Kong and Shanghai Bank (HSBC). Mercantile Bank was subsequently acquired by HSBC.

In the late nineteenth century the early banks were engaged predominantly in the finance of trade, working capital and foreign exchange remittances with London, India and China. Their branches were generally located at the ports and other commercial centres.

However, with the growing importance of rubber and tin and the establishment of foreign-owned plantations, tin mining companies, agency houses and international trading companies, foreign banks became increasingly involved in servicing the needs of these organisations. The foreign banks were the pioneers of the financial system in Malaysia, acting as bankers to the government in the absence of a central bank. Under a system that survived until the 1960s, transactions with the local business community were conducted mainly through a system of compradores, whereby a prominent Malayan businessman or community leader was appointed to act as the middleman between the banks and local customers.

The twentieth century saw rapid growth in the number of branches of foreign banks. There were 15 branches by 1926 with British banks dominating. With their international connections – HSBC already had branches in London, Singapore, Tokyo, San Francisco and New York – the foreign banks had key advantages in their knowledge of markets such as foreign exchange. They provided credit in the form of overdrafts, packing credits, advances against shipping documents, trust receipts and the discounting of bills.

During the Japanese occupation the banks were liquidated, and then reopened after the war, before facing the challenge of independence. This brought a reorganisation and rationalisation of the banking system. Then came the creation of the central bank, the Bank Negara, whose priority was the development of a Malaysian-oriented banking structure. To achieve this, more local banks were set up. In their infancy, these received much support

Exhibit 8.2

Commercial banks: key data

	As at end of		*% change*	
	1987	*1988*	*1987*	*1988*
Number of banks	38	38	–	–
Total deposits (M$m)	57,607	61,139	+5.1	+6.1
Domestic banks	43,129	46,075	+5.4	+6.8
Foreign banks	14,478	15,064	+4.3	+4.0
Total banks (M$m)	52,181	56,432	−0.3	+8.1
Domestic banks	36,989	40,494	+1.6	+9.5
Foreign banks	15,192	15,938	−4.5	+4.9
Loans-deposits ratio (%)	90.6	92.3	−4.9	+1.7
Domestic banks	85.8	87.9	−3.2	+2.1
Foreign banks	104.9	105.8	−9.7	+0.9
Shareholders' funds/net working funds (M$m)	5,885	6,226	−5.3	+5.8
Domestic banks	3,521	3,797	−5.4	+7.8
Foreign banks	2,364	2,429	−5.2	+2.7
Capital adequacy ratio (%)	7.3	7.3	+0.3	–
Domestic banks	6.4	6.3	+0.7	−0.1
Foreign banks	9.8	9.9	−0.4	+0.1
Branch network	862	911	+3.0	+5.7
Domestic banks	716	765	+3.6	+6.8
Foreign banks	146	146		
Persons served per office	19,174	18,574	−0.4	−3.1
Number of employees	41,020	41,604	−0.4	−3.1
Domestic banks	30,928	31,611	+0.7	+2.2
Foreign banks	10,092	9,993	−1.3	−1.0

Source: Bank Negara

from the more experienced foreign banks during the post-independence period, which saw the arrival of more foreign banks, among them the First National City Bank (Citibank) in 1959.

In the 1970s the most important role for the foreign banks was to act as a conduit for foreign investment and a medium for the introduction, adaptation and promotion of new ideas, techniques and systems from the more developed world. Then, as now, the foreign banks carried on their traditional role of financing foreign trade with their substantial resources and worldwide branch networks. In the 1980s, the foreign banks led the way as more innovations and technology were introduced into the banking system. HSBC pioneered the computerisation of customer banking facilities in its branch network in 1979. In 1982 it introduced the country's first electronic teller card (ETC). Today, electronic banking and computerisation have become an integral part of banking in Malaysia. Almost every bank in the country now provides ATM facilities. Foreign banks also played a major part in the introduction of electronic corporate banking facilities.

Ranked by size of assets, the top three foreign incorporated banks in Malaysia are the Hong Kong and Shanghai Banking Corporation, Standard Chartered Bank and Citibank. A new challenge facing the 16 foreign banks will be the requirement to incorporate locally within five years of 1989. Describing proposed legislation as "purely administrative", Bank Negara governor Tan Sri Jaffaf Hussein has said that the requirement will bring all banks – domestic and foreign – under the same regulations and provide a proper basis of comparison. The locally-incorporated subsidiaries will not be required to restructure their equity to comply with the New Economic Policy except where they want to expand local operations, such as through an increase in the branch network.

Chapter Nine

Other financial institutions

Finance companies

In Malaysia, the second largest group of deposit-taking financial institutions, after the commercial banks, are the finance companies. These emerged as a potent force in the mobilisation of resources in the 1960s and they expanded as more and more of the commercial banks established wholly-owned finance company subsidiaries. Of the 47 finance companies now operating in Malaysia, 16 are subsidiaries of commercial banks, of which 12 are owned by the domestic banks.

Regulated under the authority of the central bank since 1969, Malaysia's finance companies are now the second most important institutional source of private sector credit, where they operate in the short- to medium-term credit market. They are, however, prohibited from accepting deposits which are repayable on demand, or dealing in gold or foreign exchange, or granting loans in the form of overdrafts, including unsecured loans. Consequently, more than 80 per cent of the deposits with the finance companies are in the form of fixed deposits of varying maturities which usually pay higher interest rates than the commercial banks.

Finance companies have seen a steady increase in the funds deposited with them since 1969. These have grown at an annual average rate of 24.9 per cent since 1969 (compared with the banks' rate of increase of 17.1 per cent over the same period) and totalled M$17.7 billion by the end of September 1988. These funds represent 30.1 per cent of total deposits placed with commercial banks.

In terms of total resource growth, the finance companies have shown equally impressive expansion. At the end of September 1988, their total resources stood at M$23.8 billion, following average annual growth rates of 24.5 per cent, compared to the banks' growth rate of 17.8 per cent during the same period. The finance companies gained the edge over the banks during these years by offering higher interest rates, although their expansion was also a reflection of generally high growth throughout the economy. Their advantage dated from 1973, a landmark year for finance companies which saw deposits soar by 46.9 per cent when the central bank lifted controls over interest rates and many finance companies took the opportunity to widen the differential.

At the end of the 1980s, the finance companies entered a new era in which the delineation between their activities and those of the commercial banks has been further blurred. As part of a programme gradually to deregulate and develop the money markets, 12 selected finance companies, each with shareholders' funds of not less than M$30 million were allowed access to the interbank money market late in 1987. The intention was to encourage financial intermediation, to bring about increased efficiency in the market and to create more competition for funds. However, to prevent these finance companies from becoming over-reliant on the interbank money market as a funding source for their operations, the amount of net borrowings by each finance company from the interbank money market is for the time being limited to a range of M$30-50 million each.

As well as being able to draw on interbank market funds, the finance companies have had an additional financial instrument since the establishment in 1987 of the National

Housing Mortgage Corporation, Cagamas Berhad. The new market for Cagamas bonds enabled the finance companies to trade their assets that are tied up in long-term housing loans through the Cagamas bond market since they are eligible for inclusion as liquid assets.

Direction of lending

Finance company lending has centred on the broad group of construction, real estate and property development, including end-financing for housing. In all, their lending in these areas represents 11.5 per cent of the total housing credit extended to home buyers in Malaysia. Reflecting this expansion, total credit extended by the finance companies increased from M$218 million at the end of 1969 to M$15.3 billion by the end of September 1988, an annual average growth rate of 25.4 per cent.

In what is becoming a consumer society, about 26 per cent of the loans extended by the finance companies was for the purchase of durable goods, particularly motor vehicles. This represented almost 90 per cent of all hire purchase loans, and it can be expected that the finance companies will stand to benefit as Malaysian consumer demand continues to grow in the 1990s.

In common with the commercial banks, finance companies have had to conduct their lending policies with reference to the broad needs of the community. Since credit guidelines were introduced in 1976, finance company credit to Bumiputera companies and individuals has increased rapidly to represent 31.6 per cent of total loans, or M$4.8 billion, by the end of September 1988. Growth in such credit has averaged 31.7 per cent a year.

Merchant banks

Merchant banks in Malaysia, as elsewhere, operate as "wholesale" bankers, providing a full range of specialised financial services relating to all aspects of corporate financing, investment and management advice, investment portfolio management and corporate advisory services. Unlike commercial banks, which depend on their large deposit base to fund their loan and investment portfolios, the merchant banks function as specialist financial intermediaries in money and capital markets. The main functions of merchant banks, however, are concentrated on mainly fee-based services which must necessarily form at least 30 per cent of their annual income.

The emergence of merchant banking in Malaysia at the beginning of the 1970s coincided with the start of the Second Malaysian Plan, 1971-75, and was timely in that it filled a gap in the financial services of the domestic economy. While the commercial banks tended to concentrate their activities in the traditional areas of trade finance and providing working and investment funds, the merchant banks were able to fill the growing need for a full range of specialised services.

Since 1976 no new merchant banks have been permitted to operate in Malaysia. Total paid-up capital of the merchant banks increased from M$6 million in 1971 to M$306.5 million by the end of 1988, of which M$229.9 million, or 75 per cent, was subscribed by Malaysians, comprising mainly domestic banks and other financial institutions. The remaining shareholders comprise foreign banks and financial institutions in Japan, Hong Kong, the US, the UK, West Germany, Australia, Switzerland and France.

The 12 merchant banks are obliged to have a minimum paid-up capital of M$5 million and are required to observe two gearing ratios: the first stipulates that their domestic borrowings (including deposits) should not exceed 15 times their shareholders' funds, while the other stipulates that their domestic borrowings (including deposits) and contingent liabilities (including guarantees and acceptances) should not exceed 20 times their shareholders' funds. In addition, the merchant banks are required to maintain a minimum liquid asset ratio of 10 per cent of their total eligible liabilities and a reserve ratio with Bank Negara of 3 per cent against their total eligible liabilities.

The merchant banks are unique in providing a range of corporate advisory services in relation to mergers, acquisitions, reconstructions or capital restructuring. For those companies making use of the Kuala Lumpur Stock Exchange, they are involved in company flotations and listing exercises including the underwriting of new issues of shares or bonds. In assisting clients to find suitable partners or investors, they promote new investments, diversifications and joint ventures.

The merchant banks also offer investment advice, namely portfolio management and financial management advisory services, including the establishment and management of unit trusts, property trusts and other forms of investment including custodian and nominee services.

Increasingly, the merchant banks are being drawn into the issue of new and more sophisticated forms of financial instruments and securities. They have undertaken banking intermediation services which include the management of syndicated and other loans and the provision of acceptances and guarantees. Under the aegis of the government's privatisation policy, they have been active in carrying out studies as well as giving advice on the execution of privatisation exercises. The merchant banks also provide feasibility studies and industry studies for potential investors, as well as advice on relocation of industries to Malaysia.

To be effective "wholesale" bankers merchant banks have to have the ability to serve the corporate sector's financial needs by providing project and bridging financing, term loans, revolving credits, block discounting and rediscounting, factoring, hire purchase, bills documentation, big ticket leasing and participation in syndicated loans. Additionally, merchant banks are becoming increasingly involved in investment in corporate equity through provision of venture capital to assist the growth of enterprising businesses and new industrial ventures. Because of their international links, merchant banks have been successful in arranging international financing for major projects and take part in consortium loans and bond issues of large corporations, government and statutory bodies.

Since 1982 the merchant banks have been allowed to extend loans in foreign currency to residents for the financing of ventures to raise domestic productive capacity and to support the purchase of assets in Malaysia owned by non-residents. To enable the merchant banks to fund such loans, they have been allowed to accept foreign currency deposits from non-residents, equivalent to at least M$250,000 each. These deposits are exempt from the 15 per cent withholding tax on interest earned.

The structure of loans as at the end of 1988 was weighted toward the manufacturing sector (just over M$1 billion, or 26 per cent) and property and real estate development (M$775 million, or 19 per cent). General commerce and trading accounted for 13.5 per cent and other customers comprised statutory authorities and government agencies (25.5 per cent). The balance was channelled to finance activities in agriculture, transport and storage, construction, mining and quarrying and hotels, restaurants and other services.

The major source of funds for merchant banks has been deposits (including money at call), which accounted for 69 per cent of their total resources at the end of 1988, or M$3.1 billion. Of these deposits, about 94 per cent has been in the form of fixed deposits. The commercial banks, finance companies and corporations were the major source of deposit funds for the merchant banks, accounting for 29.6 per cent, 19.7 per cent and 22.3 per cent respectively in late 1988. Borrowings from both Malaysian and foreign banking institutions were another major source of funds, increasing from M$1.6 million at the end of 1971 to M$261.7 million at the end of September 1988. Much of the borrowing from foreign sources represented counterpart funding for their participation in syndicated foreign exchange loans.

To ensure that merchant banks did not lose sight of their special role in development and corporate financing, a requirement was introduced in 1979 that at least 30 per cent of their income should be derived from fee-based activities. To encourage the development of secondary markets for various financial and capital market instruments, with effect from 1 January 1987, the fee income requirement was revised to include net income gained from trading in government securities, Treasury bills, negotiable certificates of deposit, Cagamas (the national mortgage corporation) bonds and other such financial instruments as may be specified by the central bank from time to time.

The future of merchant banks will depend on their strategies in an environment of intense competition from within and outside the industry. A probable result of this is that some of the small merchant banks will have to concentrate on niche banking. The future should see merchant banks involved in the securitisation of debts through the issuance of fixed rate corporate bonds, revolving underwriting facilities, note issuance facilities, floating rate notes, swaps and the issuance of corporate promissory notes. The merchant banks have recently ventured into stockbroking through the incorporation of stockbroking firms. This has broadened the scope of their services considerably and means they are well placed to offer investment analysis.

Arab-Malaysian Merchant Bank

Rapid development

The youngest of Malaysia's merchant banks, Arab-Malaysian Merchant Bank (AMMB) is the largest and most dynamic, leading in the conventional yardsticks of assets, deposits, shareholders' funds and profits, and also in its pioneering spirit and flair for innovation. The last of the 12 merchant banks to be set up, AMMB was the first to be listed on the Kuala Lumpur Stock Exchange in a share offer at the end of 1988 that was over-subscribed 5.8 times.

Headed by Tan Sri Azman Hashim, AMMB is close to becoming a one-stop financial supermarket. The bank has scored many firsts. It is the only merchant bank to own a licensed finance company and a leasing company, a life and general insurance company, a stockbroking company and a property trust management company. It is the only merchant bank with three branch offices – in Johor Bahru, Kuching (Sarawak) and Kota Kinabalu (Sabah) – and is the market leader in corporate finance and advisory work, investment services, and money and securities market dealings. It is a leading dealer and major market maker in primary and secondary negotiable instruments markets.

The bank sponsored the establishment of The Malaysia Fund Inc., a US-incorporated closed-end investment company listed on the New York Stock Exchange and was the first financial institution to launch a tax-exempt, open-ended unit trust, Arab-Malaysian Gilts, with funds invested primarily in government securities. AMMB launched the first venture capital company in Malaysia, Malaysian Ventures Bhd. The bank was the first to arrange a leveraged lease facility in the country for a private sector corporation. It was also the first merchant bank to establish a factoring department and is now the market leader. Its finance subsidiary was the first financial institution to facilitate payments for several public share issues at any one time through its ATMs.

History and ownership structure

Formerly known as Arab-Malaysian Development Bank Bhd, AMMB was incorporated in August 1975 as a joint venture merchant bank with 55 per cent Malaysian interest and 45 per cent Arab interest. Tan Sri Azman Hashim acquired the entire issued and paid-up share capital of AMMB in 1982. The following year he divested 31.5 million shares representing 45 per cent of his equity interest in the bank to Arab-Malaysian Development Bhd (then known as Taiping Textiles Bhd), a publicly listed company in which he has substantial interests.

In order to institutionalise the shareholding structure of the bank, Azman disposed of

40 per cent of AMMB to The Tokai Bank and Antah Holdings in 1987, a move that allows it to tap contacts and business opportunities from the prominent Antah group and benefit from Tokai Bank's assistance in developing Japanese business. Tokai Bank helped in setting up AMMB's Japanese desk in April 1987.

Further growth

To facilitate its public listing, AMMB offered for sale 15 million shares to directors and staff of the AMMB group, minority shareholders of AMMB and the public. Citing the bank's listing as providing the impetus for future growth through better access to the capital markets, Azman says he does not discount the possibility of a number of AMMB subsidiaries such as Arab-Malaysian Finance, Arab-Malaysian Credit and Arab-Malaysian Securities being listed in future.

With net pre-tax profits of M$43.05 million forecast for the tax year ended 31 March 1989 – helped by the 5 per cent cut in corporate tax to 35 per cent – AMMB has shown impressive growth. After hitting a low of M$29.76 million during the recession period of 1986, AMMB profits soared to M$37.97 million in 1987, followed by M$41.92 million in 1988. The bank's position in the provision of financial services enabled it to achieve 36 per cent of the total market share of fee-based income among Malaysia's merchants banks for the six months ended 30 June 1988.

Major corporate advisory work

AMMB handled the privatisation of Malaysian Telecoms, the first major public utility to be corporatised, and is a member of the consortium appointed by the government to prepare a privatisation master plan for Malaysia. It handled the flotation of electrical component and equipment manufacturer Lim Kim Hai Holdings – the first company to be listed on the second board of the Kuala Lumpur Stock Exchange, set up in November 1988 with the objective of providing a market for small and medium-sized companies with growth potential to tap funds from capital markets for their expansion. AMMB is presently grooming several other companies for listing on the second board.

Investment services

The bank's investment services department is among the largest investment portfolio managers with about M$240 million worth of funds under management. It was ranked top portfolio manager in 1987 for retirement and pension fund managers in Malaysia by an independent professional actuarial firm.

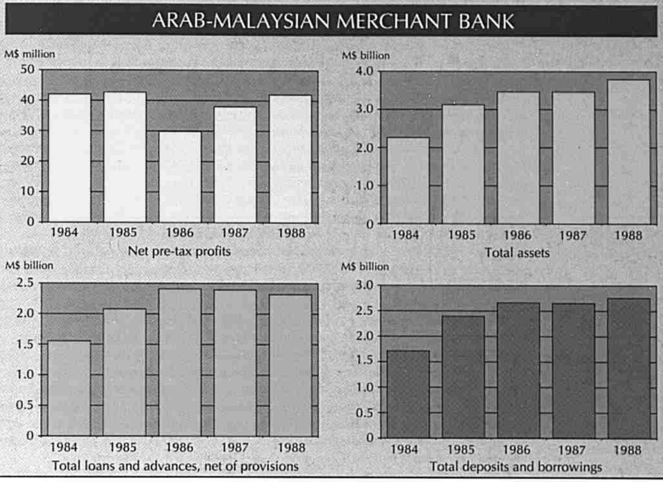
AMMB launched its US$45 million Malaysia Growth Fund in Japan with Japan's fourth largest securities house, Nikko Securities, as a partner. The fund is a closed-end investment fund similar to AMMB's Malaysia Fund Inc in the United States. The new fund will tap the Japanese financial resources to invest in the Malaysian stock market. AMMB is now working towards the setting up of other country funds.

AMMB launched the first unit trust, Arab-Malaysian Gilts, to invest in government securities. At the end of 1988 it received approval to increase its fund size from M$100 million to M$250 million. The bank also launched the Arab-Malaysian First Fund, a unit trust to invest in stocks and shares. AMMB is the first merchant bank to provide a share financing scheme, AMIM, to the public. AMMB's factoring department is the market leader with volume for the year ended 31 March 1988 of M$120 million. In the year ending 31 March 1989 it reached M$180 million, about 30 per cent of the market.

Property trust

AMMB was one of the first Malaysian banks to go into the property trust business with its M$100 million Arab-Malaysian First Property Trust with an initial fund size of M$135 million. The first property trust listed on the KLSE, the trust will purchase prime

Exhibit 9.1



commercial, industrial, retail and residential properties in major growth areas in Malaysia, particularly in the capital, with the aim of providing attractive returns to unit-holders. An Australian company, BNZ-Norths Ltd, a wholly-owned subsidiary of the Bank of New Zealand, will provide advisory and technical assistance in establishing and operating the new business.

Subsidiaries

AMMB's subsidiary finance company, Arab-Malaysian Finance Bhd, has a network of 22 branches and is among the top five finance companies in the country. Arab-Malaysian Credit Bhd is among the top leasing companies in terms of assets, profits and branch network. Arab-Malaysian Eagle Assurance Bhd, which provides both life and general insurance, had sums assured outstanding of M$316 million at the end of the same financial year. Arab-Malaysian Securities Sdn Bhd was the first incorporated stockbroking firm in Malaysia when the bank acquired Kris Securities and it is now one of the country's leading stockbrokers.

Development finance institutions

As in most developing countries, Malaysia's development finance institutions emerged to fill gaps in financial services not already covered by existing financial institutions. Commercial banks, for example, did not have the expertise to appraise projects involving complex industrial or agro-industrial technology. At the same time, the private capital markets, a conventional source of long-term financing for industry and agriculture, were not sufficiently developed to step in.

While the development finance institutions have performed a worthwhile role in Malaysia, today they face increased competition from other financial institutions which have become more development-oriented in outlook. With their larger sources of funds, the commercial banks, finance companies and merchant banks have whittled away at the traditional areas of the development banks. In particular, they have been able to break into the more lucrative and secure areas of business, leaving the development finance institutions only the newer and riskier ventures.

The diminishing role of the development banks is apparent from the example of Malaysian Industrial Development Finance Berhad (MIDF). It was the leading source of medium- and long-term credit in the 1970s (34.3 per cent of the total gross loans) but, at the end of 1988, total outstanding loans extended by MIDF to the manufacturing sector amounted to just M$321 million, compared with M$11 billion extended by commercial banks, M$718 million by finance companies and M$1.1 billion by merchant banks.

The earliest development finance institution in Malaysia was the "Loans to Planters" scheme set up in 1904 to fill the need for medium-term financing in the then new rubber industry. Established with a total fund of M$500,000 to promote rubber planting on a large scale, the fund was only accessible to the large European planting companies.

In the 1950s two more development finance institutions were established by the Commonwealth Development Corporation to assist in the economic diversification of Sabah and Sarawak. They were the North Borneo Credit Corporation (later renamed the Sabah Credit Corporation) and the Borneo Development Corporation.

With the growing recognition that medium- to long-term credit was required for Malaysia's growing industrialisation, the Malaysian Industrial Development Finance Berhad (MIDF) was established on the recommendation of the World Bank in 1960. MIDF was established with equity participation of the government, the commercial banks, insurance companies and the Commonwealth Development Corporation.

To mobilise resources for agricultural development and to coordinate the flow of funds from the public sector for agricultural development and rural development projects, the Agricultural Bank of Malaysia was established in 1969. This was followed by the formation of the Development Bank of Malaysia in 1973, primarily to promote Bumiputera participation in commerce and industry, and, in 1977, by the Sabah Development Bank Berhad. This was set up by the Sabah state government to provide medium- and long-term

Exhibit 9.2

Loans to the industrial sector (M$m)

		% change	
	At end 1988	*1987*	*1988*
Banking system	12,943	0.8	23.1
Commercial banks	11,099	1.8	21.6
Finance companies	718	−3.9	29.4
Merchant banks	1,126	−5.7	34.4
Industrial finance institutions	689	−15.4	−1.3
Sabah Development Bank Bhd	46	−67.4	3.9
Malaysian Industrial Development Finance Bhd	321	−9.7	−8.0
Development Bank of Malaysia Bhd	184	0.7	11.3
Industrial Bank of Malaysia Bhd	116	6.0	4.2
Borneo Development Corp Sdn Bhd	9	−12.7	−10.8
Malaysian Industrial Estates Sdn Bhd	13	−19.4	−28.0

Source: Bank Negara

loans to private and state enterprises in Sabah.

Two years later the Industrial Bank of Malaysia was established as an institution to provide long-term credit to capital-intensive and high-technology enterprises. In September 1988, the bank's activities were expanded with the takeover of the Malaysia Export Credit Insurance Berhad (MECIB) with the intention of launching a nationwide Export Credit Insurance and Guarantee Scheme in conjunction with the launching of a revamped Export Credit Refinancing (ECR) Scheme by the central bank.

In addition to these main specialised institutions there are a number of public development statutory agencies funded largely by the Federal Government's Development Budget that extended credit to individuals and companies for investment in commerce, agriculture and industry. Apart from the various state economic development corporations and other authorities, they include: the Council of Trust for Indigenous People (MARA); the Urban Development Authority (UDA); the Federal Land Development Authority (FELDA); and the Rubber Industry Smallholders' Development Authority (RISDA).

Agricultural credit

The main sources of agricultural credit have been the banking system, the government development agencies and the rural credit institutions. The main ones are the Agricultural Bank of Malaysia or Bank Pertanian Malaysia, Bank Rakyat, the Farmers' Organisation Authority, farmers' cooperatives, the agro-based cooperative societies and the rural credit cooperatives in Sabah and Sarawak. In line with improving commodity prices, credit extended to the agricultural sector rose almost M$500 million in 1988 to reach M$9.1 billion, following a marginal decline in 1987.

In terms of total financial resources, the Agricultural Bank of Malaysia is the largest of the development finance institutions with 39.9 per cent of the total resources at the end of 1987. The Sabah Development Bank accounted for 23.5 per cent of total resources and the Development Bank of Malaysia for 13.7 per cent.

Funds and lending

The sources of funds for the development institutions, which totalled M$4.5 billion at the end of 1987, were loans from federal and state governments (25.5 per cent); deposits from federal and state governments, public agencies and financial institutions (43.3 per cent); and loans from other domestic financial institutions and international capital markets (13.6 per cent). In terms of the direction of lending, almost two-thirds of the funds of the development finance institutions are dispensed in the form of loans to the industrial and agriculture sectors with loans outstanding of M$2.8 billion at the end of 1987. Of outstanding loans at the end of 1987, 41.4 per cent were with the agriculture sector and 19.4 per cent with the industrial sector.

Malaysian Industrial Development Finance (MIDF)

MIDF's principal role is to provide financial assistance to private industrial enterprises in the form of medium- to long-term loans, factory mortgage loans and hire purchase facilities and to mobilise industrial capital in the form of direct equity participation. To complement its financial services, MIDF provides advisory, technical and managerial services through its wholly-owned subsidiary, the MIDF Consultancy and Corporate Services Sendirian Berhad (MIDFCCS), and, through another subsidiary, the Malaysian Industrial Estates Sendirian Berhad (MIEL), it renders assistance in the design and construction of factories.

The government owns 44.1 per cent of the equity of MIDF, which has total resources in excess of M$500 million. The bulk of loans extended by MIDF are to small-scale industries and are in the medium- to long-term range with maturities of up to 15 years. Loans of M$500,000 and below accounted for 81.5 per cent of the total and loans to

Bumiputera enterprises represented about 20 per cent of total loans outstanding.

Borneo Development Corporation
The corporation was established in 1958 as a wholly-owned subsidiary of the Commonwealth Development Corporation to assist the states of Sabah and Sarawak to diversify from a reliance on agricultural activities into manufacturing and commerce. In 1988, after three consecutive years of decline, total paid-up capital had dropped below M$20 million. The bank's main activities are in financing the development of residential and commercial properties.

Sabah Development Bank Berhad
The bank was incorporated in 1977. With total resources of just over M$1 billion, its area of operations has gradually switched from the provision of finance for the timber and metal-working industry into lending in the property and real estate sectors. The bank is also engaged in the provision of fee-based services, including loan syndication, corporate finance and management advisory services.

Sabah Credit Corporation
The corporation commenced operations as a rural credit institution in 1956 financing small- and medium-scale agricultural and fishing ventures. Just over 70 per cent of its total resources of around M$200 million were extended for home loans. This focus resulted from the transfer to the corporation of the administration of the government housing loan scheme from the Borneo Housing Mortgage Finance Berhad in 1981.

Industrial Bank of Malaysia
The bank was established by the government in 1979 to provide long-term finance to all sectors. At the end of 1988, total loans outstanding stood at M$138 million, of which around two-thirds were in the form of loans for shipbuilding and ancillary financing.

Agricultural Bank of Malaysia
The bank was established in 1969 to mobilise savings from and provide credit to the agricultural sector. Assets at the end of 1988 stood at M$1.6 billion. The principal source of funds, accounting for 70 per cent of total resources, comprised fixed, giro and savings deposits. Under both the Fourth and Fifth Malaysian Plans, the bank's financing operations were concentrated on the priorities of the National Agricultural Policy which include food cultivation and commercial crop production and deep-sea fishing. In 1981 the bank introduced the Entrepreneur Development Programme to develop entrepreneurial skills among the agricultural community.

Insurance companies

The insurance industry in Malaysia is beset with problems, largely of unprofitable operating costs and of fraud. There are 60 insurance companies with assets totalling about M$7 billion and competing for a gross premium base of M$2 billion. Their assets represent only some 3.2 per cent of the total assets of the Malaysian financial system, whereas insurance companies in the developed countries generally account for 10-15 per cent of the assets of the financial system. Thus it is felt that there is considerable scope for the sector to assume a more prominent role in the Malaysian capital markets through exploiting the relatively large untapped insurance potential. Only one in nine Malaysians has life insurance, for example, against 93 per cent of all Japanese.

The industry has been characterised by fraud, agency-related problems, claims under-provisioning, high intermediation costs, and lack of professionalism. For every

Arab-Malaysian Securities' Institutional Dealer's room is at the core of their innovative operations

dollar collected, half goes in administration costs and commission. Motor insurance fraud, in particular, is very high with claims in 1987 of M$500 million. Growing public dissatisfaction with the quality of the service was reflected in the 2,653 written complaints received by the Office of the Director General of Insurance in 1988.

The supervision of the insurance industry was passed from the Treasury to Bank Negara in 1988 and reforms have been promised. Bank Negara's preliminary investigation of the industry showed shortcomings in the quality of management, systems and control, and breaches of the Insurance Act and other laws and regulations. Longer-term monitoring of the industry will include an early warning system to detect companies that are approaching financial stress; the formulation of uniform accounting standards and practices; and the creation of a code of ethics for the industry.

To strengthen supervisory mechanisms, 40 staff of the former Office of the Director General of Insurance in the Treasury were absorbed into the central bank's service. The bank also recruited an additional 60 employees to cope with the increased workload and embarked on a training programme with a number being sent overseas to learn the latest techniques in the field of insurance supervisory practices.

The insurance industry faces a major restructuring in the 1990s. The general insurance market, in particular, is highly fragmented with a large number of small undercapitalised firms vying for a relatively small market premium base of only M$1.2 billion, an average of only M$21 million per insurance company. This intense competition has led to undercutting of premium rates and the payment of excessive commissions in an effort to secure business – a strategy which has resulted in losses.

Chapter Ten

The capital markets

Malaysia's capital markets are evolving rapidly, with the Kuala Lumpur Stock Exchange experiencing a period of rapid growth in recent years, and a secondary market beginning to develop in government securities. While the corporate securities market is the most active component of the capital markets in Malaysia, the funds raised in this market have been only a fraction of those raised in the government securities market.

By comparison, the funds raised through the private sector in the two years 1983 and 1984 through ordinary share issues, bond issues, term notes and loan stocks, amounted to M$3.8 billion, more than the entire amount raised during the preceding 22 years. After a sharp decline in 1985 and 1986 (in the latter year only M$189 million was raised, the lowest figure for the 1980s), there was a substantial increase in 1987 and 1988 coinciding with a strong economic recovery, improved commodity prices and the generally buoyant trading conditions in the stock market.

Government securities market

This has developed over the years as a primary market, providing a captive source of funds for financing of development in the public sector. The amount of Malaysian government securities (MGS) increased from M$853 million at the end of 1960 to M$16.8 billion at the end of 1980 and M$54.6 billion towards the end of 1988.

Because of the relatively low interest rates payable on government securities, they have generally been unattractive to most private sector investors. At the same time, however, government securities find a ready market because most financial institutions are legally obliged to invest a minimum proportion of their funds in government securities. The largest single holder of such securities is the Employees Provident Fund which is required to invest 70 per cent of its funds in government securities. As a whole, the social security institutions as a group held 61 per cent of the total securities outstanding at the end of 1988. Since government securities are eligible for inclusion in computing the minimum level of liquid assets that the commercial banks and finance companies have to maintain, the financial system is a significant holder of government securities with the commercial banks alone holding 12 per cent of outstanding securities.

As the yields of government securities do not change significantly, the investing institutions have tended to hold their portfolio of such securities until maturity. Historically, this had inhibited the development of a significant secondary market, although some trading of paper near its maturity date did occur. In order to foster the development of a secondary market, there has been a shift in the maturity structure of new issues since 1987. One motive for this is in the government's desire to reduce foreign borrowings by creating a more market-oriented domestic securities market. In 1988, two-year securities were reintroduced for the first time since 1965, and shorter-term securities (five, six, eight and nine-year securities) accounted for M$4.7 billion or 55 per cent of the new issues in 1987-88, while medium-term securities of 10, 11 and 13 years constituted another M$3.2 billion or 37.4 per cent. Long-term securities (16-21 years) accounted for the balance of M$650 million or 7.6 per cent of the new issues, whereas during the 1981-86 period they comprised some 85 per cent of issues.

Helped by improved economic performance and the drop in interest rates, the government has been able to act in other ways to promote a secondary market in MGS and the financial markets generally. The statutory reserve ratio of the banking institutions has been realigned, interest rates on deposits unpegged and the compliance of the liquidity requirements of the banks changed to enhance their flexibility in financial management. The central bank expanded the money market participants to include selected finance companies; the commercial banks and some of the merchant banks are now allowed to issue floating rate negotiable certificates of deposit (FRCDs); and the Kuala Lumpur Interbank Offered Rate (KLIBOR) was introduced as an official indicator of the conditions in the interbank money market.

As from the start of 1989, a system of principal dealers for government securities has been in operation. This involves commercial banks, merchant banks and discount houses, which are required to provide buy and sell quotations in the secondary market. The central bank now conducts its open market operations through these dealers, through which it auctions all securities with maturities of less than 10 years. To promote an active market in Treasury bills, the existing seven discount houses will be appointed principal dealers for these bills and only they will be allowed to participate in the weekly Treasury bills tender. Other institutions and individuals which intend to purchase Treasury bills will have to do so in the secondary market.

Corporate securities market

From its modest beginning as a group comprising four Kuala Lumpur stockbrokers in 1960, the Kuala Lumpur Stock Exchange (KLSE) has grown to become the third largest among 19 "emerging equity markets" of the developing countries listed by the International Finance Corporation. There are 53 member broker firms in the major towns of Peninsular Malaysia and 292 companies listed on the exchange with a total nominal paid-up capital of M$28.2 billion and market capitalisation of M$99.1 billion.

Turnover on the KLSE is dominated by trading in industrial shares which represented around 63 per cent of total turnover in 1988. Hotels and property companies were next in importance (14 per cent), followed by financial institutions (11 per cent), and, as a group, rubber, tin and palm oil companies (12 per cent).

The substantial increase in the KLSE's total market capitalisation to M$99.1 billion at the end of December 1988 from M$73.8 billion at the end of the previous year, reflected the continued strong performance of the economy. The market's barometer, the KLSE composite index, rose 36 per cent in 1988. Apart from some reshuffling, the top 10 companies in terms of market capitalisation in 1988 were the same as the previous year, with Overseas Chinese Banking Corporation still firmly in first position with a market value of M$6.2 billion at the end of 1988, while Development Bank of Singapore (M$4.44 billion) and conglomerate Sime Darby (M$4.43 billion) were in a close fight for second place.

The first Malayan Stockbrokers' Association was formed in 1937, but public trading of stocks and shares did not begin until 1960 when the four original stockbrokers met daily at the central bank's clearing house to "mark" prices. Under various reorganisations the stock exchange evolved through the Malayan Stock Exchange (1960), the Stock Exchange of Malaysia (1963), the Stock Exchange of Malaysia and Singapore (1965) and finally, the Kuala Lumpur Stock Exchange (KLSE) in 1973, when it parted company from the Singapore Stock Exchange (SES).

The early years of activity were characterised by considerable speculation in new issues and in the trading of issued shares. Several measures to establish a more restrained market were taken over the years of the exchange's development, culminating in the passage of the Securities Industry Act which came into force in 1976 and was aimed at generating more orderly conduct of the securities business in the country. The Act gave the government the power to curb excessive speculation, insider trading, share rigging and other forms of market manipulation.

A new Securities Industry Act came into force in 1983 to replace the old Act. Further refinements have taken place since then, including legislation in 1987 which introduced the concept of incorporation of stockbroking companies where only stockbroking companies rather than individuals are entitled to dealing licences. Corporate participation was implemented either through equity participation in existing stockbroking firms or through new companies. Banks, both commercial and merchant, and investment institutions were allowed to participate.

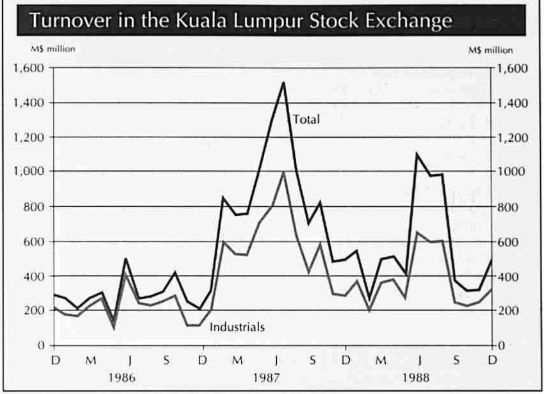
In mid-1988 the government set new limits for the capitalisation of firms seeking listing on the exchange – up from M$5 million to M$20 million. The government also announced that foreign stockbroking companies would be permitted to have 49 per cent equity in local stockbroking firms as against the general NEP limit of 30 per cent. This move is in line with the government's desire to see incorporated Malaysian broking firms, especially those with foreign participation, capture a larger share of the foreign market and to expose the Malaysian stockbroking industry to international markets. Foreign interest in the Malaysian stock exchange is thought to be on the increase in light of the need to maintain holdings in both traditional Malaysian plantation stocks and new manufacturing stocks at a time when the KLSE and the SES are growing apart.

The KLSE's attitude towards the SES has changed in recent years. Despite the separation in 1973, a large number of Malaysian stocks (over 180) are still quoted on the SES and turnover in Malaysian shares is crucial to the SES. Many Malaysian stocks enjoy a higher turnover on the SES than the KLSE. The KLSE index has continued to track the *Straits Times* index, although the trend is towards a de-coupling of the markets. The SES has won a greater share of business through its computerisation, while the Malaysian authorities have sought to win back Malaysian firms, encouraging newcomers not to list on the SES and even supporting the idea of "de-listing" for some companies.

A controversial move at the end of 1988, the most drastic measure taken since the Securities Industry Act came into force in 1983, was a government announcement of a change of structure at the KLSE with the appointment of an executive chairman and four government representatives on the nine-member committee instead of the previous one. Previously the chairman had been elected by the committee. Many brokers were angered that there had been no consultation, although the government in fact appointed the then chairman, lawyer Mohamad Din Nik Yusoff, as executive chairman. Behind the restructuring was the need felt by government financial leaders for the KLSE to take a more significant role in international markets. Foreign investors often go through the Singapore exchange to trade in Malaysia and with countries like Korea and Taiwan liberalising their markets, it was felt that the KLSE would face increasingly stiff competition. The new structure, it was felt, would project a more independent image and enhance the exchange in the eyes of foreign investors.

Major hardware improvements are due to take place in 1989. The exchange will get a central depository system, a warehouse for share scrips, the aim of which is to reduce their movement to cut down on potential loss and fraud. The scrip problem has been the major obstacle to a proposed new shorter delivery and settlement period that had to be deferred. Another equipment upgrading is the trading support system due to begin operating in the third quarter of 1989 initially matching buyers and sellers of financial and plantation stocks. The current Masa system will be enhanced and prices will be truly real time. It will provide an automated trading environment as opposed to the current open cry system. Market surveillance will be tightened with electronic terminals replacing the trading boards and changes to trading rules. One competitive measure that the market will have to consider is

Exhibit 10.1



the introduction of graduated commissions, which have already come to the SES.

In order to remain competitive with other emerging stock markets in Indonesia and Thailand, the KLSE is also considering a range of new securities and a relaxation of the rules on the minimum size of marketable parcels of shares, from 1,000 to 500. Stock options, stock index futures and corporate bonds are all under consideration.

Any expansion of the market should help support the Malaysian privatisation programme. In all, some 246 enterprises are due to be privatised over the next 10 years, to raise M$16.34 billion. Some 176 will be sold in the next five years, with projected revenues of M$13.0 billion for the government. It is not clear, however, whether all the privatisations will be carried out through flotation.

The KLSE second board

One recent interesting development has been the establishment by the KLSE of a second board to enable smaller companies which are viable and have strong growth potential to tap additional capital from the market through a listing on the KLSE. Companies seeking to be listed should have made "reasonable" profits for a three-year period and have a minimum issued and paid-up capital of M$5 million, but not exceeding M$20 million, compared to a minimum of M$20 million for a listing on the main board.

Launched with considerable fanfare in November 1988, the response to the board has been slow and, by the end of January 1989, only one company had been listed, although merchant banks and accounting firms say a number of their clients are looking into the possibility of listing their companies. Listing is also a time-consuming business, taking typically somewhere between six and nine months, but up to a year in some instances. With scores of local companies fitting the criteria for listing, the weak response has surprised the financial community. One explanation offered is that it reflects the lack of success of second boards in other countries, namely Australia and Singapore. Another possible disincentive is that because public ownership often requires an expanded board there can be a dilution of family control. Cost is another factor. While considerably less than listing on the main board (there is no requirement to advertise the full prospectus in a newspaper), costs can still be substantial, particularly the hidden cost represented by the considerable amount of senior management time necessary during the run-up to flotation.

What might encourage more companies to seek a listing is that the introduction of public shareholders eliminates the need for directors' and owners' guarantees on loan funds, thus the debt remains with the public entity and the private assets of the vendors are not encumbered. Another advantage is that the greater capitalisation of the company should give greater access to loan funds. Similarly, listed shares are more readily accepted by financial institutions as collateral for loans.

The most controversial set of conditions revolves around chain listing and cross shareholding. No guidelines have yet been set by the Capital Issues Committee, the first approving authority. Chain listing refers to the listing of two or more related companies or subsidiaries, and cross shareholding to companies holding more than 20 per cent in the equities of other companies including those under the same corporate umbrella.

Bumiputera Stock Exchange

The exchange only admits public limited companies owned by the Bumiputera community and the purpose of establishing a separate exchange was to increase Bumiputera participation in the commercial activities of the country. There are only eight companies listed on the exchange and trading activity in 1988 was insignificant with total turnover of shares valued at M$94,234 in the first nine months of the year.

Unit trusts

Malaysia's premier unit trust is the National Unit Trust Scheme, launched in 1981. At the end of 1987 it had some 2.28 million unit holders (compared to only 109,332 for all the other unit trusts combined). The scheme had accumulated investments totalling M$4.2 billion in finance shares (33.5 per cent), commodity shares (33 per cent), industrial shares (19.5 per cent) and property (14 per cent). The first gilt-edged unit trust fund in Malaysia was launched at the beginning of 1987 by the Arab Malaysian Merchant Bank, managed by its wholly-owned subsidiary, the Arab Malaysian Unit Trusts Berhad, and at the end of October 1988 it had mobilised funds totalling M$108.9 million.

Property trusts

A number of property trusts were to be established in 1989 largely as a result of low property values. Approval in principle for five such trusts had been given by the end of October 1988. Property trusts, usually medium- to long-term investments, are a form of unit trust scheme whereby capital from investors is used to acquire prime properties. Critics of the new property trusts in Malaysia have accused the banks of rushing to set them up to unburden themselves of non-performing loans secured against property. The critics say that the banks, unable to auction off these properties at court-approved reserved prices and frustrated by the slowness of legal recourse against defaulting borrowers, may seek to unload them into property trusts.

Supporters of the new trusts see them as an extension of the financial services that banks should be offering. So far two of the institutions that have received licences, Malayan Banking and Bank Bumiputra, have opted for joint ventures with Australian partners. While an Informal Committee on Property Trust has been established, with representatives of several government departments, to vet the funds' pre-launch stage, it is not clear who will take over the regulatory and disciplinary functions once the funds have been established.

Private debt securities

Debt papers have been used largely by blue chip companies to raise funds, but Malaysia has not seen an active secondary market develop in these securities. New guidelines issued by Bank Negara are expected to promote a more active market although some of Malaysia's smaller financial institutions have criticised the guidelines as being in favour of the larger institutions because of the high minimum amount of issues.

According to Bank Negara, approval was given for the issue of some M$1.37 billion in debt papers in 1987 and 1988. Debt papers, commonly issued in the form of bonds, floating rate notes (FRN) and debenture notes have been used to raise funds by Sarawak Shell, Esso Malaysia, Peradanan Nasional Berhad, Malaysia International Shipping Corporation and the Johor State Economic Development Corporation. The tenure of these papers ranged from two to five years with coupon rates ranging between 6.5 per cent and 8 per cent. The approvals were for issues between M$19 million and M$140 million.

The guidelines laid down by Bank Negara are expected to provide a framework for an orderly development of future issues and pave the way for greater issues, in turn acting as a stimulus for the creation of a secondary market. The framework of guidelines includes several elements. Debt papers can only be issued by companies with shareholder funds of at least M$25 million and an issue must be at least M$50 million. The original tenure of the securities must be at least three years. A company making an issue needs to furnish details of how the funds raised are to be used and the sources of repayments – including interest and principal repayments. A prospectus is required for issues of private debt securities but exemption is given when the issuer is not under a liability to repay any money accepted by it on deposit or loan from more than 10 persons or when the money accepted by the issuer on deposit or loan is fully guaranteed by the government. For an issue unaccompanied by a prospectus, its secondary trading is only limited to prescribed corporations, registered insurance companies, statutory bodies, approved pension funds and a corporation formed outside Malaysia.

Finance companies are required to seek Bank Negara's approval for debt paper issues to more than 10 persons. All proposed issues must be fully underwritten by commercial banks and/or merchant banks. However, where an undertaking to subscribe has been secured by the lead managers from the market participants before the issue, that amount can be excluded from the amount to be underwritten. All lead managers of the issue must ensure the debt equity ratio of the issue is within "prudent limits" and generally should not exceed the ratio of 2:1.

Subscription to debt securities issued by non-resident-controlled companies is limited to 40 per cent for non-resident-controlled financial institutions at the primary issue but not the secondary market. An issuer must also appoint an authorised depository approved by Bank Negara for all securities issued. A proposal for an issue should contain details of the proposed issue, a brief profile of the issuer, the shareholding of the issuer, financial statements relating to the issue for the last three years, cash flow projections, credit facilities and debt equity ratio.

New instruments are being promoted to add both depth and breadth to the capital market. Cagamas Berhad, the national mortgage corporation, was established in 1986 to develop the secondary mortgage market by assuming the role of an intermediary in purchasing mortgage loans from primary lenders and raising finance from investors of long-term funds with the issuance of Cagamas bonds. Cagamas' experience as the first institution to issue fixed rate securities is expected to pave the way for other private sector corporations to tap the market for capital funds outside the equity and bank loans markets. By the end of September 1988 Cagamas had made three bond issues with a total value of M$900 million. An active secondary market has been established in Cagamas bonds through a network of principal dealers because of their attractive yields, shorter maturity of up to five years, their eligibility as a secondary liquid asset and exemption from stamp duty.

Further measures aimed at developing a more diversified capital market were announced in the 1989 budget presented in October 1988. These included the exemption of corporate bonds from stamp duties; tax incentives for unit trusts and property trusts and a review of guidelines on the establishment and operation of unit trusts and property trusts to facilitate their development; tax incentives for the establishment of venture capital companies; a review of the stamp duty legislation; plans for the listing of property trusts on the KLSE; and the establishment of a task force to look into ways of developing the market.

Commodity futures markets

Initially confined to trading in a crude palm oil (CPO) futures contract, the Kuala Lumpur Commodities Exchange (KLCE) was incorporated in 1980. RSS rubber futures were added in 1983 and SMR rubber futures and palm kernel futures in 1986. In October 1987 the KLCE launched a tin futures contract, becoming the only exchange in the world to deal in tin futures. In August 1988 the exchange launched a US$ cocoa futures contract, the first time cocoa futures have been traded in a producing country. The range of commodities now traded on the exchange has established KLCE as a reputable commodity futures exchange and a forum for price discovery and hedging of primary commodities

Volumes have surged since the relaunching of the exchange in 1985. In 1987 3.3 million tonnes of CPO futures were traded and this level rose to nearly 4.9 million tonnes of CPO between January and November 1988.

With the exception of palm kernel futures and cocoa futures, trading was generally active in 1988. Daily average turnover in tin futures rose from 100 tonnes in January 1988 to about 185 tonnes at the end of the year.

To enhance market liquidity, KLCE is promoting a total market package which, with a series of aggressive campaigns locally and overseas, is aimed at attracting more participants to enter the market. KLCE is also discussing the need for a refined palm oil contract (such as refined, bleached and deodorised palm oil) with the Palm Oil Refiners' Association. A number of overseas parties have shown interest in such a contract which would be quoted in US dollars.

Chapter Eleven

Industry

Overview

The Malaysian government has long been concerned to promote the role of manufacturing industry within the economy, a policy which bore fruit most noticeably during the 1980s. Manufacturing now occupies a key sectoral role, one which is expected to flourish during the 1990s as the country continues on its transformation into a Newly Industrialised Country (NIC).

While Malaysia's success in manufacturing has been a particular phenomenon of the 1980s, import-substitution industries began in the late 1960s and experienced gradual growth until the mid-1970s. During that period, the emphasis shifted from import-substitution to export-oriented industries, and the manufacturing sector embarked on rapid growth before slowing down in the early 1980s. Compared with the annual average growth of 11.4 per cent during 1973-81, the rate for the 1981-83 period was only 4.9 per cent and there was no growth in 1985. However, manufacturing came to contribute an increasingly significant proportion of Malaysia's GDP during the decade of the 1980s: 19 per cent in 1981, 20 per cent in 1985 and 24 per cent in 1988, exceeding Malaysia's Fifth Plan target of 20.2 per cent of GDP by 1990.

The 24 per cent of GDP which manufacturing contributed in 1988 meant that industry had achieved a target level that had had been set for 1995 in the 1985 Industrial Master Plan (IMP). The three strong years of manufacturing growth at the end of the 1980s saw manufacturing draw steadily away from agriculture as the biggest contributor to GDP. Growth in manufacturing output peaked at 15.3 per cent in 1988 – the highest since 1976. Expansion within industry has been broadly-based, with 10 out of 14 industries registering double-digit growth rates in 1988, and growth is expected to continue at a rapid pace during the 1990s.

History

In 1954, three years before Malaysia's independence, a World Bank survey which formed the basis of Malaysia's first Five-Year Plan stressed the need to reduce dependence on the agricultural sector. All of Malaysia's economic plans since then have re-emphasised the same need. Malaysia's manufacturing industry began in the area of import substitution during the late 1960s and early 1970s with rapid expansion in the food, household appliances, furniture and clothing industries. A shift towards export-oriented industries drew Malaysia nearer her goal of industrialisation. The 1970s saw rapid economic expansion with GDP growth averaging 8 per cent, in which manufacturing, with annual average growth of 12.5 per cent, was the fastest growth sector. Manufacturing also recorded the highest rate of employment growth, averaging 7.6 per cent per annum during the decade. Exports of manufactured goods registered an annual growth of 24.3 per cent during the 1970s, with electrical machinery, appliances and parts accounting for the larger share at the end of the decade, followed by wood products, textiles, footwear and food products. In the first half of the 1980s, the manufacturing sector was able to maintain a respectable growth rate, despite the sluggishness of the world economy. During this period, the main growth came from the electronics industry in the free trade zones, while resource-based manufacturing grew only marginally.

This bias in growth in the 1980s has created a manufacturing base which is skewed towards multinational investments. Employment in these industries is predominantly of semi-skilled female workers, particularly in electronics and textiles. By 1988 more than one million people were employed in industry, accounting for 16.6 per cent of total employment. The IMP had targeted 1990 as the year that employment in industry would surpass the one million mark.

Capital-intensive heavy industries, including chemicals, petroleum, non-metallic and base metal products, dominated manufacturing investment during the early 1980s, in contrast to the traditional, labour-intensive industries. A significant proportion of foreign investment continues to be concentrated in the petroleum and electronics industries. The principal strategy for the Fourth Plan Period (1981-85) was to change the product mix of manufacturing activities and the market orientation of manufacturing output simultaneously. Strategies were designed to develop export-oriented manufacturing activities, resource-based industries, selective second-round import-substitution products and to establish certain heavy industries that would foster linkages and the expansion of the industrial base. Continued strong external demand towards the end of the 1980s spurred greater manufacturing efforts with a jump in exports of over 30 per cent in 1987 and 32 per cent in 1988. Malaysia has had a comparative advantage deriving from labour shortages and rising labour costs in the newly industrialised countries in South East Asia.

Investment

Continuing strong investment in the manufacturing sector is reflected in the pace of demand for manufacturing licences. This continues to grow: in 1988 there were 952 applications, an increase of 554 over the previous year. Licence applications for 732 projects, involving a total proposed capital investment of M$12.8 billion, were approved by the Malaysian Industrial Development Authority (MIDA) – twice the 1987 total.

These projects should create an additional 180,000 jobs in industry. The rubber products sector dominated the applications (363), followed by electrical and electronic products (125), textiles and textile products (78), wood and wood products (62) and food products (50). These five industry groups had total proposed capital investment of M$5.55 billion or 43.4 per cent of all project applications received.

Within the total of M$12.8 billion, domestic sources accounted for M$4.4 billion of the total proposed capital investment, while foreign investment increased four-and-a-half times over to M$8.4 billion. Eight countries accounted for 76 per cent of foreign capital and the biggest five were Japan (M$1.7 billion), the US (M$1.4 billion), Singapore (M$1 billion), Taiwan (M$889 million) and France (M$523 million).

Investment from foreign sources has increased markedly over the period, and in 1988 represented 65 per cent of the proposed manufacturing projects. The sharp increase in foreign capital investment was attributed chiefly to a number of approved capital-intensive projects, of which four were particularly large. Aluminium Industries of Sarawak Sdn Bhd received a total foreign capital investment of M$525 million from France; Asia Pacific Petrochemical (M) Sdn Bhd is a M$500 million US-Taiwan venture in ethylene and propylene products; Penternakan Udang Song Cheng (M) Sdn Bhd has drawn M$200 million from Taiwan for a venture in prawn feeds and processed chilled fresh and frozen prawns; and Asia Pacific Polyethylene (M) Sdn Bhd is a M$150 million Taiwan-US-Singapore polyethylene resin business.

Planning for future industrial investment and expansion is being assisted by the Asian Development Bank (ADB), which is providing a technical assistance grant to Malaysia for a study of its industrial capacity. This is aimed at identifying key technologies required to facilitate development of several strategic industrial sub-sectors, such as biotechnology and microelectronics. The ADB has identified a lack of capacity in the country's technology system and a low level of industrial research in both public and private research institutions as hampering development of modern technology-based manufacturing industry.

The government is also concerned over the low level of industry's spending on research and development, equivalent to only 0.7 per cent of GDP in contrast to the 2 per cent which Korea spends. It has set up a body of scientists, engineers and businessmen to help in research on industrialisation. Another organisation, the Council for the Coordination and Transfer of Technology, is studying ways to upgrade and promote greater technological capability in industry. Their recommendations will include selective sectoral plans for the 12 priority industries identified by the Industrial Master Plan.

Investment is also likely to come from Malaysian corporations themselves, which have also seen an increasing attraction in manufacturing. Plantation-based conglomerate Sime Darby, for example, has committed M$100 million for investment in 1989 entirely on the manufacturing side – to re-equip IT International, DMIB, and its shoe factory, and to expand its examination glove plant. Most of Sime's manufactured products, including earthmover and aircraft tyres and shoes, are exported. In expanding its manufacturing side, Sime is getting technical assistance from Sumitomo of Japan and BF Goodrich of the US.

Electrical equipment and components

Output

Driven by the surge in worldwide demand for personal computers, telecommunications and data processing equipment, consumer electronic products and motors, Malaysian production of components rose during the 1980s to become the leading foreign exchange earner in 1988. Factories throughout Malaysia produced 4.7 billion integrated circuits and 2.2 billion semiconductors. In all, the production of electronic components accounts for 80 per cent of output in the sector.

The distortion of the sector toward components is something which Malaysia's Industrial Master Plan has targeted for correction. The bias is reflected in the fact that consumer and industrial electronics, which account for 55-70 per cent of output in most NICs, contribute a much smaller 15-20 per cent in Malaysia. It is a lopsided structure that makes the electronics industry precarious, particularly because component manufacturing is limited to simple assembly and testing activities based on imported materials and is dominated by foreign multinationals attracted by low wages and tax incentives.

Nevertheless, Malaysia's electrical appliance industry is becoming more firmly established. In all, the consumer and electronic sub-sectors account for 13 per cent and 7 per cent respectively of the total annual output of about M$9 billion. Of the 101 new projects approved by MIDA in 1987 and 1988, 60 per cent were for the production of electronic end-products, underscoring the increased contribution projected to be made by the consumer and industrial electronic sub-sectors. The IMP projects that they will contribute 24 per cent and 15 per cent respectively of total production by 1995. This structural change is intended to shape Malaysia's electronics industry from a narrow base of electronic components production to a diversified spectrum of manufacturing and ancillary services.

Malaysia presently has 10 companies manufacturing television sets with total paid-up capital amounting to M$125 million. Six of them are joint ventures between Malaysians and foreign parties and three are wholly-owned foreign concerns. Together they employ about 3,700 workers. In 1988 MIDA granted seven new licences for manufacturing televisions.

By 1990 it is envisaged that the country will be producing six million colour TV sets a year. Matsushita Television Co alone says it will be producing a million a year by 1994, 90 per cent of them for export. The output record of another subsidiary, Matsushita Electric Co (M) indicates the impressive rate of growth which can be achieved in the sector: output of its first million electric fans took 15 years from 1963, the second took four years and the third less than three years. Matsushita says it will pass the five million mark early in the 1990s. In 1988 production of air-conditioners leapt by 42 per cent to almost 750,000 units and refrigerators by over a third to 200,000 units. With only an estimated 2.6 million households having access to electricity supply in Malaysia, the electrical equipment industry has to be highly export-oriented.

Government planning and investment

The Fifth Malaysian Plan had envisaged overall growth of 9 per cent for the electronics sector during the plan period 1986-90. But the remarkable progress in the production of electrical components and electric equipment has far surpassed expectations, with growth of 28 per cent in 1986, 30 per cent in 1987 and almost 18 per cent in 1988. This is against a background of IMP forecasts of output growing from M$5.2 billion in 1984 to M$16 billion in 1995, with employment in the electronics industry reaching 150,000 by 1995.

The government is now trying to shape future development in two ways. It has established the Malaysian Institute of Microelectronic Systems to help the domestic industry to increase its retained profits. While Malaysia is one of the world's largest producers, it supplies mainly low-income inputs such as labour, land and communications, with profits going to foreign-owned multinationals.

Secondly, MIDA is trying to attract more broader-based production ventures. Although production of colour TV sets has registered an annual growth of 50 per cent a year for five years, the six million sets expected to be produced in 1990 will require M$1 billion worth of imported components (mostly cathode ray tubes, indoor antennae, speakers and filters). An emphasis on local component production means that, by 1990, it is estimated that the value of locally produced parts will reach M$450 million. Parts already being locally produced include deflection yokes, flyback transformers, tuners, resistors, capacitors and transistors. A significant proportion of plastic parts such as cabinets and packaging materials are also being produced locally.

Private investment

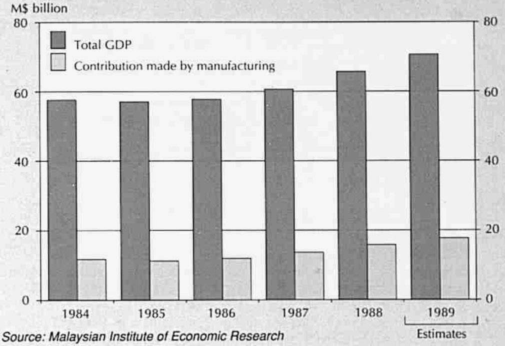
Malaysia has managed to attract some of the top names in high technology in electronics, including Motorola and National Semiconductor. Both have wafer fabrication facilities, and a number of other foreign companies such as Hewlett Packard, Intel, Hitachi and Fujitsu are looking at Malaysia with a view to moving into high-tech wafer fabrication there in the 1990s. Fujitsu Microelectrics (M) Sdn Bhd is looking carefully at Malaysia's infrastructure with a view to investing in a M$120 million so-called "wafer fab" plant in the 1990s. Water purity and stable electric voltage are crucial for wafer fabrication. Government incentives for investors manufacturing selected items like wafers, cathode ray tubes and compact disc players include a 10-year pioneer status.

As more locally manufactured components become available, the industry hopes that overseas companies will be increasingly drawn to the country, although the bulk of investment is coming only from Japan at present. Electronics and electrical manufacturers are spread throughout Malaysia's industrial estates and free trade zones, but Penang – Malaysia's "silicon island" – has attracted the largest share of investment because of its high-quality labour. Philips, with three plants in Malaysia, has its Audio Electronics plant there.

Local component availability was the reason cited by Japan's Victor Company (JVC) as the reason for locating a M$40 million plant to produce video equipment in Shah Alam. Matsushita Compressor and Motors is also investing M$70 million to expand production capacity of high-precision rotary compressors to boost production to 1.5 million units a

Exhibit 11.1

Total GDP and contribution made by manufacturing 1984-89



Source: Malaysian Institute of Economic Research

year, underpinning higher output of air-conditioners. Sister company Matsushita Electronics Corp is establishing a M$60 million robotised fluorescent lamp manufacturing facility, the first of its kind outside Japan. Fujitsu has opened a M$52 million memory and logic chips plant in Shah Alam, Selangor, bringing its total investment in Malaysia to M$150 million.

Canon is also establishing component plants at a cost of M$180 million with a start-up in 1990. Sumitomo Electric will build an M$80 million plant in Shah Alam with a workforce of about 500 to produce high-quality enamelled wire for export. Japan's massive Shin-Etsu group is to invest more than M$500 million in a number of projects in Malaysia over the next five years. Shin-Etsu, which already has a plant in Selangor, producing polished silicon wafers, also makes synthetic quartz, rare earth products and speciality chemicals for the electronics industry. Besides Japanese investment, Sweden's Ericsson's is considering a Malaysian location for its telephone production operation. Although most of Ericsson's business is with China, Malaysia is already its regional centre for training, R&D and manufacturing.

Textiles

Textiles have been another of those key light industrial manufacturing sectors which have been responsible for rapid growth in the 1980s. Output growth slowed at the end of the 1980s: after a sharp increase of 14 per cent in 1987, growth slackened to only 4 per cent in 1988. However, export values rose by 25 per cent and the industry is buoyant after three years of growth, full order books and a surge in demand for quality fabrics and brand-name apparel in export markets. Manufacturing is spread throughout the country and much of it takes place on industrial estates and free trade zones. Melaka is expected to become a more important centre of the industry during the next few years with two major projects there.

Through contract manufacturing, Malaysian apparel makers are producing for 200 world famous brand names such as Christian Dior, Yves St Laurent, Ralph Lauren, Ladybird, Mothercare, Adidas, Nike and Puma. The industry presently comprises about 310 companies with a total paid-up capital of M$1.8 billion and employs 100,000 people. By 1995 employment is expected to grow to 116,000 workers.

Advantages

Although Malaysian products have in the past been marginally higher in price than those of its regional competitors, the weakening ringgit has helped improve competitiveness. The country's textiles and apparel have a good reputation in international markets because of their high quality, the result of the aggressive pursuit of high standards in the industry through the use of advanced technology, skills development, good labour relations and effective cost management. But the industry has suffered from low productivity, relatively high wages and a high labour turnover.

Government plans

The IMP, created at a time when textiles and apparel was considered a "sunset" industry, recommended a cautious approach for the future with modernisation and rationalisation of existing factories. With factories operating at less than capacity, this strategy was preferred to the commitment of capital to new factories. The plan predicted that output would grow to M$6 billion by 1995 compared to M$2 billion in 1981, and that exports would grow from just over M$700 million in 1981 to M$3 billion by 1995.

In fact, market demand pushed exports to almost M$3 billion by 1988 and the target should be comfortably over-achieved. Domestic consumption is low and is not expected to change significantly in future. Malaysia's export sales of slightly over US$1 billion represent about a 1 per cent share of the Western world market.

The plan recommended manufacturers to concentrate on gaining a greater share of the apparel business as its quality depended on the fabrics and skills in design and thus required relatively more modest investment, rather than on the primary textile sub-sector, with high investment needed in technology. The Fifth Malaysian Plan forecast that growth in textiles and apparel between 1986 and 1990 would average 5 per cent.

Private investment

In contrast to the relatively cautious attitude of the government, private sector investment has been booming in the textile sector. Hong Kong shipping magnate Frank Chao, who was the main inspiration behind the formation of the Malaysian International Shipping Corp, has signed a deal with the Melaka State Development Corp to set up Textile Corporation Sdn Bhd at Melaka's Merlimau industrial estate. The joint venture will eventually employ 1,400 workers and make spun, woven, finished, and printed and dyed products for export to the US and European markets. Taiwanese company E-Hsin has also signed up to build a M$200 million textile plant at Melaka's Tangga Batu industrial estate which will provide jobs for 800 workers.

One of Malaysia's biggest garment manufacturers, South Pacific Textiles Industries (SPTI) has also become expansionist outside the country. In association with a UK company, Klynton Davis Ltd, it is to manufacture in Europe. South Pacific's wholly-owned subsidiary, Soutex Sdn Bhd, is undertaking the project which gives SPTI a network of plants in Puerto Rico, Jamaica and Fiji – as well as Malaysia and the UK – and access to markets in Europe, the US, Australia and New Zealand. In 1988 SPTI acquired 51 per cent of South Island Garment Sdn Bhd, the largest manufacturer of outerwear in Malaysia, in order to broaden its product range.

Other contracts involving overseas producers include SPTI's with Britain's Marks & Spencer group to make high fashion garments, and a M$3 million joint venture plant with another UK firm and three Bumiputera companies to produce specialised waterproof uniforms for the police, armed forces, post office and telecommunications workers. The three local partners are Rohas Sdn Bhd, an investment company, Gas Pantai Timur Group, manufacturing industrial gases on the east coast, and Sinar Sari Sdn Bhd, a general trading company.

Outlook

A blueprint outlining recommended directions for the industry was being prepared for the Malaysian government by leading Swiss textile consultants, the Gherzi Organisation, in 1989. The World Bank-sponsored study will recommend steps the industry should take in the next five to 10 years to sustain its present growth. The outlook for the industry is felt to be good in light of the effective negotiating approach adopted by the government in bilateral textile negotiations, the exchange rate advantage of the weakened ringgit, the well-established quota allocation system and the sound industrial/investment management policies that have seen the industry achieve consistency and credibility. While Malaysia's utilisation of quotas for the US market has always been high, those for the EC have been under-utilised, leaving scope for further exploitation by Malaysian manufacturers. Malaysia is actively diversifying into non-quota markets like Japan and Australia.

Rubber products

Output

As the world's leading rubber producer, it is appropriate that Malaysia should be developing a healthy rubber manufacturing industry. At present, it manufactures only a minute share of rubber-based products for the international market and Malaysia's contribution to tyre exports on a global basis is also negligible. This is changing, however, as tyres are a labour-intensive industry in which Malaysia has a cost advantage. The rubber gloves business also presents major opportunities for Malaysian producers.

Attracted by the prospect of returns on investment within a year, numerous companies have invested in new start-ups to make rubber examination gloves, demand for which has soared because of AIDS. Malaysian manufacturers produced 1.3 billion pairs in 1988 (compared to 35 million in 1987), but there are problems of pricing, over-capacity and quality control in the industry. Many of the plantation companies have gone into the production of examination gloves. These include Harrisons Malaysian Plantations Bhd and Asiatic Development (in a joint venture with SA Burnet of France). Manufacturing of rubber products has pushed domestic consumption of rubber up to 100,000 tonnes in 1988, an estimated 120,000 tonnes in 1989 and consumption is expected to reach the Industrial Master Plan target of 300,000 tonnes by the year 2000.

The rubber products boom has not been confined to gloves. Production of all kinds of rubber products has been on the increase and output of the industry generally recorded an unprecedented growth of 75.6 per cent in 1988 after registering a growth of 31.8 per cent the previous year. The manufacture of tyres and tubes grew by 19 per cent in 1988, to six million tyres, and the industry is dominated by large manufacturers such as Sime Darby, Hume Industries and Ganda Holdings. The well-diversified Lion Group, which exports a large part of its output of steel bars, is also going into the tyre manufacturing business on a large scale.

The gloves boom

Early in the boom, the rubber gloves industry was marked by rapid growth using Taiwan-made production lines, but without the proper capital and technical and marketing know-how. At the end of the 1980s, there was a shake-out of the companies which jumped in too quickly because of the appeal of profit margins that peaked at almost 50 per cent.

The rush into the industry peaked in 1988 when MIDA issued 347 licences (of which 20 per cent were not taken up). In total, 456 licences were issued and MIDA has come in for much criticism for not vetting applicants sufficiently. Although Malaysian manufacturers secured a 20 per cent share of the US market in 1989, problems with quality meant some shipments were refused entry by the Food and Drug Administration.

At the height of the glove boom in 1988 the price was about US$80 per 1,000 pieces. It is now believed that prices will stabilise at about US$40-45. Malaysian manufacturers are being advised to be satisfied with marginal profits on long-term business and to concentrate on high quality. For a stable pricing structure, the new Association of Rubber Glove Manufacturers in Malaysia is proposing a standardised price index whereby the price of gloves will move in relation to the price of latex. The index would show the price of latex ranging from M$2 to M$6, against the price of rubber gloves from US$40 to US$90 per 1,000 pieces.

Quality will be the key to success for Malaysia, which has an edge over neighbouring competitors like Thailand and Indonesia because of good-quality latex and technical experience. In the long term, the small manufacturers may not be able to compete with the foreign giants in Malaysia, like Ansell and Baxter Healthcare, and industry experts believe that about 35 per cent of the 85 factories making rubber gloves, most of which are under-capitalised and lacking in technical expertise, will be forced to close.

Advantages

Both local and foreign manufacturers of gloves chose to set up in Malaysia because of the ample supply of quality latex. Malaysia is the world's largest producer, supplying 350,000 tonnes in 1988, of which only about 10 per cent was used for domestic manufacturing. Another incentive is the Malaysian government's discount of 20 per cent on latex purchased from agencies like MARDEC and FELDA. These attractions and the gloves boom have seen investment increase rapidly in the natural rubber product manufacturing sector. From M$160 million investment doubled to M$339 million in 1987 and shot up again to M$1.5 billion in 1988.

Nevertheless, there are drawbacks to producing in Malaysia. The small domestic market requires that companies penetrate export markets, but high freight costs are a deterrent. Malaysian manufacturers are unable to compete with Japanese and South Korean makers whose governments have made special arrangements with their shipping lines to transport finished rubber products at a fraction of international freight rates.

Although freight charges are a problem, the choice of tyres is still a logical one for the future since about 75 per cent of natural rubber is used in tyres and related products and about 67 per cent of world imports of rubber-based products consist of tyres. There is great potential for Malaysia in selling technologically sophisticated rubber tyres in mature markets like the US and Western Europe.

The advantages presented by local natural rubber supplies have been put to good use by Sime Darby's Dunlop Malaysia Industries Bhd (DMIB). It has achieved considerable success in overseas markets, exporting its brand name Simtex tyres to West Asia, Europe, Africa, Australia, New Zealand, Singapore and Indonesia since 1986. In 1989, competing on a worldwide tender, it won a contract to supply 30,000 bus tyres worth M$8 million to India. It clinched a similar deal with Nigeria to supply 20,000 truck tyres worth M$4 million. DMIB is investing M$40 million to expand and upgrade its plant near Kuala Lumpur. Sime's other tyre plant, Sime Tyres International (M) Sdn Bhd, is a joint venture with PERNAS.

Development plans

Malaysia's government-owned development corporation will spend M$100 million up to 1992 on high-technology equipment to modernise and expand its plant at Alor Star in

Textiles: a booming exporter and source of employment during the 1980s. Malaysian producers are set to move up market through a series of joint ventures and new investment

Kedah. Rubber manufacturing is a priority industry under Malaysia's Industrial Master Plan and thus qualifies for a wide range of incentives. The plan recommended, with the approval of the Malaysian cabinet, that in order to break into the world tyre market it would be necessary for Malaysia to acquire a leading rubber products manufacturer, preferably a tyre manufacturer, to gain access to the necessary technology, R&D and major markets.

The plan forecasts annual growth of the rubber products industry at 13.5 per cent during the plan period 1986-95 with tyres leading the way and accounting for just under 50 per cent by 1990 and just over 50 per cent by 1995. In 1988, however, tyre production and export fell well below the IMP target. The plan forecasts that domestic processing will reach 160,000 tonnes by 1990 and 309,000 by 1995. It said investments of M$1.4 billion and an additional 24,000 workers would be needed during the period 1991-1995. The target implies a much higher degree of productivity in the industry.

In prioritising the rubber products industry, the IMP established the main targets as overcoming the barriers to world markets and access to technology through Malaysian initiatives rather than foreign initiatives and decisions of multinational corporations; developing the entire rubber products industry, particularly tyres, as a major export-oriented industry; strengthening research activities in both downstream and plantation activities; and developing ancillary industries including synthetic rubber. In Malaysia's long-term industrialisation after the year 2000, rubber-based industries, particularly tyre-making, are projected to have the greatest promise.

Private sector companies also take a positive view of the outlook for the industry. Goodyear Malaysia Bhd expected to sell about M$160 million worth of tyres in 1989, helped by a breakthrough deal worth M$11 million with Japan to supply 100,000 Vector tyres, and another from Britain worth M$8 million for 18,000 radial steel Unisteel tyres. Its plant at Shah Aalam is the only one in Asia to produce Unisteel tyres which it also exports to Australia, New Zealand, Papua New Guinea, Bangladesh, Tahiti and the Philippines.

Rubber processing equipment

Malaysia's long history of rubber production has also encouraged the development of a rubber processing machinery industry. The leading firms involved are the General Electric Company of Malaysia Sdn Bhd (GEC), Guthries Industrial Malaysia Sdn Bhd and Kwan Cheong Engineering. Since the local industry has been saturated, and with many rubber growers turning to oil palm and other crops, the manufacturers of rubber processing machinery have turned to export markets. Sales of crushers, shredders, driers and hammermills have been made to producers in Thailand, Sri Lanka, Indonesia and in African countries.

Guthrie Industries, a wholly-owned subsidiary of Kumpulan Guthrie Bhd, has emerged as the world's largest manufacturer of rubber processing machinery and has supplied equipment from its wide product range to 20 countries worldwide. It also regularly undertakes turnkey operations. Only 30 per cent of its production is sold on the domestic market. GEC's turnover is about M$1 million annually, and it too supplies a complete range of equipment as well as undertaking turnkey projects. Kwan Cheong sells approximately M$2 million worth of rubber processing equipment annually, exporting 25 per cent of its products.

Other manufacturing

Manufacturing is overwhelmingly dominated by the export-oriented industries, particularly electronics and textiles, with rubber products taking an increasingly important role. Between them they represented almost 70 per cent of manufacturing licences granted in 1988. Other sectors with strong growth potential are wood products, plastic components and transport equipment. Downstream timber manufacturing has been slow to develop, whereas manufacturers in Singapore, Hong Kong and Taiwan have turned Malaysia's timber resources into a M$1 billion export industry. Malaysia is a massive exporter of timber and wood-based products, but furniture represents less than one per cent of timber exports. Similarly, the plastics industry has come in for criticism from companies like Matsushita which claims local products are not up to the mark. The chemical industry is still at an early stage of development with exports of M$130 million in 1987, but is ahead of the target set for it by the IMP.

Engineering

Malaysian Mining Corporation (MMC) has been a leader in developing engineering capabilities and facilities over three-quarters of a century. As the largest mining engineering group in Malaysia, MMC Engineering (MMCES) has developed and accumulated substantial know-how and skills in the design, construction and operation of dredges and processing plants.

MMCES was formed in 1984, since when it has successfully secured and completed engineering contracts for the oil and gas, railway, energy and defence industry in Malaysia. MMCES is spearheading MMC's thrust into three core areas of engineering diversification, namely equity investment, construction and project consultancy and management. MMC's renowned expertise in alluvial dredging technology is exported to other countries, such as Indonesia, Thailand, Brazil, Peru and Bolivia.

The main efforts of MMCES have been in tendering for engineering contracts and participating in suitable privatisation projects. Among the projects undertaken are the

PETRONAS Carigali Gas Terminal Project, conceptual design and detail engineering design of PETRONAS' Peninsular Gas Utilisation Project Stage II, Teluk Intan stabilisation project and the dieselisation of Commando Vehicles V-150/V-100 for the Ministry of Defence. MMCES' subsidiary MMC Gas Sdn Bhd secured the Engineering, Procurement and Construction (EPC) contract for the Peninsular Gas Utilisation Project Stage II. This EPC contract for 730 km of pipeline is worth some M$400 million and it will take three years to complete. MMCES, in joint venture with a well-established foreign partner, was also successful in securing a contract for the construction of 16 km of the North-South Expressway stretching from Gurun to Ladang Petani. MMC has also made inroads into railway engineering with its made-in-Malaysia bogies and wagons manufactured by MMCES for the Malayan railway.

Engineering workshops, steel foundry operations in Bradken Malaysia Berhad, repair workshop and laboratory facilities complement the group's move into fabrication, manufacturing and engineering services industries. MMC is also currently the second single largest shareholder in Sime Darby Berhad, a Malaysia based multinational group of companies, comprising business activities in the fields of plantations, tractors and heavy equipment, property development, tyre manufacturing as well as insurance and trading.

Small- and medium-scale industries

Malaysia's small- and medium-scale industries (SMIs) are beginning to get the help they need. They account for about 10 per cent of total industrial output and provide 16 per cent of employment in industry and manufacturing. Typically, SMIs are relatively poorly organised businesses with problems ranging from inadequate financial resources to lack of marketing knowledge, technical skills and understanding of government rules and regulations. Independent researchers estimate that half the new products introduced locally fail because of lack of quality, inadequate research and promotion.

Malaysia is looking closely at the achievements that Japan, Korea and Taiwan have made through their SMIs which – supported by help from the large firms – are credited with having successfully propelled them into industrialisation. The development of a successful SMI sector is considered important to the achievement of NIC status.

A realisation of the need to promote the activities of supporting industries followed Malaysia's economic slowdown in the mid-1980s. This demonstrated that SMIs created employment, reduced foreign exchange outflows through import substitution and provided support for bigger industries. Incentives and assistance are now being offered to SMIs on a more concerted basis as opposed to previous ad hoc methods. Small enterprises whose annual sales turnover of taxable goods does not exceed M$100,000 are exempt from sales tax. Banks are now required to reserve increased sums for loans to small-scale enterprises and "small-scale" has been redefined as businesses with paid-up capital of M$500,000 instead of the previous M$250,000. The 1989 budget offered a whole package of incentives, including automatic "pioneer" status; an increase in investment allowance from 40 per cent to 50 per cent; exemption from import duties on raw materials, components, machinery and equipment; a new abatement deal for large manufacturing companies that buy components from SMIs; preferential treatment in government purchases; and double deduction on training costs.

SMIs also benefit from loans for new investments in manufacturing at interest rates of less than 6.25 per cent from the ASEAN-Japan Development Fund loan scheme. Malaysia – the first country to take advantage of the scheme – will use the major allocation of its M$890 million share of the US$2 billion fund to help SMIs. Maximum loans will be M$20 million, but priority will be given to loans of M$5 million or less. Four financial institutions have been designated as disbursing agents, each to cater for specific sectors. The Malaysian Institute of Management has launched a small business management programme to help would-be entrepreneurs develop more sophisticated skills.

In 1989 the Ministry of Trade and Industry initiated a year-long study of the sector to help formulate government policy for the Sixth Malaysian Plan. The only real data available on the sector is from a study of 16,000 companies made in 1981. At the same time, the government has transferred the responsibility of small-scale industries from the Ministry of National and Rural Development back to the Ministry of Trade and Industry.

Heavy industry

While manufacturing overall has exceeded the goals of the IMP, heavy industry has failed to live up to the expectations and objectives of the IMP. The targets set for heavy industry were, in themselves, controversial in that they were based on the premise that a richer Malaysia could be created by leapfrogging from an agriculture-based economy into a fully-fledged industrial one.

The government's strategy towards the Heavy Industries Corp of Malaysia (HICOM) has changed in response to this perceived failure. HICOM is gradually being dismantled and private sector buyers are being sought to take over the non-financial public enterprises which are threatened with closure if they still remain unprofitable. Current large-scale industrial projects are still in train in petro-chemicals and a M$1.2 billion specialised steel project is being considered. But it is likely that the new Five Year Plan for the 1990s will place greater emphasis on the previously neglected small- and medium-scale industries.

Malaysia launched itself into heavy industry by setting up the 100 per cent government-owned HICOM in 1980 in the belief that Japan would have to reduce energy-intensive industries and there would thus be scope for Malaysia, with its oil and gas resources, to take up some of the slack and leap directly into the ranks of the Newly Industrialised Countries. With virtually no experience in heavy industry, HICOM's chiefs embarked on over-ambitious turnkey deals in heavy engineering with foreign partners.

Recession, a drop in commodity prices and the soaring yen conspired to send Malaysia's embryonic heavy industries towards failure before they had a chance to become well established. Three of HICOM's prestige ventures – to produce steel, cars and cement – typified the problems the sector was to encounter.

Steel

The most disastrous project was the M$1.2 billion integrated iron and steel project on the east coast. Perwaja Terengganu Sdn Bhd was incorporated in 1982 and the plant built on a 70 hectare site with annual production capacity forecast at 600,000 tonnes of sponge iron and steel billets using the direct reduction process. Perwaja is 51 per cent owned by HICOM, 30 per cent by Japanese companies led by Nippon Steel and 19 per cent by the Terengganu State Development Authority.

The plant has lost hundreds of millions of dollars since it went into production and the company has had to undergo continuous refinancing. Steel production started in 1985 but the plant has never operated effectively because of the failure of the direct reduction ore processing plant on which output depended. Nippon Steel tried to remedy the problem for over a year, before the processing plant was closed down early in 1987. The steel mill itself is working at only one-third capacity using imported scrap steel.

The plant has become a considerable financial drain because a 100 per cent appreciation of the yen against the ringgit has effectively pushed up interest rates on the repayment of the Japanese loans – ¥30 billion, plus M$66.5 million – to 18 per cent. Proposals submitted by steel companies in Japan, West Germany, the UK and Italy to turn the plant into a profitable venture are being studied by the Malaysian government.

Cement

HICOM's new cement plants, which had raised Malaysia's production total capacity from three million tonnes in 1981 to almost eight million in 1986, have faced the crucial problem of a lack of domestic outlets. They came on stream as the worst construction slump ever gripped the country. There are, however, prospects of improved demand for cement as the massive highway project gets under way.

Proton

As Malaysia's number one prestige project, the Proton car plant (see below), was readying for production start-up in 1985, car sales went into a swift decline from a high of 100,000 in 1983. A recovery to profit has since occurred and increased sales are forecast in 1989-90.

Other projects

A M$1 billion gas project in Labuan, which includes a briquetted iron plant and a methanol plant, is now producing according to target and seven of HICOM's smaller ventures are in the black. The group's three motorcycle engine companies, HICOM-Honda, HICOM-Yamaha and HICOM-Suzuki, have been making profits since 1987. A fringe benefit is that 60 local companies are now supplying parts for the Proton plant and the three motor-cycle manufacturers.

The motor industry

The buoyant economy of the late 1980s came to the rescue of Malaysia's motor trade which had been languishing in recession with losses and chronic over-capacity for four years. More particularly, it salvaged Proton Saga, the troubled government-owned national car company which was established at a time when Malaysia decided to make its leap into heavy industry. High domestic demand and a modest success in export markets have given Proton its first, albeit modest, profit since the controversial project went into business in 1985. The year ended March 1989 showed profits of M$32 million on the back of a 73 per cent

Exhibit 11.2

Market share of the top 10 passenger cars in 1988 (%)

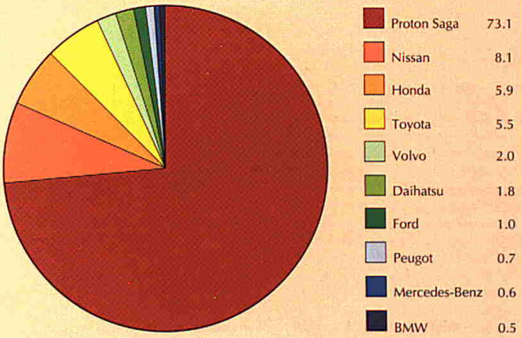


Exhibit 11.3

Number of motor vehicles per 1,000 population

US	732
Singapore	147
Malaysia	103
Thailand	25

domestic market share. The company expects profits to reach the M$100 million mark in 1989-90.

Losses in 1985 (M$10 million), 1986 (M$42 million), 1987 (M$39 million), and 1988 (M$58 million) forced Proton to venture into the export business ahead of the target date of 1990. Capacity of about 56,000 vehicles was not met by local demand, which slumped from a peak of 100,000 units in 1983 to 38,000 in 1987. With domestic demand recovering there is now less pressure on Proton to be aggressive in export markets where it has experienced some teething problems, especially in the coveted US market. Production targets of 100,000 units were set in mid-1989.

However, the industry still has problems. Vehicle assemblers are suffering because of an ever-decreasing share of the small domestic market through the heavy protection given to Proton, particularly its pricing advantage in the medium-range 1300cc to 1500cc class. They are also being threatened by the imposition of minimum quotas in line with the Industrial Master Plan (IMP) proposal which called for a shake-out in the industry before 1990. The government is proposing to terminate the licences of assemblers of medium-range vehicles producing less than 2,000 units per model a year which would drastically reduce the number of companies assembling cars, although "medium-range" has yet to be defined.

The Automative Federation of Malaysia (AFM) wants market forces to be the influencing factor and believes assemblers should be allowed to stay in business irrespective of how many units of a particular model they produce, as long as operations are profitable. The AFM, the umbrella body grouping the four associations representing motor traders, car and motorcycle assemblers and the motor spare parts traders, has made a counter-proposal recommending that assemblers who manufacture more than 300 units of any one model be allowed to continue. The government is not expected to make any decision until 1990, when a compromise is thought the likeliest outcome.

The industry believes the government is reneging on the target of the IMP which proposed a 55:45 split for Proton and non-Proton sales based on a market projection of 219,000 units by 1995 – a target now seen as being wildly over-ambitious. The plan also called for a "strategy of coexistence" between Proton and the other assemblers, but it also suggested a rationalisation of the existing assemblers. If the government were to institute its proposed minimum quota of 2,000 units per model, on the basis of 1988 production, it would knock half the existing assembly companies out of business.

Although Nissan, for example, has an 8.1 per cent market share, it assembles three different models, only one of which, the Nissan Sentra, fell into the 2,000-plus bracket in 1988. And at the lower end of the scale, the quota rule would mean that assembly of Volvo, Daihatsu, Ford, Peugeot, Mercedes Benz and BMW would have to be abandoned. The motor assemblers argue that as Proton has already well exceeded its IMP target of 55 per cent, the quota should be reduced from 2,000 to 300.

There are seven main assemblers. Tan Chong Holdings, the Nissan franchise holder, a major component manufacturer, went into production of its own engine in 1989. Toyota has a relatively large production of both cars and commercial vehicles. Kah Motors operates as the Honda franchise holder. Cycle & Carriage Bintang (CCB) is the franchise holder for the assembly and distribution of Mazda and Mercedes cars. Assembly is carried out at its own plant in Kelang – with investment of M$20 million in new tools in 1989 – and by Associated Motor Industries Malaysia (AMIM), a member of the Sime Darby Group. AMIM, 70 per cent owned by Tractors Malaysia, with the balance held by Ford of the US, assembles Ford vehicles as well as other makes for the franchisees of Suzuki, BMW, Land Rover and Mazda. Land Rover Malaysia, with a plant at Shah Alam, is a joint venture between Sime's Tractors Malaysia Group (60 per cent) and the Bapema Corp (40 per cent). It has a capacity of 800 units a year and its main customer is the Malaysian government. Ibis Automobile is the assembler for Peugeot cars.

For these assemblers, phase two of the IMP will be even more unpalatable. For the post-1990 period, the plan proposes that the number of manufacturers, including Proton, should be whittled down to three, a step it says can be achieved through mergers between Proton and some of the assemblers and between some of the assemblers themselves.

Traders projected sales of 82,000 passenger cars and commercial vehicles in 1989. Proton was expected to account for 46,000 cars out of a total of 63,000, other brands 17,000 units and commercial vehicles 19,000. The actual levels of demand have created a severe shortfall against the projections of the Industrial Master Plan which had forecast passenger car demand to reach 163,000 by 1990 and almost 220,000 by 1995.

The importation into Malaysia of complete vehicles is limited to 10 per cent of the number assembled and manufactured in the country. Approved permits (APs) are issued only to 100 per cent Bumiputera companies.

The Proton Saga

Perusahaan Otomobil National, or Proton, has accumulated losses in excess of M$100 million. Proton's success locally is largely due to the high tariff protection that forced up prices of competing models, but the Saga has been well received in overseas markets.

The Proton plant at Shah Alam near Kuala Lumpur has an installed capacity of 40,000 units a year on a single-shift operation and double that on a two-shift basis due to be introduced in the latter part of 1989. The plant was designed to be upgraded to 120,000 units a year. Proton's corporate general manager, Katsuharu Asao, who has been seconded from Mitsubishi Motor Corp of Japan, Proton's 15 per cent shareholder, said that

The Proton Saga. Disappointments with the level of domestic market have not prevented a home-grown auto industry establishing a firm foothold in world markets

increased production efficiency has allowed a single-shift capacity to reach 55,000 units. Local assembly of engines was due to start in mid-1989 to replace the importation of fully assembled engines from Japan.

Proton's major target market was the US. Under an agreement with Proton America Inc, whose parent company is Global Motors Inc, the US company was to get import approvals by November 1988 and to import 30,000 cars in the first year with an annual sales target thereafter of 100,000 units. However, Global Motors failed to get the appropriate federal and state approvals and the agreement was terminated. Proton is now looking for a new distributor in the US, but industry sources believe it will be a protracted affair to get the Malaysian-made cars into the US, which is recognised as being a particularly difficult market.

Undaunted by the US setback, Proton turned its attentions to the UK and Eire, where two shipments totalling 1,000 cars were soon sold after a number of changes were made to meet British safety and emission control standards. The vehicles were imported under GSP requirements which stipulate that to qualify for duty-free status, they must have a 60 per cent local component. Proton has a UK and Eire sales target in 1990 of 10,000 cars. Between its launch in New Zealand in mid-1987 and mid-1989, Proton sold about 300 cars there. The Proton Saga also has modest sales in Hong Kong, Macau, Bangladesh, Sri Lanka, Brunei, Jamaica and Malta and the company is looking at markets in Singapore, Taiwan and Papua New Guinea.

New policies

Under the stewardship of Finance Minister Daim Zainuddin, HICOM is gradually being dismantled with much of the management control being handed over to foreigners and local Chinese businessmen. The government's eventual aim is to privatise the corporation. Perwaja's director and general manager has been replaced by a private sector Malaysian Chinese businessman, Proton's executive director has been replaced by a Japanese executive from Mitsubishi Motor Corp, Proton's 15 per cent shareholder, and another Chinese businessman has been seconded from the private sector to run HICOM's Kedah Cement.

Daim has slashed government spending on all non-financial public enterprises (NFPEs). In 1984, the year he took over, they absorbed M$7.2 billion, or 42 per cent of public expenditure, as against M$2.5 billion in 1981 (18 per cent). Daim's cuts reduced the NFPE's expenditure to M$2.9 billion, M$3.7 billion and provisionally M$4.4 billion respectively in the financial years 1987, 1988 and 1989. However, in equity and external debt guarantees, the government is still exposed to the tune of almost M$20 billion.

Daim believes it is unlikely that any more public money will be committed to the loss-making NFPEs and has warned that if they cannot be turned round they will be closed. Ideally, private sector buyers will be found with the capital and management expertise – including foreign expertise – to make them profitable. Expansion in the petrochemicals sector is expected to make a significant contribution to improved performance.

Inward investment

PETRONAS' new venture into downstream petrochemical and plastics industries (see also Chapter 13) in a joint venture with Finland's National Oil Corp, Neste Oy, and Japan's Idemistu Petrochemical Co, represents one of Malaysia's current largest industrial projects. Scheduled for completion in 1992, one plant will produce methyl tertiary butyl ether (MTBE) and propylene and the other will produce polypropylene. Both plants will be located at the Gebeng industrial estate at Kuantan on the east coast. PETRONAS will have a majority stake in both projects which will cost a total of US$260 million. Another polyethylene plant has been proposed at Terengganu which would cost US$1 billion.

The projects, which will enable Malaysia to utilise its abundant natural gas for higher value added products, are projected to save M$6 billion in imports and gain M$1 billion in exports within a 15-year period after completion of the new plants. An estimated 240,000 tonnes of butane and 110,000 tonnes of methanol will be consumed annually for the production of 300,000 tonnes of MTBE, a flexible blending component used to replace lead in petrol. Another 100,000 tonnes of propane will be used annually to produce 80,000 tonnes of propylene. Because of the worldwide trend to reduce lead in petrol there is a ready-made market for MTBE. Refineries in Singapore and Malaysia are expected to be able to use 150,000-200,000 tonnes and the balance will be exported to the US, South Korea and Thailand.

The 80,000 tonnes of propylene yearly will be fully consumed as feedstock by the polypropylene plant which has production capacity of 80,000 tonnes. Demand for polypropylene in Malaysia is expected to reach 50,000 tonnes in 1990.

Johor is vying to be another centre for the petrochemical industry. A M$400 million petrochemical plant being constructed on a 32-hectare site at Johor's Pasir Gudang industrial estate will go into operation in 1990. The Asia Pacific Polymer plant is a Taiwanese investment from the parent company, China General Plastic Corp (CGPC) which has also proposed a M$1 billion naptha cracker complex on a 100-hectare site in Johor, representing the state's largest investment by a single foreign company. The two projects will produce polypropylene, ethylene and propylene for domestic consumption and export.

The London-based Metdist Group and its Malaysian subsidiary, Metrod (Malaysia) Sdn Bhd, a manufacturer of copper rods and wires, are building a M$110 million copper tube plant on a 10-hectare site at Shah Alam near Kuala Lumpur. The plant is expected to go into operation early in 1991 with an annual production capacity of 10,000 tonnes of highly-specialised thin-walled and inner-grooved copper tubes to meet growing demand primarily from the local air-conditioning industry. There is expected to be a small surplus for export. Mitsubishi Metal of Japan, one of the leading producers of such tubes, will have a stake in the venture. With annual production of over a million air-conditioners a year, Malaysia is one of the world's largest producers.

In other major industrial projects, Malaysia's Perdama Corp has agreed with the Chinese Metallurgical Construction Corp (MCC) to construct a high-tech steel plant costing M$30 million. The plant, to be located near Port Kelang, will be the first in south-east Asia producing stainless steel wire and other alloyed steel products. It will have an initial annual production of 3,500 tonnes of which 95 per cent will be exported.

MCC has also been involved with the giant West German Thyssen Group to produce a preliminary study for the setting up of a M$1.17 billion cold roll mill complex. The study has gone to HICOM and, if accepted, MCC and Thyssen will probably be joint venture partners in the private sector to produce 600,000 tonnes of steel coils, steel plates and galvanised sheet. Half of the production would be consumed locally and half exported, mainly to China and West Germany.

Malaysia will spend M$700 million during the next five years (from 1989) to develop its foundry industry, M$500 million on a foundry and engineering park in Selangor and M$200 million on a similar project in Perak. The parks, the first of their kind in south-east Asia, will be equipped with facilities for research and development and testing.

Pfizer Malaysia, a wholly-owned subsidiary of the US Pfizer Corp, is planning to set up a plant to manufacture pharmaceuticals and industrial chemical products by 1992. Pfizer Malaysia ranks fourth in the local pharmaceutical industry, worth about M$350 million, after Glaxo, Sterling and Warner-Lambert.

The canning industry has been given a boost with the opening of the Malaysian Can Co's M$46 million plant in Bangi, Selangor with an eventual capacity of 293 million beverage cans a year. 200 million beverage cans a year are intended for export, worth about M$60 million. The other big can-maker in Malaysia is Kian Joo Canning Factory.

Together the two plants are presently producing about 200 million cans annually, but there are about 20 smaller manufacturers of other types of can. A problem for manufacturers is that the only supplier of tin-plate is Perstima, whose installed annual capacity of 90,000 is 30,000 tonnes less than demand. Manufacturers can import supplies but all documentation must come from Perstima and the monopsonistic situation is a source of considerable dissatisfaction in the industry.

Chapter Twelve

Agriculture and forestry

Structure and diversification

Nourished by almost daily rainfall (annual average 200-250 cm), hot and humid throughout the year (average temperature 27°C), Malaysia is a tropical hothouse, rich in natural hardwood forests which cover more than 50 per cent of the total land area on the peninsula and even more on Sabah and Sarawak. About 11.6 million hectares, or 35 per cent of Malaysia's total land area, is suitable for agriculture. Of these, 6.33 million hectares are on Peninsular Malaysia and 2.1 million and 3.2 million hectares in Sabah and Sarawak respectively. About 80 per cent of total cropped land is under rubber, oil palm, cocoa and coconut and about 10 per cent is under rice.

Agriculture contributed 24 per cent of GDP in 1979, but its contribution has been falling steadily and is expected to decrease to 18 per cent by 1990. It accounted for 1.91 million jobs or 39.7 per cent of total national employment in 1980 – a proportion which is expected to fall to about one-third by the end of the Fifth Malaysian Plan period ending in 1990. Even then, it is still expected to provide some two million jobs.

The agricultural sector is unusual in that there is a shortage of more than 7 per cent in the numbers of plantation workers, despite overall unemployment around 8 per cent. This has been one factor in rising production costs in rubber and palm oil over the past decade. Shortages are acute on palm oil estates, as a result of which unharvested crops are causing serious losses, estimated at M$24.3 million for palm oil and M$17.2 million for rubber in 1987. As many as a million illegal immigrant workers from Thailand and Indonesia are employed to keep the problem under control.

Unemployed urban workers are reluctant to move to the estates where housing and social and welfare amenities are inferior. Equally, the children of plantation workers often prefer to migrate to the urban areas. Malaysia sees the solution in the increasing use of labour-saving techniques for field maintenance, harvesting and processing.

Agriculture has been characterised by an efficient estate sub-sector engaged in export-oriented production of tree crops and less well organised smallholders engaged in tree crops, food crops and mixed farming. The demarcation is blurred by the emergence of an increasingly efficient and organised smallholder sub-sector under the administration of public development agencies. These three sub-sectors create a disparity in the levels of efficiency, productivity, competitiveness and income.

Because of these problems and dependence on a narrow base of tree crops, the Malaysian government initiated an analysis of agriculture policies and strategies in the early 1980s resulting in the formation of the National Agricultural Policy (NAP) which was aimed at ensuring a balanced and sustained rate of growth in the agricultural sector. The NAP switched the emphasis of agricultural development from a strategy of creating a prosperous peasantry, which had been in place since the early 1960s, to a structural transformation involving the modernisation and commercialisation of the smallholder sub-section through larger scale production units and increased participation of the private sector. Efforts to revitalise the agricultural sector are expected to begin to have an impact by the mid-1990s. Government programmes and incentives designed to encourage increased private sector participation are targeted at the big players as well as entrepreneurs with medium-scale operations.

In the development of its major agricultural commodities, Malaysia has learnt to cope with wildly fluctuating prices. Because of the uncertainties of prices and climate, Malaysia has sought to diversify rather than resort to the radical crop-switching of earlier years. In the 1970s, for example, millions of hectares of rubber trees that had come to the end of their productive cycle were destroyed and the land was given over to the planting of oil palm, profits from which were soaring up to four or five times higher than rubber. Yet by the end of the 1980s the price pendulum had swung back and rubber was the star performer, netting M$5.25 billion out of Malaysia's total commodity earnings in 1988 of M$23.4 billion. Again, in the early 1980s, the price of cocoa overtook that of oil palm, while by the end of the 1980s the cocoa market was in bad shape because of over-supply. Over a long time scale, oil palm on a per hectare basis has out-performed rubber in profitability terms. The total hectarage under rubber is still larger than that under oil palm.

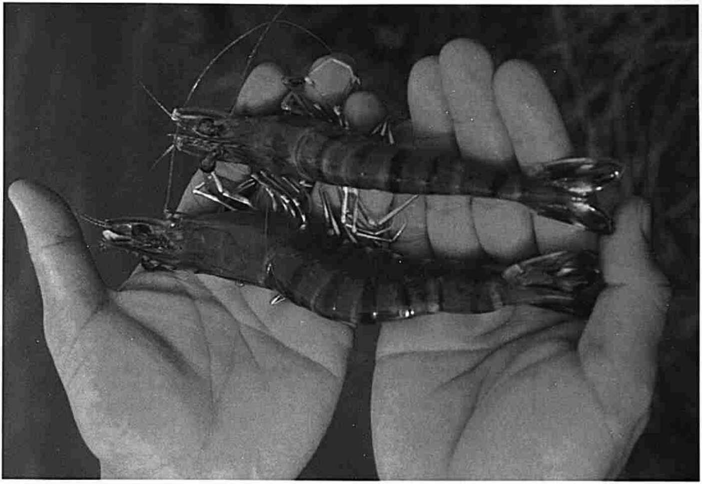
The diversification strategy has taken Malaysian agriculture into the production of fruits, fish and livestock both for domestic consumption and export. A wide array of incentives offered to the agricultural sector in the 1986 budget led to a strong surge in start-ups, from 23 projects valued at M$90 million in 1987 to almost 100 projects worth M$500 million in 1988. The value of exports from meat processing, including frozen chicken, is projected to grow from M$3.1 million in 1981 to M$42.6 million in 1995 at an annual average rate of 19 per cent.

Prawn aquaculture and fruit cultivation have attracted the most private sector interest and there have been substantial investments in integrated poultry farming, with corporate giants like Innovest and Gold Coin featuring strongly. The result has been exports of 60 million chickens worth M$150 million in 1988 and a breakthrough into the important and stringent Japanese market.

The contribution of aquaculture to the total production of fish in the country amounts to about 10 per cent, valued at approximately M$50 million annually at the end of the 1980s. The area of freshwater fish culture has increased steadily to 2,600 hectares of fish ponds. Projected production is 136,000 tonnes of fishery products by 1990, increasing to 206,000 tonnes by the year 2000. In addition to freshwater fish, land use for the production of marine tiger prawns more than doubled in the 1980s to over 1,000 hectares. It is a high value/high risk business. Kumpulan Guthrie, for example, pulled out of a privatised aquaculture venture in Johor after incurring substantial losses.

One problem in diversification into aquaculture is that major commercial ventures are often decided on the basis of inadequate R&D and given up with equally little consideration. The big companies currently involved are the Lion Group, East Asia Marine, Ternakan Marine and Holcom. Of the major markets, the nearest is Singapore where both live and chilled tiger prawns are in demand. Others are Japan, the US and Europe. Exports from Peninsular Malaysia and Sabah totalled about 1,100 tonnes in 1988 and were projected to increase by an estimated 10-15 per cent per annum.

Exports from fruit cultivation totalled 125,000 tonnes valued at M$78 million in 1988 and are expected to reach a value of M$90 million in 1989. The major producing areas in Malaysia are Johor, Perak, Kelantan, Kedah and Terengganu. The majority of fruits are still exported to the traditional markets of Singapore and Hong Kong. The industry in Malaysia is now only just starting to take a serious look at markets further afield such as Japan, Europe and West Asia (although Europe has long been a big importer of Malaysia's star fruit which does travel well). There are numerous obstacles still to overcome: market acceptance, the high cost of freight, technology and packaging. The alternative to expensive air freight is shipping, but Malaysia has not yet advanced sufficiently in the packaging technology necessary to extend the shelf-life of her fruits. To be acceptable in Japan, fresh fruits have to undergo vapour heat treatment, but the Japanese-made equipment is



expensive, about M$1 million for one unit. Post-harvest handling practices also need to be improved. Storage and packaging methods to facilitate long-distance transportation at cost-efficient prices need to be worked out.

Malaysia's Federal Agricultural Marketing Authority (FAMA) targeted Holland, West Germany, the UK, Denmark, Sweden and France in Europe, and Saudi Arabia and the United Arab Emirates in the Middle East, for an export campaign it launched at the beginning of 1989. The growing interest in fruit cultivation in Malaysia stems from the depressed levels of palm oil and rubber of the mid-1980s and scarcity of labour, making diversification into crops that use less labour attractive. There was also recognition by the plantation groups and corporate land-owners of the need for diversification, but in some cases diversification became an aim in itself with the original reasons for it forgotten.

Prawn aquaculture is one example of the diversification of agriculture to meet the challenge of new markets

Palm oil and rubber

The "big three" of palm oil, rubber and timber are still the most important products of Malaysia's agricultural economy. Rubber and palm oil alone, with estimated export earnings of nearly M$10 billion in 1988, surpassed the combined export earnings from oil and gas. Cocoa, which has only been grown in Malaysia for just over a decade, is expected to play an increasingly significant role.

As the Malaysian economy is a market-oriented one, the thrust of investment decisions are made within the private sector, particularly with the government's emphasis on privatisation and deregulation. At best the government can inspire the private sector by showing the strategic direction industries should take and inducing potential investors towards such direction by guidance and incentives.

The private sector will increasingly be encouraged to invest in agriculture, particularly in the production of food and the development of new land. The production of food is encouraged in view of the high import bill, while involvement in new land development is based on the need to exploit the expertise in management and other resources of the plantation companies.

Rubber

Rubber is a not a native of Malaysia. The industry began a hundred years ago when the director of Singapore's botanical gardens, H.N. "Mad" Ridley, started experimenting with rubber seeds that had been brought from the Amazon and persuaded some planters to try the crop out. It was an immediate success and rubber estates were planted throughout Malaysia to meet soaring demand created by the fast-growing automobile industry in the West and by the First World War. Since then, Malaysia has continued to be the major world producer.

Malaysia now produces 70 per cent of the world's supply of latex concentrate – 58,100 tonnes in 1988 – which is used in the manufacture of medical gloves and condoms. Output of natural rubber grew by 3.5 per cent from 1.58 million tonnes in 1987 to a record level of 1.61 million tonnes in 1988. Production from Peninsular Malaysia constitutes 96 per cent of the total, and more than two-thirds is grown by smallholders. The total area under rubber cultivation amounted to approximately 1.87 million hectares at the end of 1988. Rubber output is expected to increase marginally into the early 1990s, although hectarage is projected to decline.

Malaysia contributes a third of the total world natural rubber production and is expected to remain the leading producer for the next few years with the possibility of being overtaken by Thailand by about the turn of the century. Total worldwide production of elastomers increased to an estimated 14.27 million tonnes in 1988, approximately one-third of which represents natural rubber (NR) production, while the balance is made up of synthetic rubber.

Long-term estimates of world demand beyond 1990 vary according to the methodology used. A median estimate suggests demand will be about 17 million tonnes by 1990, 18.5 million tonnes by 1995 and 20 million tonnes by the year 2000. Tyre products are expected to account for about 74.3 per cent of world demand by the year 2000.

Costs and sales

With labour costs increasing, the long-term viability of the rubber industry sector hinges on cost-effectiveness and competitiveness. Measures to minimise production costs have been intensified through planting of high-yielding clones which need tapping only once in every three to four days compared to the previous one to two days. With labour representing 49 per cent of production costs, efforts are being undertaken to mechanise tapping and collection and through the use of a different tapping system which increases yields by 30 per cent. The dilemma for the rubber industry is that techniques to improve labour productivity are often not developed because they often fail to bring the expected returns.

Singapore is the major buyer of Malaysia's rubber, taking about 13 per cent of all exports. Korea is the second major market, taking 10.6 per cent, followed by US (7.9 per cent) and China (6.7 per cent). With the increasing efforts to develop rubber processing industries in Malaysia (see Chapter 11), however, it may well be that more consumption will take place domestically.

Palm oil

Structure of production

Like rubber, palm oil is not a native of Malaysia. It was introduced from West Africa as an ornamental plant in 1875. Estates were developed between the 1920s and 1950s, but palm oil had little economic significance until the 1960s. Today, with almost 2 million hectares of land under oil palm it is a vital element in the economy contributing more than 10 per cent of Malaysia's GNP. More than 60,000 rural families work in related government land schemes and 250,000 agricultural workers on estates and smallholdings. The industry is seen as playing a significant role in the government's effort to eradicate rural poverty. Unlike rubber, palm oil is an estate crop with about half of the country's production under private estate management and 30 per cent under the Federal Land Development Authority (FELDA).

Production of palm oil was virtually unchanged in 1988 at just over 4 million tonnes. Good weather brought higher yields and an additional 120,000 hectares entered production for the first time. The projection is for production to keep rising and to pass the 10-million tonne mark by 1999.

Malaysia is currently the world's biggest producer but could eventually be overtaken by Indonesia. At present, however, Indonesia's high level of domestic consumption means that it is also a major customer for Malaysian palm oil. Imports rose by 73 per cent in 1988 to 265,000 tonnes.

Export markets

Until 1974 exports were all in the form of crude palm oil and major markets were the EC countries, the US, Japan and Iraq. Since then Malaysia has diversified its markets to include India, Pakistan, Bangladesh, China, West Asia, Africa, Eastern Europe and East Asia with exports to more than 50 countries. Following the removal of a ban on palm oil, Iran, which imports 600,000 tonnes of edible oils annually, is likely to become a major buyer.

India is currently the single largest importer, buying 754,219 tonnes in 1988 (17.4 per cent of production), followed by Indonesia and then China, where imports jumped 147 per cent to 212,000 tonnes. Egypt's imports increased by a huge 218 per cent to 114,000 tonnes. The US is a relatively small market, in which Malaysian exports have faced strong lobbying pressure from the American Soybean Association and the National Heart Savers' Association.

Palm oil is expected to corner the major share in the world's oils and fats market by the year 2007 when consumption is forecast to reach 118 million tonnes. One leading authority, Dr Siegfried Mielke, expects palm oil's world market share to rise from 11 per cent in 1987 to 20 per cent by 2007, overtaking soybean oil.

The greatest rivalry to Malaysia's position as a supplier will eventually come from Indonesia, where production is projected to increase from 1.38 million tonnes in 1985 to 5.2 million tonnes in the year 2000 and 7.1 million tonnes in the year 2007. Indonesia has been increasing its palm oil growing area by more than 100,000 hectares a year for several years, but has generally fallen marginally short of achieving its targets. Malaysia's target is to produce seven million tonnes of palm oil by 1995 which necessitates having the present 2 million hectares under mature palm.

Forestry products

Structure of production

The commercial establishment of forest plantations started in 1957 in Peninsular Malaysia with the planting of teak in the northern states of Perlis and Kedah. The total forested area of Peninsular Malaysia is 6.4 million hectares, Sabah has 4.5 million hectares and Sarawak 9.4 million hectares – 76 per cent of its total land area. Forestry provides jobs for about 180,000 people in Malaysia.

Increasing consumption has been met with a government programme of fast-growing tropical timber replantation. This, known as the Compensatory Forest Plantation Project, aimed at establishing 188,000 hectares of forest plantation on the peninsula within 15 years.

The total cost of the project is estimated to be M$517 million, involving the planting of fast-growing species like acacia mangium, gmeline arborea (yamane) and albizzia falcataria (batai). Timbers of these can be respectively used as pulp biomass, saw logs and blockboard. In addition it is estimated that an average of 1.66 million cubic metres of rubberwood logs will be available annually during the 1988-2005 period. This will still represent a shortfall as wood-based industries step up their activities with requirements of an estimated 10.06 million cubic metres during the 1986-2000 period. The shortage is being overcome by shipments of logs from Sabah and Sarawak, but cost is a governing factor with stiff competition from Japanese buyers. The result could be a rationalisation of the industry on Peninsular Malaysia.

For the moment, Peninsular Malaysia's annual logging volume of natural forest is set at 8.2 million cubic metres between 1988 and 1993. This level will be reduced by 41 per cent after 1995. From 1995 to 2010 permissible logging on the peninsula will remain stable at 4.8 million cubic metres and it will decline thereafter. The lower supply from natural forest will be compensated by logs from forest plantations and the supply of rubber wood. The current forest plantation should give a yield of 0.19 million cubic metres in 1998 and from the year 2009 onwards annual net production is targeted at 2.1 million cubic metres. The plantation industry is also thinking about compensatory forest and some pilot planting has been started.

Environmental concern

Growing concern internationally over the depletion of the Malaysian tropical rainforest has provoked the government into setting up a task force. This is composed of officials from the Malaysian Timber Industry Board, the Forest Research Institute of Malaysia and the government's Forestry Department. The task force will collect data on forestry development and operations to counter claims that Malaysia is not adhering to its stipulated annual coupe – the area permitted to be logged. This totals 438,200 hectares under the Fifth Malaysian Plan (1986-90) and comprises 71,200 hectares in Peninsular Malaysia, 181,000 hectares in Sabah and 186,000 hectares in Sarawak.

The task force will examine claims by environmentalist groups in Europe like Friends of the Earth which are pressing for a total ban on logging. There is already pressure in the Netherlands, which consumes about 48 per cent of Malaysia's timber exports to EC countries, for local municipalities to ban the use of tropical hardwoods for housing projects. The Malaysian government claims it has one of the best forest management programmes in the world, but concedes there are still cases of intensive logging by the private sector and nomadic tribes, particularly in Sarawak. It faces the arguments of critics who contend that there is no real proof that forests will regenerate and that the methods used to log them "economically" are very destructive.

Exports

The concern over environmentalist pressure is all the greater because timber and forestry products have become Malaysia's top-performing non-fuel commodity sector, generating about M$6.84 billion in 1988. Exports are expected to continue to play a major part in the industry, with world consumption of sawn wood likely to grow by about 2.5 per cent annually in the period 1985-2000 and growth in the developing countries of closer to 4 per cent. A little over half of the total exports were round logs, with the balance coming from sawn timber, plywood, veneers, mouldings and furniture.

Japan buys more than half of Malaysia's log production of about 20 million tonnes annually, while Singapore is the biggest market for sawn timber, buying about a quarter of an annual output of 2 million tonnes. China, which builds about 10 million houses annually, is seen as a future major market. Malaysia is already the major supplier of China's annual hardwood imports of almost a million cubic metres, but faces strong competition from cheaper logs exported by Papua New Guinea, Western Samoa and the Solomon Islands.

Malaysia is seeking closer cooperation with Singapore in the development of the timber industry. Singapore, one of the region's major exporters of furniture to the US, the world's largest market, can provide Malaysia with expertise and technology for downstream development. Because Singapore is increasing levies on labour-intensive industries such as furniture making and sawmilling, Singapore's wooden and rattan furniture manufacturers are looking for overseas locations with Malaysia being the obvious choice.

Apart from Singaporean companies, others from Europe, Japan, Taiwan and Korea are keen to participate in the downstream development of the industry. The industry in Malaysia is at a stock-taking phase, relatively backward and prepared for a second wave of growth which will depend on foreign investment for expansion, modernisation and technology transfer. Particular emphasis will be on maximum utilisation of wood-waste and the use of less-known species.

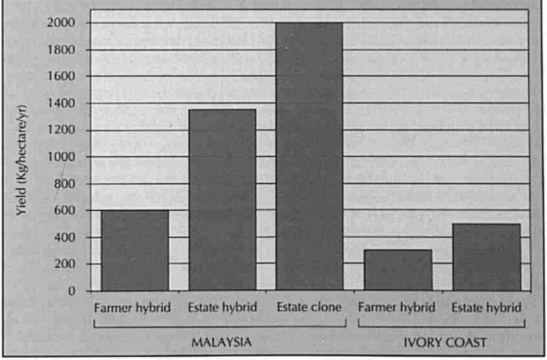
Cocoa

Structure of production

Cocoa only became a commercial crop in Malaysia in the 1950s when African cocoa suffered a virus disease and commercial-scale cocoa was first grown in Terengganu. In the

Exhibit 12.1

Maximum cocoa yield comparison



early days the crop was very susceptible to disease, but the situation improved with extensive research and the introduction of new germ-plasm. It was found to grow well on the west coast of the peninsula and in the Tawau area of Sabah. But even as late as the mid-1970s Malaysia was an insignificant producer of cocoa with 50,000 hectares under cultivation.

Today 357,000 hectares are planted with cocoa which has seen a spectacular increase in Sabah, which produces 60 per cent of the Malaysian crop. The area under cultivation has increased from less than 15,000 hectares to almost 200,000 hectares in little more than a decade. Malaysia's production of 210,000 tonnes in 1988 made her the world's third largest producer, accounting for 11.2 per cent of world production, behind the Ivory Coast (31.5 per cent) and Brazil (16.5 per cent) and slightly ahead of Ghana. 77 per cent of production was from estates and the remainder from smallholders. Unlike palm oil and rubber, cocoa requires more care, pruning and fertiliser. Because of these factors, and because it can be integrated with other crops such as coconut and fruit trees, it is considered an ideal smallholder crop.

There is a wide discrepancy in yields between estates and smallholdings and an urgent need for rehabilitation. Substantial amounts of disease-prone, low-yielding seedlings which give a non-uniform bean size were planted following the shortage of planting materials during the 1970s when high cocoa prices triggered a rush to plant the crop.

Prices and exports

Cocoa prices have been depressed because of a long-term world glut, and cocoa is no longer an exciting crop. Growth in the foreseeable future will be nothing like the huge increase in output of the first half of the 1980s which averaged 23 per cent a year. Prices have been kept low because of estimated stocks of 800,000 tonnes, equivalent to half the annual world production, and growth in Malaysia will certainly be slower. Low yields and quality aggravate problems, and the high cost of inputs may mean planters having to cut back on fertilisers. A shortfall in production of 255,000 tonnes was expected for the 1988/89 season.

Cocoa prices in the early 1970s hit M$10-12 per kilo but from a peak in 1984 prices slumped to M$2.4 towards the end of 1988. They have been fluctuating between M$3 and M$4 per kilo and over-supply means that there is little sign of an improvement.

Despite the less buoyant world position, the Malaysian cocoa industry has, however, performed well in the sheer volume of its growth and contribution to the economy in barely a decade. The value of exports grew from M$35 million in 1975 to M$409 million in 1985. The Netherlands and West Germany are Malaysia's major markets, each taking about a third of production, while Singapore is another major buyer.

Other agricultural produce

Pepper. A world surplus towards the end of the 1980s resulted in a drop of earnings from M$159 million in 1987 to M$150 million in 1988, despite increased exports from 14,000 tonnes in 1987 to 17,000 tonnes in 1988. The low price of pepper is expected to continue into the early 1990s because of increased production, primarily in India. Malaysia grows about 14 per cent of the world total supplies.

In the area of research and development, efforts are being directed towards yield and quality improvements. Apart from the development of high yielding strains, research efforts are also being undertaken to improve agronomic practices and post harvest technology. Almost all of Malaysia's pepper is grown in Sarawak, with a little coming from Sabah and Johor. The total cultivated area in 1988 amounted to 8,622 hectares. It is grown by approximately 40,500 smallholders and production is expected to increase annually by about 17 per cent.

Tobacco. About 70 per cent of the tobacco planted in Malaysia is located at Kelantan, 20 per cent at Terengganu and the remaining 10 per cent in Kedah, Perlis, Pahang, Melaka, Negeri Sembilan and Johor. It is grown by about 46,000 smallholders with another 32,000 workers at 260 curing stations. Land planted under tobacco declined by about 20 per cent to 9,700 hectares in 1988 because of the significant reduction of nearly 30 per cent in the production quota for cured tobacco leaves in 1988. Total earnings of the sector were about M$100 million in 1988, a decline of 27 per cent from the previous year.

Pineapples. Production achieved an estimated 10 per cent growth at the end of the 1980s, despite small reductions in total planted area. The growth was due to a remarkable 75 per cent increase in yields achieved by the Pineapple Cannery of Malaysia following the adoption of a new planting system which enabled the company to increase planting density from 14,500 plants to 22,000 plants per acre. The estate sector accounted for 87 per cent of total pineapple production of 143,600 tonnes in 1988. Similarly, the smallholder sector achieved an almost 10 per cent rise in production due to better yields. Major markets for Malaysia's canned pineapples are West Asia, the US, the UK and Japan. Exports of canned fruit and juice were valued at an estimated M$60 million in 1988, and exports of all varieties of fresh fruit at M$78 million.

Food processing

Malaysia spends about M$3 billion annually on food imports. Food processing lags far behind agricultural production and has been identified as a priority area under the IMP with the aim of establishing export-oriented and import-substitution enterprises. The industry presently faces a number of problems, including a low level of research and development and technological application, which in turn create a quality control problem. There are problems of scale and competitiveness in export markets. Additionally the industry has problems of raw materials.

Contrary to the common belief that the food-processing industry is a resource-based one, about 70 per cent of the industry's raw materials are imported – the raw materials for flour milling, sugar-refining, dairy product factories, animal feed mills and beverage manufacturing. Given sufficient investment in R&D, many of the raw materials could be produced in Malaysia. Even in the areas where domestic raw materials are available, such as fresh fruit, cocoa, vegetables and fish, the industries face either shortage problems or genetic quality problems. Thus the challenges facing Malaysia are to solve the raw materials problem, improve the quality of products and reduce manufacturing costs in order to be competitive on local and overseas markets.

Cocoa products, fruit and vegetables and animals feeds have been identified in the IMP as priority industries. Output of the sector is expected to grow to M$9.6 billion in 1995 or 2.3 times the 1981 level with rapid expansion in dairy products, animal feeds, meat processing and cocoa products. Exports are expected to grow to M$1.2 billion while imports are to be controlled at about the same level as exports.

The plan envisages the fastest export growth in cocoa products, growing from less than M$50 million in 1981 to about M$500 million in 1995, enabling Malaysia to gain a significant share, as high as 18 per cent, in the world's cocoa products market. In 1981, the share was just 1.7 per cent.

The plantation companies

Most of the big plantation companies have long since diversified into manufacturing and other activities to add value to their raw materials, but as their roots lie deeply in the estates business, it is appropriate to look at them in the agricultural context. Harrisons Malaysia Plantations, for example, with one of the largest plantation acreages in Malaysia, has been widening its activities over the past four years with downstream activities in the manufacture of rubber and coconut products and oleochemicals. A manufacturer of rubber gloves, it planned to increase capacity to 120 million pieces for the year ending 31 March 1990.

Boustead Holdings, with plantations accounting for 90 per cent of its profits, has interests in trading and shipping. While the core business of Kumpulan Guthrie Bhd is still in plantations, the company has diversified into property development, the manufacture of road surfacing products and rubber products. Its subsidiary, Highlands & Lowlands Bhd, has gone into property development. Sime Darby, the largest private corporation in ASEAN, with a market value of over M$5 billion, is the uncontested leader in diversification with activities in almost all economic sectors in Malaysia. Internationally, it is a wholesaler in Hong Kong, makes steel furniture in Australia and cardboard in Singapore.

Many of Malaysia's big plantation companies are household names the world over. Created in the colonial era, carved from jungle, swamp and hillside, most of the giant estates of rubber and oil palm were eventually wrested from foreign ownership, sometimes painfully and controversially. Sime Darby had a colourful evolution, created in 1910 by a Scottish adventurer, William Middleton Sime, and an English gentleman, Henry Darby, who began by managing a 202 hectares of rubber estates in Melaka. Sime Darby's diversification started early; by 1915 it had already expanded into general trading and, soon afterwards, went into the heavy equipment business. Sime Darby had been a relative newcomer. Another Scotsman, Alexander Guthrie, had founded his plantation company almost a century earlier in 1821.

Harrisons Malaysia Plantations Bhd

Harrisons has diversified into the examination glove business through a joint venture between its subsidiary, Tegas Setia, with Hong Kong-based Dah Lee Rubber Industries. The factory has three production lines with a total capacity of 90 million pieces and an additional four lines will increase production to 210 million pieces in the early 1990s.

By the end of 1989 Harrisons will have started on its first property venture, a 286-hectare housing estate in Kanjing which will be developed over a 10- to 15-year period. Also in the pipeline are housing estate projects in Kelang of 67 hectares and another in Petaling Jaya of 40 hectares. The group is also looking at converting some of its estates near town areas to property development projects.

HMPB owns 120,000 hectares of plantation land and is seeking to increase its hectarage. Purchase of the 248-hectare Kochin estate in Sabah for M$3 million gave the group a total of 12,073 hectares under cocoa. Harrisons' planted area under oil palm is 54,253 hectares and it has 34,681 hectares under rubber.

Harrisons' main shareholders are Permodalan Nasional Bhd, Pemegang Amanah Raya Malaysia and Sekim Amanah Sahim Nasional. Harrisons was Malaysianised in 1983 when PNB acquired 50.49 per cent equity at a cost of M$700 million from Harrisons Malaysian Estates.

With improving prices of rubber and palm oil (1988/89 profits of M$200 million) Harrisons has the largest paid-up capital on the Kuala Lumpur Stock Exchange of M$846 million.

Sime Darby Bhd

Sime Darby is the bluest of Malaysian blue chip companies and the most diversified with a market value of M$5 billion. The largest private business conglomerate in the ASEAN region, it is the only Malaysian company that – with operations in 12 countries – can really claim to be a multinational. One of the oldest companies in Malaysia, over the past eight decades Sime Darby has invested in plantations, manufacturing, property development and ownership, heavy equipment, general and life insurance, petroleum-related activities,

All the big diversified plantation companies have their roots in agriculture

trading and motor vehicles. With the exception of mining and banking it spreads across all sectors of the Malaysian economy. Sime owns 200 subsidiary and associated companies in Malaysia, Singapore, Hong Kong, Britain, Australia, the US, Brunei, Thailand, Macau, the Philippines, Indonesia and Japan.

The group has controlling interest in four Malaysian publicly listed companies, namely Consolidated Plantations, DMIB (a tyre manufacturing company), Tractors Malaysia (heavy equipment) and United Estate Projects (property development and ownership). Its activities range from the exploitation of forest concessions, edible oil processing, restaurants, advertising agencies, a medical centre, cinemas, car rental, battery

Exhibit 12.2

Projected aggregate supply and demand for Malaysia's food processing industry, 1985-95 (M$m, 1981 constant values)

	1985	*1990*	*1995*
Domestic demand	5,631.6	7,414.6	9,793.9
Exports			
Meat processing	7.6	23.1	42.6
Dairy products	43.4	60.8	85.3
Fish products	199.0	209.2	231.0
Processed cereals and cereal preparations	30.5	42.8	60.0
Fruit and vegetables	69.2	72.7	88.4
Coconut products	12.9	14.2	18.1
Sugar and confectionery	75.2	71.5	68.0
Coffee, cocoa, tea and spices	106.7	252.3	500.7
Prepared animals feeds	0.1	0.1	0.1
Misc. food products	32.6	45.7	73.6
Beverages	30.5	33.5	36.4
	607.7	825.9	1,204.2
Total demand	6,239.3	8,240.5	10,998.1
Local production	5,305.4	7,043.6	9,576.1
Imports	933.9	1,196.9	1,422.0
Total supply	6,239.3	8,240.5	10,998.1
Ratios (%)			
Export/production	11.4	11.7	12.6
Import/domestic demand	16.6	16.1	14.5

Source: Industrial Master Plan

Exhibit 12.3

Crop-mix on Guthrie plantations

	1967		*1977*		*1988*	
	Hectares	%	*Hectares*	%	*Hectares*	%
Rubber*	60,060	84	39,330	51	31,791	29
Oil palm*	11,091	16	37,672	49	69,778	65
Tea	328	0	367	0	152	0
Cocoa	–	–	–	–	4,272	4
Coconut	–	–	–	–	1,736	2

* Includes hectarage (7,821 of rubber and 15 of oil palm in 1988) at Guthrie Plantations Liberia Inc, a wholly-owned subsidiary.

and waste disposal equipment manufacture, travel agencies, rice importing and trading, shipping agencies, computers and furniture.

Seen as a barometer of Malaysia's growth, Sime's progress towards the end of the 1980s augurs well for the economy. 1988 profits were almost M$500 million, 50 per cent up on the previous year. Among the major shareholders are Malaysian Mining Corp, PNB, Pemegang Amanah Saham Malaysia and the Kuwait Investment Office.

On the plantations side Sime has almost 70,000 hectares with a breakdown of 70:20:10 for oil palm, rubber and cocoa. It also has a fruit tree development project of 200 hectares. Of its various divisions, Sime's plantations have traditionally been the most profitable, but all of the group's activities with the exception of domestic property development and activities in Australia have steadily increased in profitability. Sime is very active in R&D and has carried out extensive research to achieve better quality and flavour in cocoa production.

While plantations have remained the heart of its operations, the group is moving decisively into downstream resource-based manufacturing with investment of M$100 million in 1989, primarily on the expansion of its tyre manufacturing capacity. Sime now makes dipped latex products, ceramics, shoes, batteries, paints, corrugated cartons and rubberwood furniture. Its three tyre plants make it one of the biggest, if not the biggest, tyre manufacturers in the region.

History

Already diversified into trading, particularly in the heavy equipment business, by the early 1930s, Sime moved its head office from Melaka to Singapore. By the mid-1950s it had more than 30,000 hectares of plantations and 18 branch offices. By the early 1970s, Sime had become a major force in the plantations businesses with the takeover of Seafield Estate and the incorporation of Consolidated Plantations. In 1976 there was a major boardroom tussle which put the group's control into Malaysian hands. Sime continued to make headlines in the 1970s with its controversial move to change its auditors and an abortive bid for the Guthrie Corp. In 1979 it transferred its domicile to Kuala Lumpur from London.

Throughout this period there had been considerable expansion into other activities and other countries and the tempo increased in the 1980s, early on with the acquisition of small ventures but increasingly more ambitious. It acquired BF Goodrich Philippines which resulted in the creation of Sime Darby International Tire Company (now Sime Darby Pilipinas), and it ventured into property development via United Estate Projects. From 1984 onwards Sime went on the acquisition trail purchasing DMIB Bhd (formerly Dunlop Malaysian Industries) and buying a stake in British-based Harrisons & Crosfield.

Sime's "big four"

DMIB Bhd. Traditionally the growth and success of this operation have come from its two divisions, tyres and non-tyres, but today the company sees a big future in its new third division based on dipped latex to manufacture examination gloves (with expansion from 50 million pieces at start-up in mid-1988 to a projected 200 million pieces by the end of 1989), condoms and balloons. Tyres account for 75 per cent of its turnover and DMIB commands about 45 per cent of the local market share.

Consolidated Plantations. This unit is unlikely to diversify from its main crops of oil palm, rubber and cocoa after trials with other crops such as soya bean, cashews, acacia mangium, mangoes and durian, none of which compare well in viability with the traditional crops, according to the company. Instead its emphasis will be more on downstream activities with a new latex plant in Melaka in order to increase processing capacity from 60 per cent of Sime's field rubber to 75 per cent.

Tractors Malaysia. This firm was formerly one of Sime Darby's problem companies, but looks set for a bright future given a worldwide situation of high demand for heavy equipment, the expected pick up in domestic construction and the massive North-South Highway project. It has acquired four motor companies: AMIM Holdings, the franchise holder for Ford passenger cars and motor vehicles which has a subsidiary assembling Ford, Rover, Range Rover and Suzuki vehicles; Ford Concessionaires, an authorised dealer for all Ford passenger cars and motor vehicles; Land Rover (M), importer and distributor of Land Rover and Range Rover vehicles; and Auto Bavaria which holds the franchise for BMW cars and motorcycles in Malaysia.

United Estate Projects (UEP). Production from UEP will focus on developments in the Kelang Valley and particularly its UEP Subang Jaya housing project which, over 10 years from 1990, will construct 25,000 housing units at a projected cost of M$2.5 billion.

Kumpulan Guthrie Berhad

History

Guthrie's roots are in the rubber plantation business, although the company has grown into a modern conglomerate with an impressive diversity of operations ranging from the manufacture of machinery and rubber toys to sheep farming and from agricultural management and consultancy to property development. It was established by Scotsman Alexander Guthrie in 1821, but its rapid expansion and diversification is new, a phenomenon that began after the "dawn raid" on the London Stock Exchange in 1981 by Permodalan Nasional Berhad, a quasi-government institution, which transferred the company's ownership into Malaysian hands. Guthrie had to begin anew in the non-plantation business and, less than a decade later, it consists of 56 subsidiaries and associated companies worldwide.

A recent milestone for Guthrie was a flotation on the Kuala Lumpur Stock Exchange in 1989, representing the biggest share offer in Malaysia's history. Guthrie's balance sheet at the end of 1988 showed shareholders' funds of M$1.03 billion of which M$447.65 million was share capital and M$555.08 million reserves. Pre-tax profit was M$114.4 million on a turnover of M$566.2 million. Total assets as at 31 December 1988 stood at M$1.605 billion. Fixed assets alone accounted for M$1.436 billion.

Plantations

Plantations, however, remain the core of Guthrie's business success and the plantations and subsidiary operations that have evolved from the group's expertise in agriculture are still Guthrie's most important profit centres. The largest plantation house in the country, Guthrie's 57 plantations span ten of Malaysia's 13 states and its 116,000 hectares of palm, oil, rubber and cocoa have become a symbol of Malaysia's growing prosperity. With 25,000 employees worldwide, Guthrie's plantations in Malaysia, Philippines, China and Liberia, mark the group's growing internationalisation, much of which took place before Guthrie was "Malaysianised".

An indication of Guthrie's diversification within the plantation business is the change in the crop-mix picture over the last three decades.

Guthrie's business development runs parallel to Malaysia's national aspirations which are to diversify away from a reliance on its traditional commodity base. Thus the company is constantly seeking opportunities in other business sectors.

Always on the look-out for new ventures, one of those closest to chief executive Dr Ani bin Arope's heart is Guthrie's sheep-rearing venture, initiated in 1975 with the dual intention of reducing weeding overheads on the plantations and meeting Malaysia's mutton requirements. The sheep keep the grass and weeds down and are also fed on by-products of palm oil. Mutton and wool may eventually provide attractive profits. Imaginative as the sheep project is however, it is only just now achieving commercial status and is not as significant as Guthrie's major diversification into manufacturing, general trading and services.

Manufacturing
The group's manufacturing subsidiary, Guthrie Industries Malaysia Sdn Bhd, has established an international reputation in the design and fabrication of rubber processing and machinery and equipment, registering sales of M$9.3 million in 1987, an increase of 55 per cent over the previous year. Another subsidiary, Guthrie Bendy Sdn Bhd, makes rubber toys and novelties, a joint venture project which notched up sales of M$3.4 million in 1987 and profits of M$855,000. Guthrie Malaysia Trading Corp Sdn Bhd, the group's trading arm marketing a wide range of agricultural, industrial and consumer goods, registered sales of M$61.1 million in 1987.

Consultancy
Through its subsidiary, Guthrie Plantation & Agricultural Services, Guthrie is doing significant business in providing agricultural services and consultancy to outside estates in Malaysia and overseas totalling 170,000 hectares. With its long experience in the business and strong emphasis on research and development, Guthrie's expertise is recognised worldwide and is in much demand. On the R & D side, Guthrie has the largest privately-owned research centre in the country and is a pioneer in commercial scale animal (integrated) farming. It is the country's largest supplier of oil palm seeds. Guthrie Development Sdn Bhd, the group's landscaping subsidiary, registered sales of M$1.8 million in 1987 with sales of 2.1 million square feet of grass.

The next five years
Oil palm. Guthrie's proposed five-year plan of action contains tremendous scope for further foreign investment and joint venture opportunities. On the palm oil side hectarage will be increased from 1,755 hectares in 1989 to 2,550 hectares in 1993.

While negative margins have forced Guthrie to put plans on hold for a refinery and kernel crusher, costing M$20 million and M$1.1 million respectively, other activities will include the identification of potential refiners for toll refining agreements and the appraisal of further downstream activities into local packing, speciality oils and oleochemicals.

Rubber. Projected hectarage to be replanted to rubber over the next five years will increase from 584 hectares in 1989 to 782 hectares in 1993.

An outside crop purchasing unit will be established and ventures with Indonesian and Thai latex concentrate producers settled, substantial re-equipping will take place and specialised grades of rubber be developed.

Cocoa. To achieve an 8.6 per cent expansion of cocoa hectarage new planting and replanting is projected to be 814 hectares in 1989 and 690 hectares in 1993.

Three new 10-tonne factories and one five-tonne factory will be built at Ladang Andrassy, Ladang Tingayu, at the OPM Complex and at Lambak respectively. Research and development to improve bean quality and flavour will be stepped up and laboratory equipment acquired. Storage capacity will be increased and a cocoa research sub-unit will be established in Sabah. Training and manpower will receive special emphasis and a marketing strategy developed.

Papaya and starfruit. Total projected hectarage will increase from 50 hectares in 1989 to 250 hectares in 1993 for papaya, and from 25 hectares in 1989 to 125 hectares in 1993 for starfruit.

New packaging facilities for both fruits will be built, processing activities developed in collaboration with food manufacturing industries and a variety of research and development activities carried out. Guthrie will monitor manpower requirements and broaden marketing efforts to the US and EC countries.

Corn. Total projected hectarage will be increased from 1,000 hectares in 1989 to 2,500 hectares in 1993. Considerable mechanisation will take place along with the acquisition of new capital equipment.

Biotechnology. A biotechnology laboratory with the capacity to produce 62,208 plants a month is planned along with an intensive R & D programme, a recruitment campaign and strong emphasis on in-house training.

Subsidiaries

Guthrie has 58.35 per cent equity in Guthrie Ropel Bhd and 51 per cent in Highlands & Lowlands Bhd, two publicly listed plantation companies both of which have been reporting more comfortable profits since the upswing in commodity prices. In an announcement of turnover and profits for the first half of 1988, Guthrie Ropel announced that pre-tax profits of M$11.25 million for the first six months of 1988 represented an increase of 308.8 per cent over the corresponding period in 1987. The company had posted a spectacular 304.3 per cent increase in pre-tax profits for the year ended 31 December 1987 to M$14.78 million from M$3.66 million the previous year. Post-tax profits jumped an even higher 674 per cent to M$7.59 million in 1987 from M$981,000 the previous year. In 1988, Highlands and Lowlands' profits before taxation were M$78.28 million – a jump of 101.9 per cent over the level of 1987.

Chapter Thirteen

Energy

Malaysia's energy policy is in transition as the country adopts a strategy of moving from a dependence on oil, both as a domestic source of power and an export revenue earner, to natural gas. Behind this switch lies the fact that reserves of natural gas are three times larger than oil reserves. The country's oil reserves would be depleted in 17 years given current production levels, but the estimated lifespan of present gas reserves is over 100 years.

In 1980 the government embarked on a Four-Fuel Energy Strategy aimed at reducing the country's over-dependence on oil as an energy source. An integral part of this strategy is diversification into other energy forms including natural gas, hydropower and coal. In the short and medium term, however, natural gas is expected to play a prominent role in the energy diversification strategy.

Gas

The use of natural gas is not new to Malaysians. Since the 1960s, gas has been piped to households and industries in Miri, Sarawak, and gas was first discovered in substantial quantities in Sarawak in the 1970s. Gas utilisation programmes are now being implemented in Sabah, Sarawak and Peninsular Malaysia and total reserves are estimated at 53 trillion cubic feet (1.1 trillion cubic metres). The year 2000 should see gas taking the major share in the provision of energy.

The PGU project

The modern gas era for Malaysia began with the completion of Phase I of the Peninsular Gas Utilisation (PGU) project in 1985. This initial stage of the three-stage project involved the landing of gas from fields off Terengganu to the peninsula where it is fed into a 250 million standard cubic feet per day gas processing plant. Phase I also involved the construction of a liquefied petroleum gas (LPG) storage and export terminal and the laying of LPG and natural gas transmission lines.

A 730 km trans-peninsular pipeline is now being laid at a cost of M$1.3 billion as the central part of Phase II. Natural gas from the east coast will be transmitted via the pipeline to the central west coast and south to Johor Bahru, where it will supply power stations. Funding of PGU II has been by a Japanese ¥42 billion soft loan with a seven-year grace period and a repayment period of 25 years at 4 per cent interest. Further financing could come in the form of suppliers' credit or further project financing by institutions, including banks.

When completed in 1991, it is estimated that over 500 million standard cubic feet of gas per day will flow through the pipeline. Malaysia Mining Corporation's (MMC) partners in the venture are Entrepose International of France and the International Management and Engineering Group of the UK. Completion of the pipeline would allow Malaysia to fulfil its promise to begin supplying gas to Singapore by 1991, providing Singapore is willing to pay the premium Malaysia wants.

A third phase of the PGU project is also being planned. This will involve the extension of the pipeline from the Kelang Valley northwards to the Prai power station on the west coast, and from Kertch to Kota Bahru on the east coast.

Post-completion

Completion of the PGU project will allow for the Malaysian economy to switch to gas. Natural gas presently accounts for 23 per cent, or 69,000 barrels per day of oil equivalent (bdoe), of Malaysia's primary energy consumption. By 1991, the share is expected to increase to 29 per cent, and by the end of the 1990s, with the establishment of a gas grid covering Peninsular Malaysia, the country's oil-based economy will have evolved into a gas-based one, with a 40 per cent reliance on gas by the year 2000. The biggest consumers of natural gas will be the power stations at Port Kelang, Port Dickson and Pasir Gudang, which are to switch from oil to gas.

The transportation sector is expected to wean itself from its present 100 per cent dependence on oil. Natural gas, LPG and compressed natural gas (CNG) will be gradually introduced throughout the country to replace the traditional liquid fuels. Natural gas will also provide the feedstock for Malaysia's gas-based industries, such as the petrochemical and fertiliser industries. Other users will be factories and households in towns near to the new pipeline. These include Kuantan, Bandar Muadzam Shah, Segamat and Johor Bahru, Seremban and the densely industrialised and populated Kelang Valley.

Other major project costs associated with the pipeline include construction of telecommunications facilities, operation and regional centres, a compressor, a metering and regulations system and upgrading of export terminal facilities in Tanjung Sulong. MMC will also construct a 44 km propane pipeline and a 44 km butane pipeline from Teluk Kalong to the Gebeng industrial estate in Kuantan where it will be utilised as feedstock by PETRONAS' joint venture plants with Idemitsu Petrochemical Co of Japan and Neste Oy of Finland for the production of methyl tertiary butyl ether (MTBE) and propylene at one plant and polypropylene at the other.

Exports

Apart from supplying Singapore, the pipeline will also allow Malaysia to export piped gas for power generation in southern Thailand, and PETRONAS has already held provisional discussions with the Petroleum Authority of Thailand. At present, under a 20-year contract, Malaysia exports about 6 million tonnes of LNG annually to two public utilities in Tokyo. Currently Malaysia's largest industrial undertaking, Malaysia LNG, a joint venture between PETRONAS, Shell, Mitsubishi and the Sarawak State Government, ships its entire production from the offshore gas fields in Bintulu, Sarawak, to Japan. This totalled about 6.2 million tonnes, worth M$2.6 billion, in 1988 and was expected to reach about 6.4 million tonnes in 1989.

Oil

Malaysia's first oil well was at Miri, which produced over 80 million barrels during the 62 years of its life. Since 1976, the country has enjoyed the status of being a net exporter of oil. Crude oil reserves are currently estimated at 2.9 billion barrels, which ranks Malaysia 22nd in the world. In terms of its crude oil production, currently about 560,000 barrels per day (bpd), the country ranks 21st among world producers.

Growing foreign interest

Following a rush of foreign interest in exploration activities, PETRONAS, Malaysia's state-owned oil company, has been very active in the signing of production sharing contracts (commonly referred to as PSCs). It introduced a revised production sharing contract system in 1985 to accommodate and encourage an increase in exploration activity.

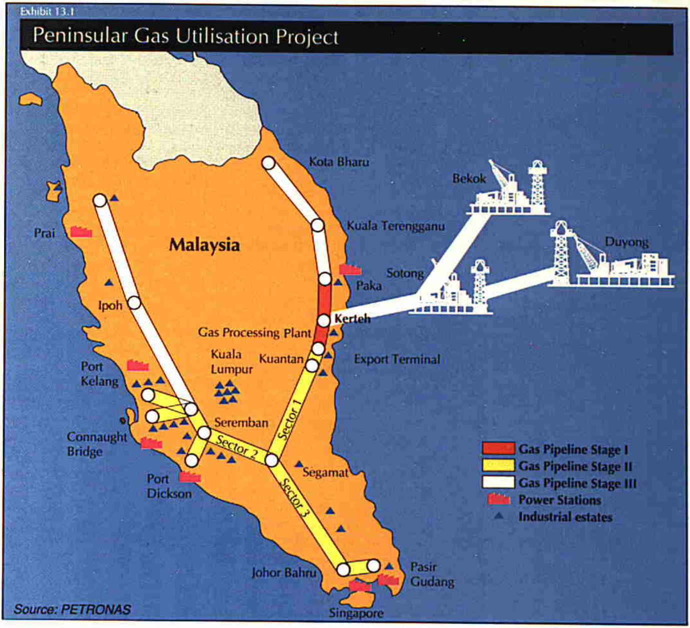


Exhibit 13.1
Peninsular Gas Utilisation Project
Malaysia
Kota Bharu
Bekok
Kuala Terengganu
Duyong
Prai
Sotong
Paka
Ipoh
Kerteh
Gas Processing Plant
Kuala Lumpur
Kuantan
Export Terminal
Port Kelang
Seremban
Sector 1
Connaught Bridge
Sector 2
Segamat
Port Dickson
Sector 3
Gas Pipeline Stage I
Gas Pipeline Stage II
Gas Pipeline Stage III
Power Stations
Industrial estates
Johor Bahru
Pasir Gudang
Singapore
Source: PETRONAS

The interest arises because foreign companies are aware that the exploration success ratio in Malaysia is considerably higher than average – 3:1 for gas and 6:1 for oil. The geological structure is highly favourable and the existence of broad sedimentary basins indicates that exploration efforts in Malaysia will prove worthwhile. The country's oil is a high quality, low sulphur crude which commands a premium price on the world market and the shallow continental shelf which makes up a significant portion of the prime hydrocarbon area of the Sunda Shelf is one of the largest calm and shallow water areas in the world.

Oil companies are also attracted by Malaysia's low-cost operating environment, political and economic stability and conducive working environment. Exploration spending is expected to total US$2.5 billion between 1989-93.

Since 1985, PETRONAS has signed 22 new PSCs with 31 oil companies from 11 countries. For PETRONAS, and the Malaysian industry generally, the heightened foreign interest means access to the latest technology and know-how. Technology is important because, for every barrel of oil extracted, two barrels are left behind and enhanced oil recovery (EOR) techniques will be vital in a position of diminishing resources.

The new PSCs

In order to allow the contractors speedier recovery of capital costs, the cost recovery rate was increased from 30 per cent to 50 per cent of gross production for crude oil, and from 35 per cent to 60 per cent of sales for natural gas. The new production sharing formula for oil, on a sliding scale based on average daily production, involves a ratio of 50:50 between PETRONAS and the contractor for the first 10,000 bpd production, 60:40 for the next 10,000 bpd and 70:30 for all production in excess of 20,000 bpd. The production-sharing formula applies only for the first 50 million barrels of oil recovered from a contract area. All production in excess of 50 million barrels will be split 70:30 in PETRONAS' favour.

The new formula for gas involves a ratio of 50:50 for the first 2 trillion standard cubic feet produced and sold and 70:30 for all production and sales exceeding two trillion standard cubic feet. In addition, signature, discovery and production bonus payments required under the previous PSCs were dropped. PETRONAS expects little difficulty attracting contractors for the 67 per cent of areas with hydrocarbon prospectivity yet to be awarded.

Upstream activities

In all, an annual investment of about M$2 billion is envisaged for upstream activities with about 40 exploration wells being drilled in 1989 – more than double the number drilled the previous year. Between 1989 and 1992, PETRONAS expects its production sharing contractors to drill about 80 wildcat wells as well as about 50 appraisal wells. On average, about 32 exploration wells will be drilled annually up to 1992. With about 40 different services and materials supply contracts, there will be an abundance of opportunities for service contractors. In the same four-year period, approximately 350 development wells are planned at a cost of about M$1.8 billion.

In the area of production activities, PETRONAS is planning to establish itself further in the area of petroleum production when its upstream subsidiary, PETRONAS Carigali, commences crude oil production from its Dulang field, off Terengganu, in the later half of 1990 on a unitised basis with Esso. The field contains some 170 million barrels of oil. Platform fabrication activities began in 1989 for installation in 1990.

Other projects for implementation in the near future include the development of four fields off Bintulu by Sarawak Shell with an estimated cost of M$1 billion for drilling, production and pipeline gathering; and the development of the Seligi oilfield, about 275 km off Terengganu, by Esso Production Malaysia Inc. The latter field, measuring only 12 km by 8 km, is the richest so far discovered in Malaysia with recoverable reserves estimated at

1.2 billion barrels. Seven production platforms will be constructed to drill a total of 177 oil wells and 20 gas injection wells. The first platform involves an investment of M$480 million and total costs for the project until 1994, leading to production of more than 100,000 bpd, are estimated at M$2 billion.

At present Malaysia's crude oil production stands at about 560,000 bpd with exports of around 330,000 bpd. In line with an agreement between OPEC and non-OPEC members early in 1989, PETRONAS proposed to cut exports of crude by about 5 per cent in the second quarter of 1989 at a cost of US$24.5 million (based on a price of US$16 a barrel). With the major Seligi oilfield off Terengganu coming on stream at the end of 1988, and increased demand for crudes by local refineries, Malaysia's production is expected to increase by approximately 4.2 per cent in 1989 to about 562,600 bpd.

Downstream

Presently about 80 per cent of Malaysia's daily production of oil is exported with the main buyers being Japan and Singapore. Apart from Indonesia, the ASEAN region's largest producer, Malaysia has increased its refining capacity the fastest although it still ranks behind Singapore. Malaysian capacity will be increased further when PETRONAS' new 100,000 bpd refinery in Melaka comes on stream in two to three years' time. Originally planned to process only light, locally sourced crudes, the M$1 billion refinery will now include facilities to handle heavy, sour crude, probably from Iran and Iraq. This allows PETRONAS a long-term option against the depletion of Malaysian supplies and the possibility of barter deals with Gulf producers against palm oil, rubber and other products.

Malaysia's refining capacity was under-utilised in 1988 with estimated production of 147,400 bpd, a small increase over the previous year. 112,000 bpd, or 76 per cent, of this was locally produced crude oil, with foreign crude forming the balance. About 31,900 bpd of these crudes, or 21.6 per cent, were processed by the PETRONAS refinery in Kerteh, virtually at full capacity, and the balance at the other three refineries at Port Dickson and Lutong. In all, these have an estimated combined refining capacity of 184,800 bpd.

Shell is building a middle distillate synthesis (MDS) plant near the Malaysia LNG complex in Bintulu. The M$1.9 billion plant would use 100 million standard cubic feet of natural gas per day to produce 12,000 bpd of middle distillates, such as diesel fuel, kerosene and naptha. Under the original proposal, work was scheduled to start in 1989 and the plant would open in 1993.

Strong retail competition

After a two-year slump in demand for petroleum products, soaring vehicle sales and increased economic activity are combining to push demand up by 6 to 7 per cent a year. Shell, Esso, Mobil, Caltex and British Petroleum as well as PETRONAS itself are competing vigorously to supply 1.5 million motorists and 2.5 million motorcyclists, a market which will consume 80 million barrels of petroleum products in 1989 comprising mainly petrol and diesel automative fuels, plus kerosene, LPG and aviation fuel.

Caltex Oil Malaysia spent M$30 million in 1988 and BP Malaysia plans investments of M$100 million over a five-year period beginning in 1989. The money will be spent on new petrol stations – Malaysia presently has 1,550 – with improved facilities. These added attractions are necessary in a country where fuel prices are controlled.

Location is considered the most crucial factor in retail sales. Shell, which had the advantage of being the first on the scene, has a 27 per cent market share, and Esso is also well entrenched. However, after less than a decade in the business, PETRONAS, with 200 stations and the advantage of being the "national" company has overtaken Esso and is close behind Shell. Because of its late arrival on the scene and because the foreign oil companies were resisting price controls at the time, PETRONAS was given preference in location. Now it has to compete equally, even for government supply contracts, although it gets the lion's share of bulk sales under Treasury contracts and shares some contracts with competitors, such as jet fuel for Malaysia Airlines, the national airline, and fuel oil for the National Electricity Board. As the national company, PETRONAS has to put in stations for social reasons where its more commercially-oriented rivals would not venture.

In terms of total turnover from downstream operations, PETRONAS leads with M$1.3 billion in 1987, a fifth of the total industry, followed by Esso (M$1.1 billion), Caltex (M$500 million) and BP (M$300 million).

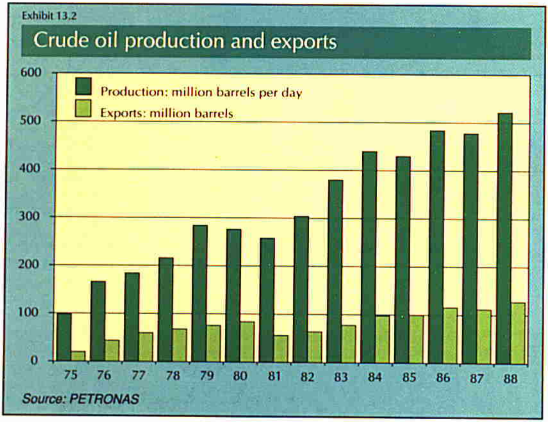
Power – the national strategy

By 1992, Malaysia's National Electricity Board (NEB) envisages that 64 per cent of electricity requirements will be gas-generated and that oil's share will be reduced to 1 per cent. Coal will contribute about 20 per cent and hydroelectric power 15 per cent or less. Malaysia does not plan to consider the possibilities of the nuclear generation of power until after the year 2000.

With a total installed capacity of 4,700 megawatts (MW) and demand of about 2,600 MW a day, the NEB is comfortably placed to meet projected maximum demand for the next three to four years. While the surplus capacity arose from a slackening of demand during the recession from projected growth of 11-12 per cent a year to only 6-7 per cent, the benefit to Malaysia is that for the foreseeable future power stations and generating equipment will not have to work at full capacity, thus ensuring a longer life. The demand for electrical energy is expected to grow by 10 per cent per annum in the next five years and drop to between 7-8 per cent towards the end of the century.

Generation, transmission and distribution systems have accounted for about 95 per cent of the NEB's annual capital expenditure of about M$1 billion a year in recent years. The NEB will spend approximately M$1.2 billion in 1989, but capital expenditure on generation projects will drop to about M$200 million from a high of M$500 million in

Exhibit 13.2



Source: PETRONAS

1988. Transmission costs will account for M$600 million and distribution for about M$250 million.

About 85 per cent of the rural areas in Peninsular Malaysia, covering 11,000 villages and almost a million households, have access to electric power supplies. The rural areas of Sabah and Sarawak are less well served, more because of the difficulty and high cost of distribution to remote villages rather than any shortage of power. For example, peak demand in Sabah, with an installed capacity of 317 MW, is only about 158 MW.

With the recent completion of three major projects – Paka Power Station (900 MW), Kenyir Hydroelectric Power Station (400 MW) and Port Kelang Power Station Phases I and II (each of 600 MW), the NEB has completed the largest programme in its history. With the construction of two coal-fired units each of 300 MW for Port Kelang Power Station Phase II, the use of coal has been restored as a more significant element. One unit went into operation mid-1988 and with start-up of the second unit scheduled for mid-1989, coal fired generation was expected to contribute about one-fifth of the supply in Peninsular Malaysia by 1990.

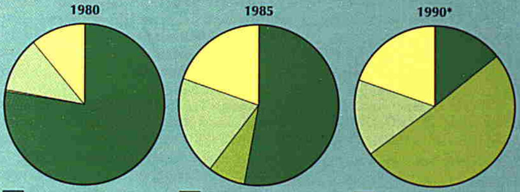
Hydroelectric power

Two more hydroelectric power projects will be completed over the next few years. One, started in 1987 and scheduled for start-up in 1992, is the M$265 million 70 MW Sungei Piah hydro scheme in Perak in the north, with a designed annual output of 380 gigawatt hours (GWh). Work on the second, the rehabilitation of the almost 60-year-old Chenderoh power station on the Perak River which will upgrade capacity from 33 MW to 45 MW, was due to begin in 1989.

Hydro potential in Malaysia is estimated at 29,000 MW, which represents an energy output of 123,000 GWh per year. This represents a very large resource base, especially when considered in relation to current energy consumption. However, the location of the country's hydro resources do not match the population and electricity demand centres. Only about 13 per cent of the technical hydro potential is in Peninsular Malaysia where

Exhibit 13.3

Electricity generation by source: 1980, 1985 and 1990 (%)



	1980	1985	1990*
Oil	87.2	65.8	14.2
Gas	0.3	9.3	50.6
Hydropower	12.5	24.9	15.5
Coal	12.5	24.9	19.7

Source: Fifth Malaysian Plan – 1986-1990

* Forecast

some 82 per cent of the total Malaysian population resides. On the other hand, Sarawak, with only 9 per cent of the total population, accounts for about 71 per cent of total hydro potential. Feasibility studies on the transmission of hydro-generated electricity from Sarawak to Peninsular Malaysia have indicated that the option is technically and economically feasible and such a project could well be on the drawing board by the beginning of the 1990s. It would involve the construction of two major hydro-stations at Pelagus and Bakun and the laying of a 650 km high voltage direct current cable to Peninsular Malaysia. This project is one of considerable magnitude and it is expected to be a major feature of Malaysia's energy scene for the future.

Coal

Sarawak has most of Malaysia's coal reserves – an estimated 500 million tonnes – of which only about 30 million have been accurately measured. By world standards, the size of Malaysia's coal reserves is insignificant. However, viewed in the national context of low energy demand, coal reserves could make a significant contribution to the country's energy needs in the future. For this reason, coal is one of the options that the government is considering in its attempts at energy diversification under the four-fuel strategy.

Thus, while for the immediate and middle-term future it is both logical and economic for Malaysia to rely on natural gas which is available in large quantities, in the long term Malaysia is in an enviable position of being relatively well-endowed with alternative energy resources.

PETRONAS

The first 15 years of PETRONAS' existence were highlighted by a record of rapid growth and development. PETRONAS, or Petroliam Nasional Berhad, is now one of the leading corporations in Malaysia. In striving to achieve this distinction, the corporation earned respect from competitors and partners alike for being a financially sound and stable corporation.

PETRONAS was established on 17 August 1974 as the national petroleum corporation of Malaysia. The Petroleum Development Act, passed by the Malaysian Parliament in October of that year, vested in PETRONAS the entire ownership and control of all oil and natural gas resources in the country.

PETRONAS was established to fulfil the need for a more dynamic and systematic approach in the development of Malaysia's petroleum resources. A cornerstone of PETRONAS' corporate philosophy, therefore, is to undertake proper planning for the orderly exploitation and utilisation of Malaysia's petroleum resources in line with national needs and aspirations.

Today, 15 years later, PETRONAS has more than fulfilled the objectives of its incorporation. PETRONAS is now engaged in almost all aspects of petroleum operations, and by doing so, is making a substantial contribution to the economic and social well-being of the nation.

Rapid growth

From only a fledgeling national oil corporation in 1974, PETRONAS has evolved into a fully integrated petroleum corporation. The range of its activities has already rapidly expanded in both size and scope. The PETRONAS corporate structure now consists of eight wholly-owned subsidiaries and ten partly-owned subsidiaries and associate companies.

Despite the fact that the petroleum business is cyclical in nature, PETRONAS has performed very well financially over the past ten years. One indication of this is that the corporation is Malaysia's biggest tax-payer. With a turnover in the 1987/88 financial year of more than M$9 billion, PETRONAS is also the only Malaysian company on the Fortune 500 listing of the world's biggest industrial companies.

The petroleum sector is now a major contributor to the Malaysian economy, accounting for 33 per cent of total federal government revenue in 1988. Crude oil is also the single largest primary commodity export earner for Malaysia. In 1988, Malaysian exports of crude oil and LNG together contributed to 15 per cent of the country's foreign exchange earnings.

Petroleum development

Under the stewardship of PETRONAS, major strides have been taken in all spheres of the petroleum industry. Upstream activities have grown steadily over the years with corresponding increases in both the levels of petroleum production and reserves.

Malaysia's oil and natural gas reserves are estimated at 2.9 billion barrels and 52 trillion standard cubic feet respectively. Malaysia ranks 22nd in the world among countries with oil reserves and 16th in terms of gas reserves.

Downstream, PETRONAS has established its own 30,000 bpd refinery on the east coast of Peninsular Malaysia. In domestic marketing, the corporation has made significant inroads in the setting up of a nationwide retail network. Substantial investments have been made in the establishment of support facilities such as crude oil terminals, supply bases, bulk depots and bottling plants.

The biggest downstream investment to date is the giant LNG project at Bintulu, Sarawak. Malaysia is presently the world's third largest producer of LNG with exports of about six million tonnes a year. Bintulu is also the location of a fertiliser complex, established as a regional industrial project. Ammonia and urea produced at this complex are exported to markets throughout the world.

The gas era

Through the efforts of PETRONAS, gas development and utilisation schemes to meet domestic energy needs have been established in Sarawak, Sabah and, more recently, in Peninsular Malaysia, with the country's biggest and most ambitious gas utilisation project. Known as the Peninsular Gas Utilisation (PGU) Project, this massive blueprint for the gasification of the peninsula will be implemented in three stages. The first stage was completed in 1985 with the landing of gas from offshore Terengganu to Kerteh where it is fed into a gas processing plant and then to industries and homes in Terengganu.

In 1991, the completion of PGU II will signal Malaysia's entry into the gas era. Now under implementation, PGU II will see an expansion of the gas processing plant and the laying of a 730 km pipeline across the peninsula. When completed, up to 500 million standard cubic feet of gas will be transported daily to feed industries and power stations along the pipeline route and for gas sales to Singapore.

A new dynamism

The Malaysian petroleum industry is going through a new expansionary phase of development in both its upstream and downstream sectors. In 1985, the terms of the production sharing contracts were revised to make them even more attractive and profitable for oil companies to explore in Malaysia. The new terms allow for a better and quicker rate of return on investment through more generous terms for cost recovery and bigger share of profit oil. The response from the multinational oil companies has surpassed all expectations with a consequent boom in exploration. Since 1985, PETRONAS has signed a total of 22 new production sharing contracts with 31 oil companies from 11 countries.

Over the five years from 1989, around US$1.2 billion has been budgeted for exploration activities alone. Development expenditure over the same period had been budgeted in excess of US$2.5 billion. In the downstream sector, several projects have been taken off the drawing board for implementation. PETRONAS is now embarking on its second refinery project which is geared towards meeting the country's growing demand for light products. Construction work on this project is expected to begin in 1990, with completion scheduled for 1992.

Blessed with three times more gas than oil reserves, Malaysia is well placed to establish a full-fledged petrochemical industry utilising gas as a feedstock. Two projects have been marked for implementation: a US$201 million methyl tertiary butyl ether/propylene project and a US$113 million polypropylene project. Both projects will be located on the east coast of Peninsular Malaysia, where the feedstock is available nearby and will come on stream in 1992.

These two projects, however, are only the beginning. In 1989 PETRONAS announced its intentions to participate in a middle distillate synthesis project to be established in Bintulu. In the meantime, the national corporation is also looking into the possibility of setting up yet another ammonia/urea plant alongside the existing one, as well as an optimum-sized ethylene complex.

A third stage of the PGU project is also planned. This will involve a northward expansion of the pipeline along the west coast of the peninsula.

Opportunities

All these new and ongoing projects translate into vast opportunities for participation in Malaysia's rapidly expanding petroleum industry. In this respect, it is noteworthy that Malaysia has traditionally welcomed private and foreign involvement in the development of its petroleum industry.

There will be opportunities for interested parties to participate as joint-venture partners in the exploration for petroleum or in the setting up of downstream projects. PETRONAS will also seek foreign participation as suppliers of technology, expertise and equipment.

The boom times that the Malaysian petroleum industry is now experiencing will ensure that there will be benefits to be reaped by all who contribute towards the development of Malaysia's petroleum wealth.

Chapter Fourteen

Transport, tourism and communications

Transport

The role of transport is increasingly important for economic growth in Malaysia as the country develops its manufacturing base. The transport sector has come under close scrutiny in major World Bank studies on national transport and national ports. At the same time, both the transport and communications industries have entered a new era with the government's decision to privatise them. The intention is to have the departments and functions of the Transport Ministry and the communications aspects of the Ministry of Energy, Telecommunications and Posts privatised or ready for privatisation by 1990. Aviation, telecommunications, roads, railways and ports have all been targeted for this transition and in many cases the change has been implemented.

As Malaysia has increasingly been involved in manufacturing from her own resources, this has brought a change in the transport infrastructure. Road and rail systems are no longer simply a link between major production areas and sea ports. The development of processing, storage, warehousing, wholesaling, retailing and freight forwarding have entailed greater mobility of goods and people and a greater demand for improved transport services.

The contribution of transport – along with storage and communications – to Malaysia's GDP was 10.3 per cent in 1988. The sector is taking a growing share of employment: 4.9 per cent (264,000 people) were engaged in transport, storage and communication in 1985, compared with 4.3 per cent in 1980. This proportion is expected to increase during the period of the Fifth Malaysian Plan (1986-90), which estimates that 326,000, or 5.3 per cent of the working population, will be employed in the sector by 1990.

Following the cuts in public expenditure in the mid-1980s, public investment in the transport sector has recovered during the Fifth Plan period. In terms of allocation among the various modes of transport, the road sub-sector has traditionally been the biggest recipient of development funds, ranging between 51 per cent and 62 per cent.

The strategy for the 1990s in Malaysia will be rationalisation and consolidation with the development of a more coordinated approach to transport planning and better management. Road transport is expected to remain overwhelmingly dominant. It carried 81 per cent of freight and 96 per cent of passengers in 1988.

Malaysia has come rather late to developing an integrated transport system which is aimed at bringing about savings, shorter transit time and increased efficiency through the use of more than one mode of transport for containerised cargo. While road and rail transport is inter-modalised to an extent, its development has been held back by initial poor response on the documentation side from some of the agencies involved including Customs, forwarding agents and banks, and lack of regulations affecting inter-modalism and the reservations of traders because of the uncertainly in respect of liabilities and responsibilities.

While major road projects – particularly the North-South Highway – characterise transport infrastructure in the late 1980s and early 1990s, it will be Malaysia's ports that will probably receive the bigger portion of development spending in the late 1990s with the adoption of a National Ports Study proposing expenditure of M$1.4 billion.

Shipping

Foreign shipping lines carry more than 80 per cent of Malaysia's seaborne imports and exports of about 70 million tonnes annually at a total cost of M$2 billion. The international maritime trade of the Malaysian International Shipping Corporation (MISC) and Perbadanan Nasional Shipping Line (PNSL) is far below the 40 per cent permitted for national carriers under the United Nations Code of Conduct on Liners Conference.

Contrary to expectations, local shipping companies have taken an increasingly small share of Malaysia's international trade. Transport Ministry statistics show that their contribution has declined to 5-10 per cent since 1985, leaving the bulk of the trade to foreign lines.

Malaysian International Shipping Corporation

Although small by international standards, MISC is one of Malaysia's biggest companies and its stock was the most actively traded on the Kuala Lumpur exchange after its listing in 1987. The company was incorporated in 1968 as a joint venture between the government and a group of private entrepreneurs including Hong Kong shipping magnate Tan Sri Frank Wen-King Tsao and the Kuok brothers, with the aim of helping Malaysia to develop as a maritime nation. In 1974 the governments of Sabah, Sarawak, Selangor, Penang, Johor and Pahang became shareholders and two years later the Federal Land Development Authority took up shares. MISC's paid-up capital increased to M$100 million with new issues and bonus issues and it was listed on the Kuala Lumpur Stock Exchange in 1987 after a special government issue and a rights and bonus issue had further increased its paid-up capital to M$500 million. The open portion of the share offer, amounting to 56.993 million shares, is still the biggest in Malaysian corporate history. Malaysia's Ministry of Finance and Bank Negara are the biggest shareholders with a 14.67 per cent stake each.

The line has a fleet of 46 vessels with a carrying capacity of 1.2 million tonnes and employs 2,600 personnel. The focus of its activities is on the very profitable Malaysia-Japan trade, involving the transportation of liquefied natural gas (LNG), for which it has five LNG carriers. It is also engaged in the transportation of consumer goods by container from the Far East to Europe with its two container vessels and seven chemical tankers.

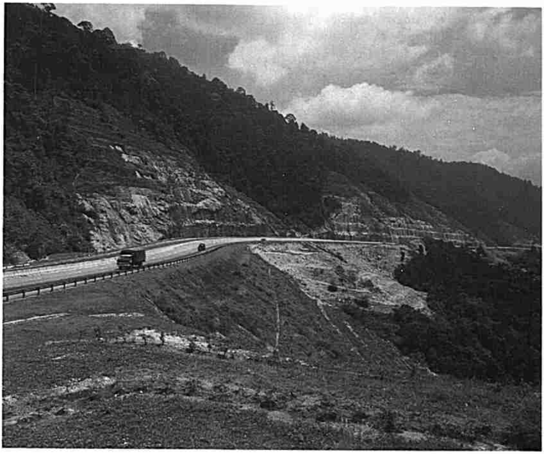
The LNG business ensured that MISC remained profitable even during the shipping slump of the mid-1980s. And, in 1988, it contributed heavily to better-than-expected

Exhibit 14.1

Public development expenditure for transport and communications (M$m)

	Expenditure 1981-85	*Fifth Plan allocation 1986-90*
Transport	7,127.29	10,760.93
Roads and bridges	4,166.67	7,644.10
Railways	650.86	1,049.42
Ports and marine services	1,481.02	400.69
Civil aviation	873.74	1,666.72
Communications	2,501.58	9,706.04
Telecommunications	2,400.48	9,572.38
Postal services	93.98	119.65
Meteorological services	7.12	14.02
Total	9,673.87	20,466.97

Source: Fifth Malaysian Plan



The North-South Expressway: Malaysia's largest infrastructure project will nearly halve journey times to Singapore

M$400 million profits, representing a 36 per cent improvement. In all, MISC derives 85 per cent of its profits and 45 per cent of its revenue from its LNG operations. About 35 per cent of revenue comes from its liner trade, 15 per cent from bulkers and tankers and 5 per cent from investments.

The line is expanding operations on the tanker side. It is in the process of adding four new chemical tankers to its fleet, each of 30,000 dwt. Two were delivered in 1988 and two are scheduled to come into service in 1989. The tankers, each costing M$60 million, were built in South Korean shipyards. In 1989 the state-owned Sabah Shipyards Sdn Bhd won a M$98 million contract to build two 16,000 dwt palm oil/chemical tankers – a landmark for the Malaysian shipbuilding industry and the first vessels of such a size and type to be constructed in Malaysia. The prestige project is expected to keep Sabah Shipyards in business for two years.

As the worldwide shipping industry picks up, MISC is expected to show profit improvements. Encouraging prospects have made its stock much sought after by institutional investors – evidenced by the sharp drop in the number of its shareholders since the listing, from 56,672 to only just over 9,000. Its share capital of 500 million shares and market price of about M$8.50 gives the company a market value of M$4.25 billion.

Other shipping services

The Malaysian coastal fleet constitutes about 20 per cent of the national tonnage, and coastal trade has grown rapidly since 1980 when the government introduced a cabotage law to reserve intra-port trade to Malaysian-owned companies and Malaysian flag vessels. This reversed the rationalisation caused by severe competition and economic downturn in the mid-1970s, when the number of ships dropped to 252 with combined gross registered tonnage (grt) of slightly less than 500,000.

The cabotage move was a blow to foreign, mainly Singaporean, shipping companies which had previously accounted for 90 per cent of the coastal business. In face of protests, the government relented and to avoid disruption introduced a phased implementation of the new laws through a licensing system.

The new laws saw a rush by local companies to get in on the business which they saw as being protected. The Domestic Shipping Licensing Board registered 132 ships with a total grt of 152,000 in 1981, almost doubling to 221 ships with a total of 376,600 grt the following year and peaking with 275 ships and total tonnage of 776,350 in 1985. A number of Singaporean companies which had been involved in the trade went into partnerships with Malaysians and reflagged their ships. They included Straits Steamship (Singapore), which formed Perkapalan Kris, and Pacific International Lines, which created Malaysia Shipping Corporation.

Modernisation accompanied the rationalisation among the coastal shipping companies. Perkapalan Kris and MISC stepped up investments in containerisation, launching joint fixed-day full container service with three vessels. The Perdana service, which links all principal container handling ports throughout Malaysia, paved the way for container shipping in the coastal trade. About 60 per cent of the liner trade is containerised with about 30,000 twenty foot equivalent units (TEU's) a year with growth forecast at 10 per cent annually.

A future step, presently seen as unlikely, could be the extension of the cabotage law to include the transhipment trade between Malaysia and Singapore, or an enforced sharing by flag carriers of the two neighbours. At present, the cabotage laws also extend to the carriage of oil from wells to refineries and the subsequent carriage of petroleum products. For this trade a total of 43 petroleum tankers are registered with the Domestic Shipping and Licensing Board compared with eight fully cellular vessels, three ro-ro ships and 81 conventional and semi-container ships for general cargo. In addition there are a number of parcel tankers, dry bulk cargo carriers and 48 supply tug, anchor, diving and crew boats to service the offshore oil and gas industry.

Coastal shipping is important to trade between the east Malaysian states of Sabah and Sarawak. These have an annual volume in excess of 2 million tonnes, more than half of which is in liner trade. Cargo movements are lopsided, with exports from Peninsular Malaysia to the eastern states providing the far greater volume.

Ports

Regulatory changes

Ports have faced a shake-up as one of the first major steps in Malaysia's privatisation programme. The container terminal at Port Kelang, the country's biggest port, was hived off in a Malaysian-Australian joint venture in 1986, since when there has been a dramatic improvement in efficiency in the handling of almost 325,000 containers a year. The privatisation of other ports and cargo handling facilities increased rapidly during the late 1980s.

Privatisation of Port Kelang's container operations gave the impetus for adoption of inter-modalism by the operators. They found that traffic from northern Johor, about 250 km away, could be routed via Port Kelang with substantial savings rather than if the same cargo was shipped via Singapore. Similarly, there were savings for shippers in Penang to take delivery of cargo via Port Kelang and transport it by rail and road instead of entirely by sea.

Efficiency in port handling has also been helped by Customs allowing the movement of transhipment cargo overland and permitting the declaration of cargo at a port which is not the port of destination. Containers can be declared at a Malaysian port of origin and transported overland for shipment to another without further examination. Another development is the agreement between Thailand and Malaysia for the cross-border movement of containers between the two countries. Thailand's container traffic has reached capacity at Klong Toey and both Kelang and Penang ports in Malaysia have additional capacity.

The government has also reviewed import and export procedures to make them easier. Documentation has been simplified and reduced (in one case from 25 to five) at the points of exit and entry. Ports have been asked to further scrutinise their procedures to expedite cargo flows and steps have been taken to harmonise terms and tariffs.

Volumes and developments

In 1988 Malaysian ports handled 513,000 TEUs of which about 325,000 were from Kelang container terminal, 155,000 from Penang port and 33,000 from Johor port. All three ports saw unprecedented growth. Johor, for example, had a 22 per cent increase to 6.2 million tonnes and a 213 per cent increase in the number of containers handled. Johor is the dominant vegetable oil handling centre in the region with a throughput of nearly 2.5 million tonnes in 1988. The buoyant traffic levels contributed to an estimated M$120 million in pre-tax profits made by Malaysia's nine ports in 1988.

The National Ports Study, carried out in 1988 with assistance from the World Bank, underlines the need to promote direct shipping via local ports; the avoidance of duplication of port facilities; and the need to improve port productivity. Recommendations included proposals to divert container traffic which is presently going through Singapore; revision of port tariffs; liberalisation of road hauliers; promotion of more inland container depots; target marketing and a framework for privatisation of port facilities and services. With the adoption of the report, the Malaysian government has for the first time the advantage of a comprehensive port development policy, which in the past was uncoordinated and characterised by random expansion of physical facilities.

However, the study advises that there should be no new major investment during the first half of the 1990s. It envisages investment at the level of just M$117 million until 1995, after which expenditure will soar to over M$1 billion. Development expenditure between 1988 and 1990 will focus on a new vegetable oil berth at Johor port and the acquisition of new container cranes and equipment at the Kelang container terminal. Between 1991 and 1995 Penang will get a new dry bulk berth while Port Kelang will see the completion of a general cargo-cum-container berth to cope essentially with container traffic after 1995, since existing facilities at the Kelang container terminal will be saturated.

Major investments will be required only after 1995 when Penang is expected to activate its North Butterworth Container Terminal and Kelang to convert its second conventional berth for container handling. The study, the scope of which extends to the year 2010, sees the need for expansion of the North Butterworth facility to three berths and the development of a five-berth container terminal at Port Kelang. It estimates total capital expenditure of M$1.4 billion between 1995-2010 and favours port specialisation by trade route and cargo. A cabinet committee has been set up to follow through the study.

Railways

Malayan Railways (KTM) recorded a surplus in 1988, the first time it had done so in nine years. This watershed was attributed to a restructuring of operations in 1987, which divided the organisation into separate passenger and freight operations. In conjunction with Kontena Nasional and Konsortium Perkapalan, KTM launched its Intermodal Freight System (IFS) on three different routes. As a result, earnings from the freight side exceeded those from the traditionally more important passenger side for the first time.

The basis of the improved freight service is that bulk goods containers can be shipped using a mixture of different transportation modes, such as rail, ship and truck. Rubber, imported finished products and electronic products can all be shipped in this fashion, and KTM took full advantage of this by substituting container wagons for its under-utilised conventional containers.

KTM's plans for the future hinge on a more aggressive marketing and management planning strategy. However, KTM's projections suggest that passenger receipts will regain their place as prime earners in 1989, bringing in M$69 million against M$67 million in freight earnings.

Technical improvements add another dimension to KTM's performance. Track rehabilitation is in its final phase, enabling KTM to offer a fast and smoother service, and eradicating complaints. The rehabilitation has involved the renewal of rails and sleepers of the 326 km track linking Paloh in Johor to Singapore and from Selim River to Seremban at a cost of M$181 million. Eventually about 1,000 km of track from Padang Besar to Selim River on the west coast of Peninsular Malaysia and from Sungei Yu to Tumpat on the east coast will be completely rehabilitated. The track rehabilitation, scheduled for completion in mid-1992, is being carried out by the Indian government-owned Railway Construction Company.

Track rehabilitation will help facilitate plans for a high-speed service on the two most profitable routes between Kuala Lumpur and Butterworth in the north and from Kuala Lumpur to Singapore. The aim would be to cut travelling time to Singapore by two hours from the present six-and-a-half hours. However, a proposal by Japan's International Corporation Agency for a bullet train service from Butterworth through to Singapore has been shelved indefinitely because of the high cost involved. The estimated cost of the project, proposed as part of KTM's modernisation, was M$10 billion. Also indefinitely shelved is a light rail transit system serving Kuala Lumpur and the satellite town of Petaling Jaya proposed at an original cost of M$697 million. The 52 km system was planned to be implemented in five stages, the first phase to cover an 18.5 km stretch between Petaling Jaya and Sentul. However, a light railbus service between the capital and Port Kelang was scheduled to go into operation in May 1989. Each railbus will carry 378 passengers.

Longer term, the privatisation of KTM is being considered. A report carried out by Bumiputra Merchant Bankers was under consideration in 1989 by the Ministries of Finance and Transport, the Economic Planning Unit and the Public Services Department. KTM has long-term liabilities of M$1.3 billion consisting mainly of government loans. Interest payments amount to M$42 million annually.

Road transport

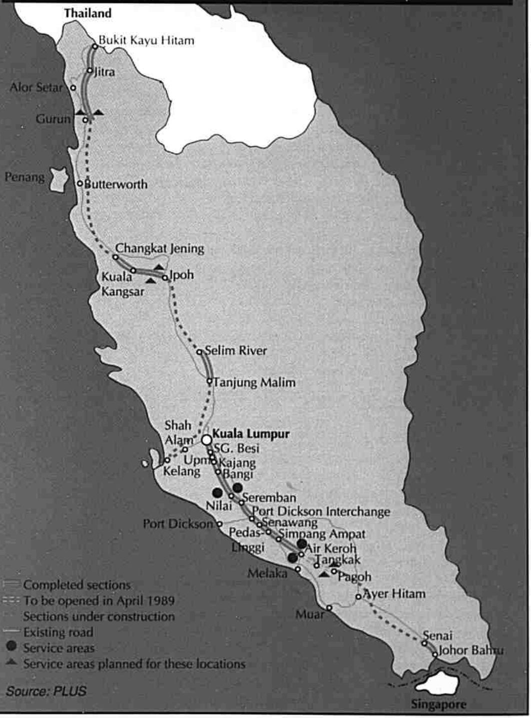
Malaysia's road transport system evolved from providing access to the major areas of rubber and tin production and linking these areas to the main trading ports. After independence, investments concentrated increasingly on new trunk roads and feeder roads in support of land development schemes and other areas to enable the exploitation of agricultural resources.

The highway network of Peninsular Malaysia now comprises about 30,000 km of roads of which about 80 per cent are paved. On the island of Borneo, Sabah has about 9,000 km of roads and Sarawak about 6,000. Only about one-third of the roads in the two island states are paved. The main trunk roads in Peninsular Malaysia are the federal highway routes serving the west coast and the highway from the capital across to the east coast at Kuantan and north to Kota Bahru near the Thai border.

By 1994, when the North-South Expressway and New Kelang Valley Expressway are completed, motorists will be able to drive on a dual two-lane carriageway from Bukit Kayu Hitam in the north to Johor Bahru in the south. More than 300 km of the expressway have already been constructed.

Exhibit 14.2

North-South Expressway



Source: PLUS

Three other major projects are also under way. Work has started on a M$269 million privatised project in Kuala Lumpur that is scheduled for completion in 1992. The project, aimed at easing traffic congestion, involves the construction of nine new interchanges and a new 2.5 km East-West link road south of Kuala Lumpur. The project is to be carried out by a consortium under Syarikat Teratai K.G. Sdn Bhd on a privatised scheme based on the Build, Operate and Transfer concept whereby it will be handed back to the government after 12 years. A 65 km M$130 million highway in Terengganu in the north-east will allow the state to develop 20,000 hectares of new land for agriculture, probably oil palm and rubber. The road, between Kuala Beranang and Gua Musang, will be completed in the early 1990s.

A 240 km highway is planned to link the three major hill resorts of Genting Highlands, Frasers Hill and Cameron Highlands. The highway, at survey status in 1989, will take three years to build and is aimed at encouraging exploration of the area's mineral resources and the farming of highland crops and fruit. It will also improve the tourism infrastructure. Minconsult and South-East Asia Jurutera Consultants, two Malaysian consultant firms contracted to undertake the survey work, will use the Airborne Laser Terrain Profiling system to survey the virgin jungle areas of the resorts and help minimise the felling of jungle trees. The government has approved an initial M$50 million for the project, controversial because of the very high costs of the four-lane highway, projected eventually to total M$600 million, making it one of Malaysia's largest public infrastructure projects.

The highway projects, other road construction and an upturn in mining activity because of improving tin prices as well equipment sales to logging areas in Sabah and Sarawak, will provide a buoyant decade for heavy equipment manufacturers and suppliers. For work on the North-South Expressway, Tractors Malaysia, a Sime Darby subsidiary, has secured orders for 20 Caterpillar units worth over M$5 million, while UMW Holdings is supplying 11 Komatsu bulldozers, loaders and excavators.

The North-South Expressway

By 1994 Malaysia will have a 772 km expressway running the entire length of the west coast from Bukit Kayu Hitam in the north to Johor Bahru in the south. With a total projected cost of M$4.6 billion, it is Malaysia's largest current infrastructural project as well as being the country's single largest privatised venture. Under a concession agreement signed in mid-1988 between the Malaysian government and United Engineers Malaysia Bhd, a UEM subsidiary, Projek Lebuhraya Utara-Selatan Bhd (PLUS), was established to manage and operate the 310 km of existing portions of the expressway and 46km of the Federal Highway I previously under the management of the Malaysian Highway Authority (MHA). It will also construct and operate the remaining 462 km.

The highway, which is operated on a toll basis, will provide an important transport link in Malaysia's highly populated and developed west coast where the major agricultural areas and industrial centres are located. It will provide substantial savings in journey time, cutting three hours off the present six hours from Kuala Lumpur to Singapore, and reducing the overall journey time of 12 hours from Penang to Singapore by virtually half.

Under the Concession Agreement PLUS is also building and will operate the New Kelang Valley Expressway (NKVE), scheduled to open at the end of 1990. It will provide an alternative route for traffic from Port Kelang and the Kelang Valley to Kuala Lumpur and to the north and east of Malaysia avoiding the congestion of the present route through the capital. The project is aimed at increasing traffic capacity by a factor of three.

The NKVE is part of the 200 km first phase of the project now underway, which also includes the Gurun-Butterworth, the Pagoh-Ayer-Hitam and Bukit Lanjan-Tanjung Malim stretches. Completion of the entire project was originally due under the Concession Agreement for 1995, but PLUS has now set the challenging target of completing the project by the end of 1993. The concession period is effective for 30 years commencing 31 May 1988. All 700 former MHA employees involved in the toll collection expressway have been absorbed by PLUS. The project is expected to generate 15,000 new jobs for the construction phase.

Finance

Amanah Merchant Bank and Britain's Morgan Grenfell Group Plc will be raising a M$2.5 billion syndicated loan to finance the project cost. The loan, Malaysia's largest ever, is being underwritten by about 50 financial institutions. Under the financial package, over M$2 billion is already arranged from local and foreign banks in Malaysia. Local financial institutions involved – subscribing more than M$1 billion of the total – include Malaysia's three largest banks, Malayan Banking, Bank Bumiputra and United Malaysian Banking Corporation.

The tenure for the loan is 15 years and drawdown is expected to be over seven years. Interest rates for commercial banks participating in the ringgit portion will be at a margin above the base lending rate, while for merchant banks, the interest rate will be set at a margin above the costs of the funds. The loan will be issued in several tranches at various interest rates, with a seven-year grace period.

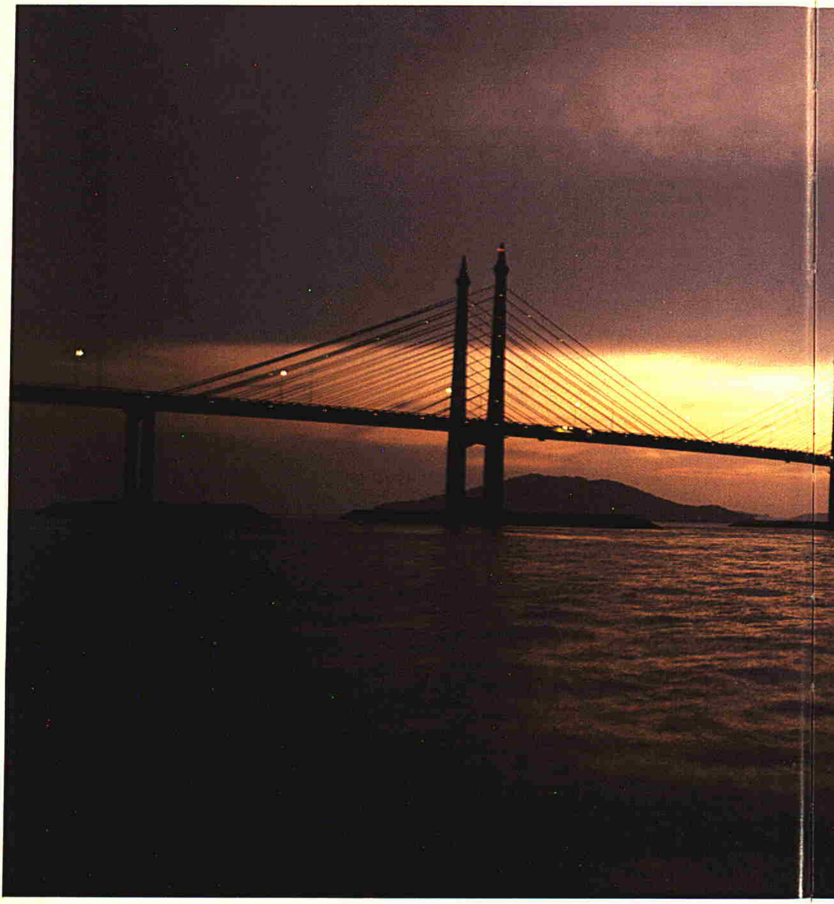
Under the contract awarded to PLUS, the company will receive a M$1.65 billion support loan from the government which has also agreed to provide an additional support loan in the event of any shortfall in the guaranteed traffic level. All government loans will rank behind commercial debt for repayment purposes. Money market dealers predict that, even at peak, the drawdown in ringgit will not exceed M$500 million and that the impact on the money market will not be substantial.

Contracts

Forty major construction contracts on the highway are planned by PLUS. So far the company has awarded eight contracts, including five major ones. Two major contracts in the north are the Gurun to Ladang Petani section, a 16.8km dual two-lane expressway at a project cost of M$87 million, which was awarded to MMC Engineering Services Bhd in a joint venture with GTM International of France on a 55:45 basis, and the 8km Ladang-Petani Sungai Petani section, which was awarded to Pernas Construction for M$51 million. Other contracts awarded, both on the dual three-lane NKVE, have been for a 15.6 km stretch between Bukit Raja and Subang, awarded on a joint venture basis to IJM Engineering and Construction Bhd and Syarikat Hassan Mat Sdn Bhd at a cost of M$104 million, and a 5.7 km expressway costing M$27 million between Subang and Damansara to a local joint venture company, Ireka-Uspa. The fifth major contract for the 9.6 km Damansara-Sungai Buloh section just north of Kuala Lumpur was awarded to Ret-Ser Engineering of Taiwan with Tripart Sdn Bhd for M$102 million.

PLUS is evaluating tenders for the remaining eight contract packages of the first phase and for the supply of toll equipment, and will invite bids progressively for other stretches of the North-South Toll Expressway and the NKVE.

All contractors, both local and foreign, must be registered with the Pusat Khidmat Kontraktor at the Prime Minister's Department. PLUS has stipulated that foreign and joint venture contractors can only be prequalified for projects exceeding M$50 million or for specialised work like the installation and supply of toll equipment, specialised electronic equipment and tunnelling. It also requires contractors and joint ventures to have a minimum of 30 per cent Bumiputera ownership or control. In addition, they must sub-let 50 per cent of the value of works to Malaysian contractors or suppliers including 30 per cent to Bumiputera contractors. Another requirement is that where the project is worth more than M$5 million, the successful tenderer is required to subscribe for preference shares in PLUS equalling 13 per cent of the contract value.



The Penang Bridge, the third longest in the world and the official state emblem

Civil aviation

Asian airlines will be big spenders over the coming decade with projected capital investment on new equipment of US$105 billion between the end of the 1980s and the year 2005. That figure, more than double the amount Asian airlines spent in the 35 years between 1952 and 1987, will represent about a quarter of all aircraft sales in that period. Contributing to the growth has been the easing of travel restrictions by South Korea and Taiwan causing an unprecedented surge in travel from those two countries. Current growth in air travel is between 15 and 16 per cent for Asia and the Pacific, against the world average of 5 per cent, and intra-south-east Asian air travel in 1989 was estimated at 6.26 million passengers.

While ASEAN airlines have ruled out the possibility of a merger, they have agreed to look at other ways in which they can cooperate. These are likely to include the training of cargo personnel, fuel purchases and spare parts. Chief executives of the airlines meet annually to discuss possible areas of cooperation. Malaysia Airlines has teamed up with Cathay Pacific, Singapore Airlines and Philippine Airlines to introduce a US$100 million computerised reservations system.

Malaysia's air passenger traffic increased annually by 8.6 per cent from 1980 to 1985, from 7.2 million to 10.8 million. Domestic passenger traffic increased from 4.9 million to 7.3 million and international traffic from 2.3 million to 3.6 million during the same period. Malaysia Airlines almost doubled the amount of cargo it carried during the same period with an annual growth of 9.3 per cent. According to Malaysia's Fifth Plan, the country's airports will handle almost 15 million passengers in 1990 with air cargo reaching almost 250,000 tonnes.

Considerable airport development and expansion has been carried out to maintain capacity and improve the civil aviation infrastructure, with further development still to come. A M$36 million runway extension was completed in mid-1989 at Kuala Lumpur's Subang International Airport to prepare for the arrival of Malaysia Airlines' new Boeing 747-400s, bringing the total runway length to 12,400 feet. Following the Phase 1 redevelopment of the airport, a second phase will see the construction of a separate domestic terminal capable of handling 3.5 million passengers annually. Domestic and international passengers presently share the same terminal. The new domestic terminal will be completed in 1990, at a cost of M$100 million which will include expenditure on new computer systems and baggage handling facilities.

Malaysian airport authorities have carried out improvements in time for "Visit Malaysia Year" in 1990. These included a M$30 million expenditure on runway and taxiway extensions at Ipoh's airport to enable it to handle larger aircraft and facilities to allow night flights. The government is spending about M$50 million to strengthen and lengthen the airport runway and improve other services. At a cost of M$20 million, Penang's international airport is getting a new cargo terminal with a throughput capacity of 30,000 tonnes until 1994 and 45,000 tonnes by the year 2000. Malaysia's Sixth Plan, beginning in 1991, is expected to make provision for extensions and improvements at other airports.

In line with its other initiatives in transport, the government is seeking to privatise 19 airports. Sapura Holdings Sdn Bhd, the leader in a three-member consortium that is involved in the privatisation of Malaysia's postal services, has submitted a proposal relating to six airports – Langkawi, Bayan Lepas (Penang), Subang (Kuala Lumpur), Senai (Johor), Kuching (Sarawak) and Kota Kinabalu (Sabah). Sapura's proposals encompass all airport-related activities other than air traffic control.

Another initiative has been the launching of Malaysia's second airline to supplement and complement the existing national carrier, Malaysia Airlines. Pelangi Air took to the air at the beginning of 1988, intending to fill a niche in tourism traffic. Pelangi Air's two Twin

Malaysia Airlines has embarked on an ambitious expansion programme with the purchase of new aircraft and an extension of its route network for the 1990s

Otters and a leased 19-seater Dornier 228-200 fly tourists to Malaysia's most popular beach and island resorts and to the national park. There is also a scheduled service to Singapore. A private company, Pelangi Air's main shareholders are the state governments of Terengganu and Perak, while Malaysia Airlines owns 11 per cent of the shares.

Malaysia Airlines

Malaysia Airlines is assembling a new fleet of modern aircraft carrying ever-increasing passenger and cargo loads to more and frequent destinations. For Malaysia Airlines, the national flag carrier, the 1990s will represent a decade of heavy capital investment to introduce what is virtually a completely new fleet of aircraft. Malaysia Airlines' managing director, Tan Sri Abdul Aziz Abdul Rahman, says it is more cost-effective for airlines to take a cyclical approach to buying new equipment which gives economies of scale, not just in the purchase of the equipment itself, but in training and other peripheral activities. Thus the last half of the 1980s was marked by a policy of very cautious spending on aircraft which will swing round in the 1990s to the opposite – a massive M$5.5 billion spending spree aimed at putting the Malaysian airline on better-than-equal terms with its regional competitors.

Fleet modernisation

By 1995 Malaysia Airlines' present fleet of 37 aircraft will be completely modernised although, in effect, this modernisation will mean an almost complete re-equipment. In the narrow-bodied range, the airline's 11 Fokker F27s will be replaced with nine F50s; the

Boeing 737s of which Malaysia Airlines has 12, with the probability of more being leased up to 1991, will then be phased out, with the replacement aircraft likely to be the new generation 737-400 and 500. In the wide-bodied category, the airline's four Airbus A300s, five DC10s and 12 Boeing 737-200s will be replaced. Malaysia Airlines is acquiring three Boeing 747-400s, the first two are passenger/cargo Combis, and one is a passenger aircraft only. Two will be delivered in 1989 and one in mid-1990. The airline has ordered another four for delivery between 1991 and 1994. The acquisition will allow passenger capacity to be increased by 20 per cent and freight capacity by 35 per cent. The new 747-400s will allow Malaysia Airlines to operate non-stop services to London, Honolulu and Frankfurt and be more competitive generally in the long-haul business.

The blueprint for the expansion, modernisation and re-equipment is the airline's Five Year Fleet Development Plan which outlines the operational developments and fleet requirements from 1989/90 until 1993/94. The plan covers traffic forecasts on which the additional capacity has been based; market and route developments governing destinations and frequency; fleet plans which determine types and number of aircraft required; and forecasts of financial results and capital investment.

The airline's revenue growth and debt/equity ratio places it in a good position to seek financing for the new equipment. In 1988 the debt/equity ratio was 1.1:1 and this will increase to 1.7:1 with the added borrowing. It could go as high as 2.5:1 or 3:1, or at the most 4:1. Malaysia Airlines will borrow directly from financial institutions for immediate future needs and will arrange a local ringgit loan for the new Fokker F50s. They will be used for domestic services and the airline believes it makes sense to borrow locally, although it will have to pay for the aircraft in foreign exchange. Another source of future capital could well be capital restructuring. Malaysia Airlines was part-privatised in 1985 with 30 per cent of its shares sold to the public. The majority of shares are held by the Malaysian government and its agencies.

Growing demand

Malaysia Airlines is looking to accelerating tourism growth, new routes, increased frequencies and better profits in the 1990s and beyond. With the regional economies developing quickly and the ever-increasing popularity of South East Asian destinations among international tourists, Malaysia Airlines is confident in forecasting overall passenger growth of 10-15 per cent over the 1990-95 period. With the increased capacity, chief executive Aziz predicts even greater growth in cargo, of 15-20 per cent over the same period. With pre-tax profit of around M$170 million in the tax year ending 31 March 1989, the airline's profitability is expected to grow at 10-20 per cent over the next three years.

Because Malaysia was a relatively late starter in tourism development, Tan Sri Abdul Aziz believes the country has the highest potential for growth among regional airlines. Malaysia Airlines anticipates that major growth will come from Japan, Taiwan and Korea in the Orient, and in Europe, from West Germany and the UK, and from the West Coast of the US. Breaking down projected growth over the five-year plan period, the airline expects domestic traffic to grow by an average of 4.2 per cent annually compared to 3.7 per cent for the previous five years.

Growth in international traffic is expected to vary considerably by region – 8.2 per cent per annum for the Australia/Europe/UK sector, but as much as 23.1 per cent on the US sector. While the growth forecast for the Orient is 6 per cent, on the KL-Tokyo and KL-Seoul sectors a higher-than-average growth of 11 per cent and 13 per cent respectively is projected. Cargo is forecast to grow by 4.9 per cent annually, against 4.1 per cent in the previous five years, with Australia, Europe and the US holding the greatest potential.

Malaysia Airlines' corporate planning director perceives the growth targets as being ambitious but achievable. The growth potential and the priority that the country is putting on tourism will mean a growth rate higher than the industry average and regional competitors. The airline's target is to be among the region's largest carriers.

There are three possible problem areas which could hinder this expansion, although Malaysia Airlines' executives believe they can be surmounted. The risk of recession is seen as a possibility, but not a seriously threatening reality. Equally, interest rates are not expected to go to the 15-17 per cent levels, and even at levels of 10-11 per cent they would be tolerable. Providing that fuel costs remain stable, they too should not present a serious problem.

New destinations

Prolonged rights negotiations in 1988 – the most intensive in the airline's history – will result in a wide spectrum of new destinations for Malaysia Airlines flights at the end of the 1980s and early 1990s. Complex international negotiations in 1988 have resulted in the airline's single biggest expansion since it was formed. The deals concluded will give Malaysia Airlines new routes to Delhi and Karachi, followed by Canton (Guangzhou), Zurich, Fukuoka in Japan, Brussels, Istanbul, Auckland, Brisbane, Ho Chi Minh City, Pontianak and Beijing. Services will be increased on many routes; from five, to six and then to seven to London alone. Depending on demand, possibilities exist for an eighth and even ninth flight.

Malaysia Airlines' agreement with Britain took two years to hammer out, a negotiating process in which Malaysian officials gained enormously in experience. An ability to be able to reach a compromise was crucial given the strong political element involved, and diplomacy is one of the important tools of rights negotiators.

The tempo will not slow at the end of the 1990s as Malaysia Airlines' executives work on increasing flights into China, to Vietnam and Laos and, if peace holds in West Asia, to Bagdhad, Teheran and Kuwait, and in Europe to Copenhagen and Vienna. Malaysia Airlines also has signed a major long-term charter with three European operators, two from Britain and one from Finland, involving around 50 flights and 20,000 passengers. Negotiations with Italian tour operators will result in similar charter trips bringing a regular high volume of Italian tourists to Malaysian resorts.

To maximise utilisation of its new capacity, Malaysia Airlines has teamed up with Singapore Airlines, Cathay Pacific China Airlines and Philippine Airlines in a computerised reservation system (CRS) called Abacus which allows airline and train seats, hotel reservations and a host of related services, such as car hire, to be made on the same computer terminal. Abacus is being developed at an estimated cost of US$100 million and Malaysia Airlines' participation is a recognition of the important part such systems play in maximising capacities and profits. It is a potent statement of the airline's determination to see Malaysia Airlines mature into a major regional carrier.

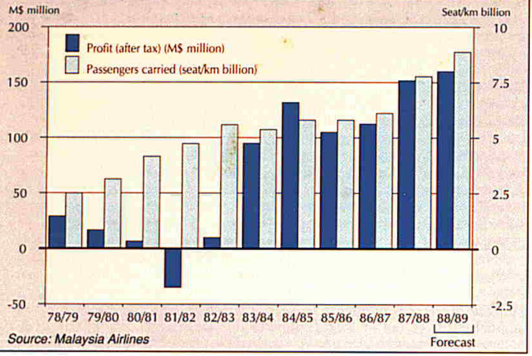
Malaysia Airlines has also installed a M$5 million computerised field management system to provide increased efficiency in seat utilisation, part of a continual upgrading of its computer facilities on which it has spent M$100 million in 10 years. The latest acquisition, Optix, bought from the Data Control Corp of the US, supplies state-of-the-art technology that will allow the airline to maximise seat capacity and revenue. It enables Malaysia Airlines to monitor demand for seats on a flight-by-flight basis, analyse historical booking patterns and forecast future travel trends. Malaysia Airlines joins nine other airlines in the world using the system.

Engineering and ancillary services

On the engineering side, Malaysia Airlines has a total maintenance capability on all of its own aircraft and made a major engineering breakthrough in third-party aircraft overhaul when it was awarded a contract by Air France to conduct C-checks on seven of its Boeing 747s. It also carries out third-party aircraft and component overhaul and maintenance work for China's CAAC, World Airways, Thai International, Dragon Air, Royal Brunei Airways,

Exhibit 14.3

Malaysia Airlines 10-year statistical profile



Source: Malaysia Airlines

Air Lanka and Merpati Nusantara of Indonesia.

With its acquisition of a Boeing 737-400 full flight simulator, scheduled to be installed by the end of 1989, Malaysia Airlines' training facilities for its pilots and engineers match that of any regional airline and is more advanced than many. Other flight simulators housed at the Malaysia Airlines' training centre at Subang include those for the DC10-30, Airbus A300 and Boeing 737-200. Seven other Asian airlines make use of the facility on an on-going basis which has generated a rental income for Malaysia Airlines of M$13 million.

Tourism

Sandwiched between the high-profile attractions of Thailand, where tourists stay longer and spend more, and Singapore, which is geared to short-stay visitors focusing on its shopping facilities, Malaysia has lagged behind its neighbours in tourism development. The average length of stay for visitors is only 4.5 nights and, more importantly, 70 per cent of them are from Singapore. What Malaysia needs are more of the Western visitors who makes tourism Thailand's leading export and foreign exchange earner and contribute 6 per cent to Singapore's GDP. At present, tourism accounts for nearly 20 per cent of invisibles earnings. Visitors from ASEAN represent a total of 79 per cent of all visitors to Malaysia. Consequently, tourism receipts in Malaysia, at around M$1.7 billion in 1988, were about a quarter of Thailand's and half of Singapore's. Nevertheless, this was the fourth largest component of Malaysia's foreign exchange earnings.

According to the ASEAN Tourism Information Centre headquartered in Kuala Lumpur, the six-member group can sustain a 9.4 per cent growth in tourist arrivals with a 13.1 per cent increase in receipts for the 1992-95 period, assuming positive growth in the world economy and political stability in the region. This would represent an increase over the 1981-87 period, during which arrivals in four of the member countries – Indonesia, Thailand, Malaysia and Singapore – showed positive compound growth of 9.77 per cent, 9.11 per cent, 5.02 per cent and 4.48 per cent respectively. Malaysia itself is projecting growth at a somewhat higher 6.5 per cent, with receipts projected to pass M$2 billion in 1990.

Outside ASEAN, Japan is the major source of tourist growth for Malaysia, expanding by 8.3 per cent per annum. Other major markets are Australia, New Zealand, the UK, the US, Hong Kong, West Germany and Taiwan. Malaysia's Tourist Development Corporation (TDC) says it is aiming for four million non-ASEAN visitors in 1990, designated "Visit Malaysia Year". An initial budget of M$100 million to promote "Visit Malaysia Year" was subsequently doubled.

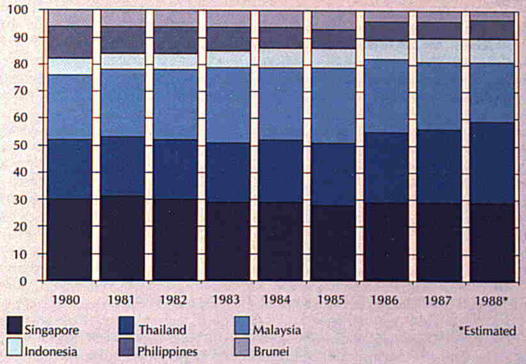
Growth is also hoped for under the aegis of "Visit ASEAN Year" in 1992, when 23.8 million visitors are expected, generating projected revenue of US$14 billion. An ASEAN tourism marketing plan is targeted to achieve a higher growth rate of 20-25 per cent by 1992 with additional funds being made available by United Nations Development Projects. The integrated plan to promote ASEAN tourism has a budget of US$5.19 million to be equally funded by ASEAN and the European Commission.

While Malaysia has an adequate tourism infrastructure and attractions that equal those of its neighbours, the industry is relatively new. Only in the mid-1980s was tourism given ministry status by being added onto the Ministry of Culture. Within the limitations of a fairly modest budget, much has been done to streamline the industry by reducing regulatory complexities and developing better infrastructure.

From lows of 50 per cent in the mid-1950s, occupancy rates at major hotels in Malaysia improved to 67 per cent – still the lowest in Asia – in 1988, by which time the

Exhibit 14.4

Tourists to ASEAN countries 1980-88 (%)



Source: Tourists associations in ASEAN supply of hotel rooms had increased to almost 40,000 from 27,500 in 1980. Occupancy rates are expected to improve to 70 per cent by 1990. There are 50,000 employees in the hotel industry.

Hotel investment in Malaysia began to pick up at the end of the 1980s after dropping to almost nil in 1986. The recovery meant that the Oriental Hotel, on which work was halted in 1985 when the 470-room luxury hotel was 95 per cent complete, has been acquired by Hazama-Gumi for M$90 million. The Japanese construction company plans to complete construction and look for a buyer.

Under the Fifth Malaysian Plan 1986-90 diversification is being encouraged. Tourism incentives were extended to cover not only new investments in accommodation projects, but also ventures such as safari parks, zoos and recreation centres. Under the New Investment Fund set up in 1985, tourism development projects can benefit from incentives such as including pioneer status for up to five years and a tax credit of up to 100 per cent on capital expenditure.

The Selangor state government has scheduled 11 projects costing M$1 billion for tourism development including coastal and esplanade development at Port Kelang and foreshore developments for water sports, a world standard tennis centre, agriculture and nature parks, improvements to the state's famous Batu Caves and other rehabilitation projects. They are to be carried out on a privatised basis.

The TDC (1988 budget M$100 million) serves as a channel of communication between the federal government and international tourism organisations and the domestic industry. Its main function is overseas promotion with offices in Singapore, Tokyo, Bangkok, Hong Kong, Sydney, London, Frankfurt and Los Angeles.

Communications and information technology

The telecommunications service of the Ministry of Energy, Telecommunications and Posts was privatised at the beginning of 1987 under Syarikat Telekom Malaysia Bhd (STM). Services available to the public include a nationwide telephone service with subscriber trunk dialling and international subscriber dialling service, car phone service, mobile radio telephone service, radio paging and a leased channel radio telephone service. New services introduced by STM include Atur (Automatic Telephones Using Radio), Maypac, Telefax and Datel. In March 1989 STM launched Telita, a national videotex service, making Malaysia the first country in South East Asia to introduce such a service. This was followed by the Malaysian Circuit Switched Public Data Network (Maycis), and the Intelsat Business Satellite Service (IBS) was scheduled to be launched later in 1989. Other new services are a public electronic messaging service called Telemail, and Digitaline, a facility for high-speed data transmission. The eventual aim is the national implementation of an Integrated Services Digital Network (ISDN), which a number of countries, including Japan, West Germany, France and Singapore, are already starting to introduce on a commercial basis. ISDN integrates voice, image and data into one network. While the cost of implementing ISDN nationally is still to be assessed, a pilot project is to be introduced in Malaysia's highly developed and populated Kelang Valley with a start-up set for 1993.

STM, the first public body in Malaysia to be privatised, faced inherited inefficiencies, debts and a large 28,000 workforce. Its first year of trading proved to be loss-making, while its subscriber network was operating at only half capacity. The 2.4 million lines with a net book value of M$2.7 billion in 1987, accounted for 40 per cent of STM's fixed assets, yet STM had only 1.2 million subscribers.

In order to boost utilisation, telecommunications received a massive M$9.5 billion budget allocation in Malaysia's Fifth Plan with the target of expanding the telephone network to 2.4 million subscribers, particularly in the rural areas, and increasing telephone availability from 6.3 per 100 of the population in 1985 to 13.8 in 1990.

Chapter Fifteen

The environment for foreign investment

Overview

This chapter compiled with the assistance of KPMG

The Malaysian government welcomes foreign investment and while compliance with the New Economic Policy is important, conditions imposed on foreign investment are generally flexible and based on the merits of individual projects. While the manufacturing sector is considered the main engine of growth, incentives also exist for companies operating in the agricultural and tourism sectors, in both of which investing companies qualify for pioneer status and investment tax allowances under most circumstances.

There are a number of non-tax incentives such as cheap land in Malaysia's 100 or so industrial estates, which are adequately supplied with roads and utilities; free trade zones and bonded manufacturing facilities for export-oriented projects that provide for duty-free import of raw materials; and two free ports. Goods originating from ASEAN countries are partially exempt from import duties and tariff protection and export refinancing facilities are readily available.

Potential growth areas for investment are extensive and include the manufacture of plant and machinery for agriculture and engineering, all types of industrial machinery, computer technology and communications equipment. As many of the materials used in the manufacture of import substitution goods for the Malaysia market are themselves

Malaysia's beaches are a hitherto underdeveloped attraction which will assist the efforts to boost the flow of Western visitors

The target has proved over-ambitious, and penetration reached just 7.8 per cent in 1989, leading to a downward revision of the target to 10 per cent by 1992. Because of the nature of Malaysia's topography with its mountains, dense forests and jungle-clad hillsides, it has been necessary to use domestic satellite and other radio-based telecommunications techniques such as the Atur system which is based on the advanced and sophisticated Nordic Mobile Telephone system using the two technologies of cellular radio and computerised SPC (stored programme control) exchange.

STM was proposing to spend M$18 million in 1990-91 to expand the Atur network, supplying and supervising radio base station equipment installation. This would bring total investments in the Atur network since its introduction in 1985 to M$82 million. The number of mobile telephone exchanges for the network will be increased from five to six and capacity from 30,000 to 42,000 lines. The expanded network will also have 129 radio base stations equipped with 2,009 channels.

Like many developing countries, Malaysia has, within financial restraints, been able to do a certain amount of "leap-frogging" in the acquisition of her communications technology. Thus about 70 per cent of communications are digital while the remainder are analogue.

Maypac

Maypac, introduced in 1985, is the most popular data communications service offered by STM with almost 1,000 subscribers in 1989. The public network, suitable for businesses supply of hotel rooms had increased to almost 40,000 from 27,500 in 1980. Occupancy rates are expected to improve to 70 per cent by 1990. There are 50,000 employees in the hotel industry.

Hotel investment in Malaysia began to pick up at the end of the 1980s after dropping to almost nil in 1986. The recovery meant that the Oriental Hotel, on which work was halted in 1985 when the 470-room luxury hotel was 95 per cent complete, has been acquired by Hazama-Gumi for M$90 million. The Japanese construction company plans to complete construction and look for a buyer.

Under the Fifth Malaysian Plan 1986-90 diversification is being encouraged. Tourism incentives were extended to cover not only new investments in accommodation projects, but also ventures such as safari parks, zoos and recreation centres. Under the New Investment Fund set up in 1985, tourism development projects can benefit from incentives such as including pioneer status for up to five years and a tax credit of up to 100 per cent on capital expenditure.

The Selangor state government has scheduled 11 projects costing M$1 billion for tourism development including coastal and esplanade development at Port Kelang and foreshore developments for water sports, a world standard tennis centre, agriculture and nature parks, improvements to the state's famous Batu Caves and other rehabilitation projects. They are to be carried out on a privatised basis.

The TDC (1988 budget M$100 million) serves as a channel of communication between the federal government and international tourism organisations and the domestic industry. Its main function is overseas promotion with offices in Singapore, Tokyo, Bangkok, Hong Kong, Sydney, London, Frankfurt and Los Angeles.

Communications and information technology

The telecommunications service of the Ministry of Energy, Telecommunications and Posts was privatised at the beginning of 1987 under Syarikat Telekom Malaysia Bhd (STM). [illegible] million and priority is expected to be given to the [illegible] with subscriber authorities, followed by postal counter computerisation in the early 1990s.

Malaysia's banks are the leaders in the use of information technology, but computers are widely used across all sectors, particularly in the travel and transport industries, including the ports, and in wholesale and retail business. STM provides a communications link-up for local banks to the Swift global financial transfer network, exclusive to banks. Some 24 banks and local associates who are members of Swift will be making use of the network.

Chapter Fifteen

The environment for foreign investment

Overview

This chapter compiled with the assistance of KPMG

The Malaysian government welcomes foreign investment and while compliance with the New Economic Policy is important, conditions imposed on foreign investment are generally flexible and based on the merits of individual projects. While the manufacturing sector is considered the main engine of growth, incentives also exist for companies operating in the agricultural and tourism sectors, in both of which investing companies qualify for pioneer status and investment tax allowances under most circumstances.

There are a number of non-tax incentives such as cheap land in Malaysia's 100 or so industrial estates, which are adequately supplied with roads and utilities; free trade zones and bonded manufacturing facilities for export-oriented projects that provide for duty-free import of raw materials; and two free ports. Goods originating from ASEAN countries are partially exempt from import duties and tariff protection and export refinancing facilities are readily available.

Potential growth areas for investment are extensive and include the manufacture of plant and machinery for agriculture and engineering, all types of industrial machinery, computer technology and communications equipment. As many of the materials used in the manufacture of import substitution goods for the Malaysia market are themselves imported, there is strong growth in resource-based import substitution industries. Similarly, as much of Malaysia's rubber, palm oil and timber is currently shipped overseas for further processing, Malaysia is encouraging the setting up of more processing and manufacturing facilities for these commodities and other agro-based industries such as the processing of cocoa and the production of heavy-duty tyres and speciality rubber products and high-value timber products such as knocked-down furniture, panels and doors. Opportunities also exist in precision products such as surgical and dental instruments and equipment and scientific gauges, electrical and electrical components, footwear and toys.

Under new investment incentives announced in February 1989, "pioneer" industries were extended to cover freeze-dried food and mirror glass manufacturing. The government announced the setting up of a task force comprising government and private sector representatives to review the development and problems of the printing industry and to examine possible incentives. These might include eliminating import duties on materials used in printing and helping the industry to identify export markets.

As part of a package announced at the same time, existing pioneer companies will be offered additional incentives to expand their operations by setting up new companies. However, the new companies will qualify for pioneer status and investment tax allowances only on condition that each new project is located in a new factory building and that it uses different equipment, machinery, facilities and staff. The new incentives follow a 5 per cent cut in corporate income tax and the progressive reduction of the development tax announced in the 1989 budget. The government has also introduced a new loan scheme for the private sector under the ASEAN-Japan Development Fund. Nearly M$900 million will be made available to provide loans of between M$2 million and M$20 million for small- and medium-sized companies for expansion.

Foreign investment is particularly welcome in the mining sector, where generous tax incentives are available to incoming firms

Foreign companies are allowed to bring in expatriate personnel, but emphasis is placed on the recruitment and training of Malaysians. For new investments with foreign paid-up capital of US$2 million or more, a company is automatically allowed five expatriate posts, including one "key" post, that can be held indefinitely by an expatriate. Expatriate passes are issued for a maximum of 10 years and applications should be submitted to the Malaysian Industrial Development Authority (MIDA) at the same time as an overseas company's application for approval of its project. Generally, the employment of expatriates is flexible and numbers are negotiable. Expatriate staff are more acceptable in export-oriented industries.

Under Malaysia's labour laws employees are entitled to 10 statutory public holidays plus eight days annual leave. There is a basic 48-hour working week. Employers and employees are obliged to participate in a national provident fund and contribute 11 per cent and 9 per cent of a worker's monthly wage respectively.

Investment guidelines

Types of companies

Limited companies. These can be companies either limited by shares, where the personal liability of members is limited to the amount (if any) unpaid on their shares, or companies limited by guarantee, where the members guarantee to meet liability up to a nominated amount if the company is wound up. As of 1 February 1986, no company can be formed and be limited by both guarantee and by shares.

Unlimited companies. There is no limit to the members' liability.

The most commonly used company structure in Malaysia is the limited company with a share capital. In practice, it is the only type of company which should be contemplated by a non-resident interested in investing in Malaysia. Such limited companies may be either "public" (Berhad or Bhd) or "private" (Sendirian Berhad or Sdn Bhd) companies.

A "public" company is generally one which desires to raise capital from the public. This type of company includes all those whose shares are listed on the stock exchange. A "private" company is generally one which is not permitted to raise funds from the public. It includes subsidiaries of "public" companies.

Foreign companies. A company incorporated outside Malaysia must register as a foreign company in Malaysia if it intends to carry on business in the country. One or more agents must be appointed and they must be resident in Malaysia. Each year, within two months of its annual general meeting, the company must file with the Registrar the audited accounts of the "whole" company as well as the audited 336 accounts. The accounts of the Malaysian operations must be audited by an approved auditor and the records kept in Malaysia.

Stock exchange requirements

A public company which is listed on the Kuala Lumpur Stock Exchange must comply with the listing requirements of the exchange in addition to complying with the provisions of the Companies Act relating to the quotation of shares on the exchange.

Stock exchange requirements relate to management and company procedures, disclosure provisions concerning the prospectus relating to the issue of shares to the public, distribution of financial statements and other matters reflecting the necessity to keep the public and the exchange adequately informed of all aspects of the affairs of the company which may be expected to affect the market value of its shares.

Conduct of business by non-residents

The term "non-resident" means a resident of a country other than Malaysia, including a company incorporated outside Malaysia. A company is deemed to be non-resident controlled where 50 per cent or more of the paid-up capital is held by non-residents; or where it is a branch of a company which is incorporated outside Malaysia; or where the majority shareholding is held by residents, but where the ultimate right of control is held by non-residents.

The conduct of business operations in Malaysia by non-residents may be undertaken by the establishment of a Malaysian subsidiary of a non-resident company; the acquisition by a non-resident company (or by non-resident individuals) of all, or a majority of, the shares of an existing Malaysian company; the establishment in Malaysia of a branch of a non-resident company; or by the establishment in Malaysia of an agent of a non-resident company in such a manner that it does not require registration as a branch. These four alternative methods of operations are discussed in further detail below.

The formation of a Malaysian subsidiary is subject to the same procedural requirements as apply to the incorporation of a local company. The investment of capital in the Malaysian subsidiary by the non-resident company should meet guidelines set out by the Foreign Investment Committee.

The provision of overseas loan funds to the Malaysian subsidiary will require exchange control approval. Interest payable on such loans generally attracts withholding tax except in certain specified instances.

The Malaysian subsidiary may obtain loan funds from local sources up to a maximum of M$10 million without formal exchange control approval, provided that at least 60 per cent of the facilities are obtained from financial institutions incorporated in Malaysia. Borrowings in excess of M$10 million require the prior approval of the Controller of

Foreign Exchange. Permission given for such local borrowings is based on genuine need for funds for operations in Malaysia.

The acquisition by a non-resident individual, or a non-resident company of shares in an existing Malaysian company has to comply with the "Guidelines for the Regulation of Acquisition, Mergers and Takeovers".

A foreign company may establish a branch to carry on business in Malaysia subject to permission from the Ministry of Trade and Industry. The branch must register itself with the Registrar of Companies first before commencing business or establishing a place of business within Malaysia and must lodge the following documents at the time of registration: a certified copy of its certificate of incorporation or documents of similar effect; a certified copy of its charter, statute, memorandum and articles, or other instrument defining its constitution; a list of directors and certain statutory particulars regarding them; where there are local directors, a memorandum stating the powers of these directors; a memorandum of appointment of power of attorney authorising one or more persons residents in Malaysia to accept on behalf of the company service of process and any notices required to be served on the company; notice of the situation of its registered office in Malaysia and the hours during which it is open; a statutory declaration in the prescribed form made by the agent of the company.

The appointed agent is answerable for the performance of all acts required to be done by the company under the Companies Act, 1965.

The activities of a Malaysian agent of a non-resident company may constitute the carrying on of business in Malaysia, in which case the foreign company would be required to register as such; it would then be regarded as having established a branch in Malaysia.

Otherwise, the existence of an agent of a foreign company which effects any sales through an independent contractor, solicits or procures any order (to be accepted outside Malaysia), creates evidence of any debt, or creates a charge on movable or immovable property, conducts an isolated transaction that is completed within 31 days (provided similar transactions are not repeated from time to time), invests any of its funds or holds any property, secures or collects any of its debts or enforces its rights in regard to any securities relating to these debts, maintains any bank account, holds meetings of its directors or shareholders or carries on other activities concerning its internal affairs, becomes a party to any action or suit or any administrative or arbitration proceeding or effects settlement of an action suit or proceeding or of any claim or dispute within Malaysia may not constitute the carrying on of business in Malaysia, and in such cases, registration of the foreign company is not required by the Companies Act. The setting up of a representative office requires the approval of the Ministry of Trade and Industry (MTI) and, in the case of specialised industries such as banking and insurance, the appropriate authorities, i.e. approvals from Bank Negara (central bank) or the Director General of Insurance would also be required.

An agent of a foreign company who imports goods for the purpose of display, exhibition or demonstration as trade samples with the view of subsequent re-export does not constitute the carrying on of a business in Malaysia.

To ascertain whether the foreign company is "carrying on business in Malaysia" it is advisable to consult an accountant and/or a lawyer in respect of this aspect of the Companies Act as well as the possible tax implications relating thereto.

Foreign equity participation in manufacturing

Foreign investors can hold any level of equity up to 100 per cent if the company exports 80 per cent or more of its production, irrespective of whether or not the company's products compete with products presently being manufactured locally for the domestic market.

Foreign investors whose applications are received by the Malaysian Industrial Development Authority (MIDA) during the period 1 October 1986 to 31 December 1990 are also permitted to hold any level of equity of up to 100 per cent providing that the company exports 50 per cent or more of its production; or that the company employs 350 full-time Malaysian workers and that employment of Malaysians at all levels should reflect approximately the racial composition of the country.

An additional proviso is that the company's products do not compete with products presently being manufactured locally for the domestic market. The level of equity participation for projects with lower levels of production for export are as follows:

For projects exporting between 51 per cent and 79 per cent of their production, foreign equity ownership up to 51 per cent is allowed. However, foreign equity ownership of up to 79 per cent is allowed, depending on factors such as the level of technology, spin-off effects, size of the investment, location value-added and the utilisation of local raw materials and components.

For projects exporting between 20 per cent and 50 per cent of their production, foreign equity ownership of between 30 per cent and 51 per cent is allowed, depending upon similar factors to those above. However, for projects exporting less than 20 per cent of their production, foreign equity ownership is restricted to a maximum of 30 per cent.

In both the above cases, the company may manufacture products irrespective of whether or not the products compete with those presently manufactured locally for the domestic market.

For projects producing products that are of high technology or are priority products for the domestic market, foreign equity ownership of up to 51 per cent is allowed.

Distribution of Malaysian equity holdings in new investments

Where foreign equity is less than 100 per cent the balance of the equity to be taken up by Malaysians should be allocated according to the following principles. For projects initiated by foreigners and where no local partners have been identified:

- If 70 per cent or more of the equity is held by foreigners, the balance of the equity will be reserved for Bumiputeras.
- If less than 70 per cent of the equity is held by foreigners, 30 per cent will be reserved for Bumiputeras and the balance for non-Bumiputeras. If foreigners hold 60 per cent of the equity, 30 per cent will be reserved for Bumiputeras and the remaining 10 per cent for non-Bumiputeras. If the equity reserved for Bumiputeras is not taken up, the MTI will allocate part of the balance to non-Bumiputeras.

For projects initiated by Bumiputeras on a joint-venture basis with foreigners:

- If 70 per cent or more of the equity is held by foreigners, the balance of the equity will be reserved for the Bumiputeras concerned.
- If less than 70 per cent of the equity is held by foreigners, the balance will also be reserved for Bumiputeras. However, if Bumiputeras are unable to take up the entire balance, the MTI will allocate part of the balance to non-Bumiputeras.

For projects initiated by non-Bumiputeras on a joint-venture basis with foreigners:

- If 70 per cent or more of the equity is taken up by foreigners, the balance of the equity will be allocated to the non-Bumiputeras concerned.
- If less than 70 per cent of the equity is taken by foreigners, 30 per cent will be allocated to the non-Bumiputeras concerned and the balance will be reserved for Bumiputeras. However, under special circumstances, the non-Bumiputeras may be permitted to take up the entire balance of the equity as decided by the MTI.

Existing investments

Companies licensed between 1 April 1986 and 30 September 1986, and which have not made any investment in respect of the implementation of the project, are also eligible for the same guidelines as above, subject to their exporting 50 per cent or more of production or employing 350 full-time Malaysian workers.

Companies licensed before 1 October 1986 have to comply with the equity condition as stated in the licence. However, the foreign partner is permitted to own up to 100 per cent of the expanded equity as a result of an expansion of capacity or diversification, if approved under the conditions mentioned above, and provided that this does not contradict the terms of any legal agreement that may have been entered into among the shareholders.

Projects involving non-renewable resources

For projects which involve the extraction or mining and processing of mineral ores, majority foreign equity participation of up to 100 per cent is permitted. In determining the percentage the criteria taken into consideration are the level of investments, technology and risk involved in the projects, the availability of Malaysian expertise in the areas of exploration, mining and processing of the minerals concerned, and the degree of integration and the value-added involved in the projects.

Assurance in respect of equity ownership

A company that has been approved under the equity guidelines above will not be required to restructure its equity at any time, even after the year 1990 when the successor to the New Economic Policy (NEP) will be initiated, notwithstanding the fact that the company may have undergone an expansion or diversification, provided that the company continues to comply with the original conditions of approval and retains the original features of the project.

Expansion and diversification

An existing licensed export-oriented company, i.e. one that exports 80 per cent or more in value of its production, can undertake expansion of production capacity for its approved products. For a company which wants to undertake expansion in order to export 80 per cent or more of its products, no approval from the Licensing Officer is required; the company, however, has to inform the MTI and MIDA on the details of its expansion plans in the prescribed form.

Any existing licensed company can undertake diversification of product(s) under the diversification programme for export, subject to the same conditions and procedures as for the expansion of production capacity. However, before the company undertakes the diversification programme, it has to inform the MTI and MIDA about the details of its diversification plan in the prescribed form in order to facilitate amendments to the manufacturing licence.

Any existing licensed company with shareholders' funds of less than M$2.5 million can undertake expansion of its production capacity of its approved product(s) for the domestic market. An existing licensed company with shareholders' fund of M$2.5 million and above can also undertake expansion of its capacity for the domestic market, provided that 30 per cent of the expanded equity arising from the increased investment is reserved for Bumiputeras. In both cases of expansion of capacity, the licensed companies are required to inform the MTI and MIDA with regard to details of the expansion plan for the domestic market.

Likewise, an existing licensed company with shareholders' fund of less than M$2.5 million can undertake a diversification of its production for the domestic market without prior approval from the Licensing Officer. The company, however, is required to submit details of its diversification plan to the MTI and MIDA in order to facilitate amendments to the manufacturing licence. A company with shareholders' funds of M$2.5 million and above which proposes to undertake a diversification is required to submit an application for such diversification in the prescribed form, for the consideration of the Licensing Officer.

Investment guarantee agreements

Malaysia's readiness to conclude investment guarantee agreements is testimony to the government's desire to increase the confidence of foreign investors in Malaysia.

Investment guarantee agreements have been concluded with 15 countries, namely the US, West Germany, Canada, France, Switzerland, Sweden, Belgium, Luxembourg, the UK, Sri Lanka, Romania, Norway, Austria, Finland and the Netherlands.

Under the terms of an investment guarantee agreement the foreign investor is provided with protection against nationalisation and expropriation; prompt and adequate compensation in the event of nationalisation or expropriation; and free transfer of profits or capital and other fees and settlement of investment disputes under the Convention on Settlement of Investment Disputes, of which Malaysia has been a member since 1966.

Assets, mergers and takeovers

In pursuit of the objectives of the NEP the government has established a set of guidelines to regulate the acquisition of assets or interests, mergers and takeovers of companies and businesses. The purpose of the guidelines is to provide a means of restructuring the pattern of ownership and control of the corporate sector. The government uses them to redress imbalances in the distribution of corporate wealth, and to encourage those forms of private investment which contribute to the development of the country, consistent with the objectives of the NEP.

The guidelines apply equally to acquisition, mergers and takeovers by foreign or Malaysian interests and regulate several areas of corporate activity.

Under their terms, any proposed acquisition of assets or interests, and any merger or takeover, is required to result directly or indirectly in net economic benefit on a broadly defined set of criteria. These include the extent of Malaysian participation (particularly Bumiputera participation), ownership and management, income distribution, growth, employment, exports, quality, range of products and services, economic diversification, processing and upgrading of local raw materials, training, efficiency and research and development.

Moreover, the proposed acquisition, merger or takeover should not have adverse consequences in terms of national policies in such matters as defence, environmental protection or regional development. The onus of proving that it is not against the objectives of the NEP is on the acquiring parties concerned.

The guidelines apply to several categories of investment. Any proposed acquisition by foreign interests of any substantial fixed assets in Malaysia is subject to them, as is any proposed acquisition of assets or interests, or mergers or takeovers which will result in ownership or control passing to foreign interests. Similarly, they apply to any proposed acquisition of 15 per cent or more of the voting power by any one foreign interest or associated group, or by foreign interest in the aggregate of 30 per cent or more of the voting power of a Malaysian company and business; to control of Malaysian companies and businesses through any form of joint-venture agreement, management agreement and technical assistance or other arrangements; to any mergers or takeovers of any company and business in Malaysia whether by Malaysian or foreign interests; and to any other proposed acquisition of assets or interest exceeding M$5 million in value, whether by Malaysian or foreign interests.

The guidelines do not apply to specific projects approved by the government.

Foreign investment

To oversee the implementation of the guidelines on acquisitions, mergers and takeovers, the Foreign Investment Committee (FIC) was established with responsibility for all major issues in foreign investment. The functions of the committee are to formulate policy guidelines on foreign investment in all sectors of the economy in line with the NEP; to monitor progress and help resolve problems pertaining to foreign private investment and to recommend suitable investment policies; to supervise and advise ministries and relevant government agencies on all matters concerning foreign investment.

The special economic advisor to the prime minister is the chairman of the committee. Other members of the FIC are the secretary-general of the Treasury, the governor of Bank Negara Malaysia, the director general of the Economic Planning Unit, the secretary-general of the MTI, the chairman of MIDA and the Registrar of Companies and Businesses. The secretariat of the Committee is in the Economic Planning Unit, Prime Minister's Department, Jalan Dato Onn, Kuala Lumpur.

The Capital Issues Committee

Proposals should be submitted to the Capital Issues Committee (CIC) by all public limited companies incorporated in Malaysia unless the company falls within any exemption made by order of the minister in the gazette. The CIC is concerned with any new issues or offers for sale of securities to the public, whether the issues or offers for sale are by way of public issues or by private placements; rights issues of securities; bonus issues of securities other than by way of capitalisation of unappropriated profits; schemes of arrangement, reconstruction, takeover, share option and acquisition of assets by way of issues of securities; general offers; and listing and quotation of securities on a stock exchange.

CIC regulations also apply to all public limited companies incorporated outside Malaysia which intend to issue or offer for sale securities to the public or to use such securities on a stock exchange prior to the registration of the relevant prospectuses with the registrar. They also affect public limited companies incorporated outside Malaysia which are already listed on a stock exchange, when they seek the listing or quotation of any additional securities.

In assessing proposals, the CIC pays particular attention to the viability of the proposals; the quality and capability of the management of the company; the suitability for listing of the company on the Kuala Lumpur Stock Exchange; and the public interest.

The CIC is not in favour of public limited companies incorporated outside Malaysia which do not have any Malaysian operations obtaining a listing in Malaysia. The committee's aim is thought to be to prevent foreign companies from tapping funds from the capital markets in Malaysia and consequently competing with Malaysian borrowers for a limited pool of funds.

The role of the CIC in approving potential listings is not confined to listings in Malaysia only. All Malaysian incorporated public limited companies seeking a listing abroad also require the approval of the CIC.

There is provision in the Act for an applicant to the CIC to appeal to the minister against the committee's decision. Such appeal must be lodged within one month from the date of receipt of the decision and the minister's decision is final.

Takeover panel

In addition to the FIC and CIC, there is a special panel with responsibility for reviewing all takeovers and mergers whose function is to review all takeovers and mergers. The Malaysian Code on Takeovers and Mergers, 1987, which is similar to the City Code on Takeovers and Mergers in London, lays down general principles that represent what are considered good standards of commercial behaviour and rules which are examples of the applications of the general principles.

Two main, though inter-related, threads run through the provisions of the code. One is that the shareholders of an offeree company should decide whether or not an offer shall succeed, and the second is that there must be equitable treatment among various shareholders of the offeree company.

All public companies and such private companies as the panel may determine are required to comply with the code. The most recent ruling by the panel determined the criteria on which private companies must observe the code: where shareholders funds are M$5 million or more or the purchase price involves a total consideration of not less than M$10 million.

Every company that intends to acquire shares in a company which, when aggregated with shares already held by the acquirer, would give the acquirer the right to exercise or control the exercise of more than 33 per cent of the voting rights of the company is required to submit all relevant information and documents to the panel at least 21 days prior to the despatch of the document to the shareholders.

The acts and decisions of the panel in the exercise of its functions in respect of the general principles and rules in the code are final and cannot be challenged in any court.

The procedural aspects of takeovers, acquisitions and mergers also come under the panel, a function formerly under the purview of the FIC. The role of the panel is to ensure that all takeovers and mergers are conducted according to the rules laid down in the code. However, the FIC continues its role of ensuring all takeovers, mergers and acquisitions are in line with national interest and comply with the NEP.

Sector regulation

Special regulations pertaining to particular sectors govern investment in these areas designated as being of key importance to the Malaysian economy.

Petroleum Development Act

The Petroleum Development Act (1974) places the entire ownership, rights, powers, liberties and privileges of exploiting petroleum resources on land or offshore Malaysia in Petroliam National Berhad or PETRONAS. The licensing powers in downstream petroleum activities are vested in the MTI. PETRONAS continues to be the licensing authority for all upstream petroleum activities.

Insurance

Insurance business in Malaysia comprises life and general insurance and comes under the control of the central bank. Only companies incorporated in Malaysia are allowed to operate an insurance business. However, companies incorporated elsewhere which have an established place of business in Malaysia or are societies registered under the Cooperative Societies Ordinance are also permitted. Foreign-controlled insurance companies are presently required to restructure their equity capital in line with the requirements of the NEP.

The government has established a national reinsurance company in order to curtail the ever increasing reinsurance premium paid by insurance companies operating in Malaysia to overseas reinsurers. As a result of the formation of Malaysia National Reinsurance Berhad in 1972 the acceptance capacity of the Malaysian insurance market has been increased.

The government has also provided a concessionary rate of income tax of 5 per cent instead of the normal 40 per cent on any income derived from inward reinsurance and offshore insurance.

All insurers must maintain at all times a deposit of at least M$300,000 in cash or certain specified securities (which include a bank guarantee) with the accountant-general. In addition, insurance companies are required to maintain an insurance fund with the fund's assets kept separate from the insurance companies' other assets. They must also invest a fixed percentage of funds in authorised assets including at least a certain percentage in government securities.

Transfer of technology

The government encourages the transfer of technology from non-residents to the residents of Malaysia. However, to ensure that the agreement will not impose unfair and unjustifiable restrictions or handicaps on the local party; that the agreement will not be prejudicial to national interest; and that the payment of fees (if applicable) will be commensurate with the level of technology to be transferred, any agreements for the transfer of technology relating to manufacturing projects must have prior written approval of the MTI.

Technology transfer agreements requiring prior approval of MTI include those that cover licence rights over specific processes, formulae or manufacturing technology (patented or unpatented); other knowledge and expertise necessary for the setting up of a plant; and provision of various technical assistance and supporting services.

Such agreements should define in detail the technological content and principal features of technology or process, anticipated production, quality and specification of products, particulars of technical assistance, services and manner in which they are to be provided.

Chapter Sixteen

Taxation

General principles

This chapter compiled with the assistance of KPMG

The Malaysian tax regime has been constructed in the context of an improving federal government fiscal position since 1987. After revenues declined in 1986 and 1987 they rebounded in 1988, coinciding with the trimming of expenditure. The greatest increases on the revenue side were registered through higher receipts of corporate and petroleum taxes, although income tax showed a marginal decline, as did other direct taxes.

Direct taxes include taxes on income, estate duty, stamp duty, real property gains tax, petroleum tax and share transfer tax. Indirect taxes include export duties, import duties and surtax, excise duties, sales tax, service tax and other taxes.

Income tax is levied on the chargeable income of a person, and a "person" for tax purposes includes a company, a body of persons and a corporation sole. Income tax is generally imposed on a "territorial" basis, whereby residents of Malaysia are taxed on all income derived from Malaysia as well as on income received from outside Malaysia. Non-residents are taxed on Malaysian-derived income only. The year of assessment is the calendar year. Generally, tax is assessed in the year of assessment on all income of the preceding calendar year (the basis year) but income from business sources is assessed on the basis of the financial year (the basis period) ending in the year immediately preceding the year of assessment.

A company is resident for a year of assessment, regardless of where it is incorporated, if at any time during the base year it is managed and controlled in Malaysia. Generally, a company is regarded to be managed and controlled in the place where its directors' meetings are held. An individual becomes a tax resident for a year of assessment if the aggregate number of days he stays in Malaysia during the basis year exceeds 182 days, although under certain circumstances it is possible to be a Malaysian tax resident even if the total number of days he stays in the country is less than 182 days.

The main sources of income liable to income tax are as follows: gains or profits from any trade, business, profession or vocation; employment income; dividends, interest or discounts; rents, royalties or premiums; pensions, annuities or other periodical payments.

Capital allowances

Against taxation, depreciation and amortisation of fixed assets for accounting purposes are not allowable. In their place, tax deductions take the form of capital allowances, mine depletion allowance and deduction of prospecting expenditure.

Capital allowances given take the form of an initial allowance (IA) which is given once for the year of assessment in which the qualifying capital expenditure is incurred, and an annual allowance (AA) which is given each year commencing the year of assessment in which the qualifying capital expenditure is incurred.

In most cases, an asset has to be owned and in use at the end of the basis period for the purpose of the business to qualify for capital allowances.

All rates are applied against the original qualifying cost of the relevant fixed assets.

Other allowances

Mining expenditure

Deduction is given against mining income over the life of the mine for capital expenditure incurred on the acquisition of mining rights, searching, discovering, testing or winning access to deposits, development, general administration or management before the commencement of actual production or during any period when minerals are not being mined. The amount of deduction is calculated by dividing the residual expenditure at the end of a basis period by the remaining life of the mine at the beginning of that period.

Prospecting expenditure

Any person who has incurred qualifying prospecting expenditure may, within three months after the beginning of the year of assessment in which the expenditure was incurred, elect to claim for deduction of expenditure incurred on prospecting in Malaysia.

The claim must contain an identification of the eligible area and the amount of expenditure incurred. A person may claim a deduction of qualifying prospecting expenditure incurred in the past but limited to expenditure incurred not more than 10 years before the end of the basis year. Such a claim must contain a declaration that prospecting has permanently ceased and that the company has no intention of carrying on any mining business in that area.

Balancing allowances and charges

Where an asset is disposed of and the disposal proceeds exceed the tax written down value of the asset, a balancing charge will be imposed on the disposer. The balancing charge is restricted to the total capital allowances claimed by the disposer. Where the disposal proceeds are less than the tax written down value of the asset, the disposer is entitled to claim the difference as a balancing allowance.

Withdrawal of capital allowances

Where an asset is disposed of within two years of its purchase, the Inland Revenue Department may withdraw the allowances already given on the asset. This "clawback" is generally not applied if a valid reason is given for the disposal of the asset, e.g. destruction by fire or act of nature.

Exhibit 16.1

Capital allowance rates

	IA	*AA*
Industrial buildings	10%	2%
Agriculture/forestry		
expenditure on initial planting of approved crops, construction of roads in a plantation	Nil	50%
buildings constructed for the welfare of persons in connection with growing and harvesting crops	Nil	20%
any other buildings and construction of roads in a forest	Nil	10%
Plant and machinery		
furniture and fittings	20%	8%
office equipment	20%	12%
commercial motor vehicle, cranes	20%	20%
private motor vehicles (limited to M$25,000)	20%	16%
other plant and machinery		
depending on type of industry	20%	8%
depending on type of plant	–60%	–20%

Unabsorbed capital allowances
If capital allowances in any year are not fully absorbed by adjusted business income, they are carried forward for set-off against future income from the same business source only.

Other deductions against aggregate income
The following deductions are allowed provided there is sufficient aggregate income remaining after deducting capital allowance and unabsorbed business losses (against income from business source only): current year business loss, prospecting expenses, approved cash donations.

Tax on companies and individuals

Withholding tax on payments to non-residents

The Malaysian income tax law provides that interest, royalty and payment for services under a contract and certain classes of income are subject to withholding tax where the recipients are non-residents. Non-exempt interest derived by a resident individual will be subject to withholding tax of 5 per cent. The withholding tax, which is a final tax, is only applicable where the payer is a licensed bank or finance company in Malaysia or any other institution that may be approved by the Minister of Finance.

Interest and royalty
Withholding tax is applicable where interest (other than exempt interest) or royalty (other than exempt industrial royalties) derived from Malaysia is paid or credited to any person not known to the payer to be resident or to have a place of business in Malaysia.

Both interest and royalty are deemed to be derived from Malaysia if they are borne directly or indirectly by the government or resident person or if they are charged out as an expense in the accounts of a business carried on in Malaysia. Interest which arises from money lent to a resident person on the security of Malaysian-based assets or employed on assets used in generating gross income will also be deemed to be derived from Malaysia.

Royalty and interest paid or credited to a non-resident person are subject to withholding tax at the rates of 15 per cent and 20 per cent. The rate may be reduced where specifically provided for in double taxation agreements.

Services under a contract
Withholding tax is applicable where payment for contract services is made or credited to a non-resident contractor in respect of services under a contract. The rate of withholding tax is 20 per cent of the contract: 15 per cent to cover the tax liability of the non-resident contractor, and 5 per cent to cover the tax liability of the employees of the non-resident contractor.

Dividends
Malaysia has an imputational system of taxation where there is no withholding tax on dividends paid by Malaysian resident companies. Instead, tax at 40 per cent is deemed to have been deducted at source as the dividends are franked from income tax paid on the company's profits.

Deduction of tax from special class of income
Section 109B was introduced in October 1983 to impose a withholding tax on payment to non-residents in respect of: rental of any movable properties excluding film rental; services in connection with the use of, or installation or operation of equipment purchased from such non-residents; and technical advice, assistance or services in connection with technical management or administration of a project, scheme undertaking or venture.

Share transfer tax

Under the Share (Land Based Company) Transfer Tax Act 1984, which was effective from October 19 1984, a tax would be imposed on the disposal of shares of a land based company. The rate of tax is 2 per cent of the disposal proceeds and the tax is imposed only where the shares disposed of are not listed on a stock exchange and the disposal proceeds are M$1 million or more.

Double taxation agreements

Malaysia has concluded agreements for avoidance of double taxation with 26 countries:

Australia	East Germany	Romania
Bangladesh	Italy	Singapore
Belgium	India	Korea
Canada	Japan	Sri Lanka
China	New Zealand	Sweden
Denmark	Norway	Switzerland
West Germany	Pakistan	Thailand
Finland	Philippines	United Kingdom
France	Poland	

These Double Taxation Agreements (DTAs) follow the general principle that the country of source has the prior right of tax and that the country of residence provides relief through either tax exemption or tax credit.

The general effect of DTAs is that industrial or commercial profits earned from Malaysia by a resident of another (treaty) country are not subject to Malaysian tax unless the non-resident of Malaysia carries on business activities in Malaysia through a "permanent establishment".

DTAs entered into by Malaysia generally provide that tax payable in either treaty country should not exceed a certain rate, say 10 per cent or 15 per cent as the case may be.

Under the Income Tax 1967 requirements, a non-resident individual who is employed in Malaysia for more than 60 days in a year is liable to Malaysian tax. Most DTAs extend this exemption period to 183 days in the calendar year if the individual is employed by a non-resident and remuneration is not claimed as an expense in the Malaysian accounts of the non-resident employer.

Certain DTAs provide that whilst interest on approved loans, long-term loans and approved industrial royalties is exempt from tax in Malaysia, double taxation credit is to be given in the foreign country as though Malaysian tax has been paid. This is termed as tax sparing which is also available for dividends paid by a Malaysian company that is tax exempt under the Promotion of Investment Act, 1986.

Exhibit 16.2

Tax rates

Tax on companies		
Income tax	35%	on chargeable income
Development tax	4%	on net income from business and rental sources, to be abolished gradually (probably at the rate of 1% p.a.)
Excess profit tax	3%	on chargeable income in excess of M$2 million
Tax on individuals		
Income tax	40%	in the case of non-residents and graduated rates up to 40% in the case of residents
Development tax	5%	on net income from business and rental sources
Excess profit tax	5%	on total chargeable income above M$300,000

Investment incentives

Tax incentives

Certain tax incentives are available to resident companies in Malaysia which are involved in promoted activity or the manufacture of a promoted product. Broad categories of promoted activities and promoted products include cultivation and processing of agricultural products (e.g. cocoa, coffee, fruits and vegetables); livestock farming; manufacture of rubber products, palm and palm kernel oil products; chemicals and pharmaceuticals; leather and leather products; wood and wood products; paper pulp and paperboard; textiles and textile products; iron, steel and non-ferrous metal products; machinery and machinery components.

The principal incentives for investments are contained in the Promotion of Investments Act, 1986 and the Income Tax Act, 1967. The Promotion of Investments Act offers pioneer status; investments tax allowance; abatement of adjusted income; export allowances; double deduction for exports. The Income Tax Act provides for reinvestment allowances; accelerated depreciation allowances (ADA); incentives for inward reinsurance and offshore insurance; shipping incentives; and incentives for re-afforestation.

Pioneer status

Companies given pioneer status incentives are exempted from the payment of income tax, development tax and excess profit tax. The period of tax relief is five years irrespective of the level of capital investment. Losses carried forward from a pioneer period are no longer allowable.

Investment tax allowance

Investment tax allowance may be applied for by any company participating or intending to participate in a promoted activity or in the production of a promoted product. An allowance of up to 100 per cent in respect of qualifying capital expenditure incurred may be given within five years or 10 years in the case of an integrated agricultural activity, from the date of approval of the project.

Abatement of adjusted income

Abatement of adjusted income can be provided in a variety of circumstances. Where a resident manufacturing company locates in a promoted industrial area, abatement is at 5 per cent of adjusted income for each year so long as the area in which the factory is located remains gazetted as a promoted industrial area. This abatement is given for a minimum period of five years.

Resident small-scale companies commencing business on or after 1 January 1986 are also eligible. Abatement is at 5 per cent of adjusted income for five years and shall cease earlier when the company ceases to be a small-scale company or ceases to be a resident. A small-scale company is defined as one in which shareholders' funds at the first day of a basis period for a year of assessment do not exceed M$500,000.

Compliance with government policy also qualifies resident manufacturing companies where they comply with the government policy on capital participation or employment. Abatement at 5 per cent on adjusted income is given for five years.

Abatement of up to 50 per cent of adjusted income is given by reference to FOB export sales in relation to total sales. In addition, a further abatement will be given at 5 per cent of the value of indigenous materials used in products manufactured for exports.

Export allowance

An export allowance is available for agricultural produce and Malaysian manufactured products exported. The allowance is calculated at 5 per cent of the FOB sales value.

Double deduction for promotion of exports

Certain expenses incurred by resident companies for the purpose of seeking opportunities for export of products manufactured in Malaysia are eligible for double deductions of such expenses against taxable income. The expenses that qualify are expenses incurred on overseas advertising, supply of free samples abroad, export market research, preparation of tenders for supply of goods overseas, supply of technical information abroad, exhibits and/or participation required in trade or industrial exhibitions.

Reinvestment allowance

A resident company which incurs capital expenditure before 31 December 1990 on a factory, plant, machinery or other apparatus used for an approved project in Malaysia can claim a reinvestment allowance equivalent to 25 per cent of that expenditure.

Prior approval of the Ministry of Trade and Industry has to be obtained to qualify for reinvestment allowance. Companies currently enjoying incentives (pioneer status and investment tax allowance) would not qualify for reinvestment allowance.

Incentives for inward reinsurance and offshore insurance

Income tax payable on profits from inward reinsurance and off-shore insurance is 5 per cent instead of the normal 40 per cent and dividends paid on such profits are exempt from tax in the hands of the shareholders. The incentives are available to all insurers, whether or not tax resident in Malaysia, including Malaysian branches of foreign insurance companies.

Shipping incentives

The statutory income of a resident person derived from the business of transporting passengers or cargo by sea on board Malaysian ships is exempt from tax.

Incentives for re-afforestation

Cultivated timber is regarded as an "approved crop" and capital allowances are available for expenditure incurred on re-afforestation.

Other incentives

In addition to the above tax incentives the following incentives in the form of financing are also available.

Export Credit Refinancing (ECR) scheme

This has been introduced by the central bank to provide Malaysian exporters with credit at preferential rates of interest to enable them to be more competitive in international markets.

Credit is extended by the commercial banks to exporters of goods manufactured in Malaysia. The central bank undertakes pre-shipment and post-shipment refinancing for a maximum period of six months. The pre-shipment facility is designed to provide working capital to the exporters from the time the export order is finalised to the time the goods are shipped, whereas post-shipment facility is offered to eligible products as soon as the goods are shipped.

Eligibility of goods for refinancing under the ECR scheme is determined through a "negative list" concept, whereby products not listed in the negative list will be eligible for refinancing under the scheme.

Products with domestic value-added of at least 20 per cent and which use local materials of at least 30 per cent of total raw material costs will have automatic access to the scheme. However, this criterion is implemented flexibly, taking into account special circumstances. Currently, refined palm oil products and textiles are exempted from these requirements. For other products that do not fulfil the local content and value-added criteria, exemption is given by the central bank on a case-by-case basis.

The current interest rate chargeable by the commercial banks under this facility is 5 per cent per annum.

The maximum amount of refinancing for each firm is M$5 million on an outstanding basis (for both post and pre-shipment), but higher limits may be given on case-by-case basis, upon application to the central bank.

The minimum amount for refinancing, that is, the minimum value of each substitution bill, is M$20,000. Exporters can "bunch" several smaller bills to make M$20,000. To encourage exports to non-traditional markets, double deduction on premiums paid for export credit insurance can be claimed provided the insurance is taken up with Malaysia Export Credit Insurance Bhd.

New Investment Fund (NIF)

As part of the government's effort to increase domestic productive capacity and to promote exports, a New Investment Fund (NIF) was introduced in September 1985 by the Ministry of Finance to help stimulate new fixed investments in the manufacturing, agriculture and tourism sectors at moderate rates of interest and to supplement financing of medium and large-scale industries. Under this scheme, the central bank will channel government deposits to the commercial banks at the NIF funding rate for on-lending for new eligible investment projects by all enterprises, including non-resident controlled companies whose fixed investment are in Malaysia. The minimum amount of financing is M$250,000 while the maximum is M$50 million per project, funding being available up to 75 per cent of the investment expenditure, excluding land, for a period of up to five years. However, working capital requirements (except in special cases for export industries) and loans to finance or refinance acquisition of shares, land or existing assets will not be funded. Loans extended under NIF are charged an interest rate not exceeding 1.25 per cent above the prevailing base lending rate of the commercial banks.

Chapter Seventeen

Malaysia into the 1990s

Over the next 10 years, Malaysia will face the same challenges and problems encountered by many of the other industrialising nations of South East Asia during the past decade. Some of those challenges are already emerging.

Political conflicts are now more apparent than at any time since independence and this has been one factor inhibiting the level of domestic investment. The Chinese community is awaiting the replacement of the New Economic Policy and, until this emerges along with any new guidelines on ethnic shareholding proportions, is perhaps hesitant about committing itself to high levels of investment. The ruling party is more divided than it has been since independence, although Prime Minister Mahathir seems secure in his personal position and there is a good chance of a compromise between the rival factions within UMNO. In any event, Malaysia has a long tradition of post-independence stability and it is unlikely that this will be seriously breached.

Rather than the political scene, however, it is economic factors that will play the crucial role in determining the country's future into the 1990s. Trade and investment will be two vital ingredients in success.

The importance of investment in the pace of future development is apparent from a comparison with Korea. In the five years between 1983 and 1988, the share of total investment in GDP in Korea went from 31.5 per cent to 34.1 per cent, while the share of manufacturing in GDP over the same period rose from 29.5 per cent to 34.8 per cent. In Malaysia over the same period, the investment share in GDP declined from 33 per cent to 21 per cent, while the proportion of manufacturing to national output rose modestly from 18.8 per cent to 23.4 per cent. If Malaysia is to sustain high levels of manufacturing growth and diversification into the 1990s, levels of investment will have to remain high. Although a retrenchment has occurred in the public sector, signs are that private sector investment is on the increase, assisted by the creation of opportunities for private capital to be deployed in the newly privatised sectors of the economy.

In overseas trade, the securing of markets may come to rest increasingly on the ability to invest overseas, particularly as fears mount in Japan and Asia's NICs over the prospects of increasing protectionism in the US and the new post-1992 unified Europe. Japan, Korea and Taiwan have made substantial investments in Europe and the US to offset the effects of a tightening-up in those markets. Malaysia does not have resources on a comparable scale and may therefore find itself at a relative disadvantage to some of the more established NICs in securing a position in these markets.

For Malaysia, a great deal rests on prospects in the US market. It currently exports almost 50 per cent of its manufactured goods to the US where it still enjoys GSP privileges which the US has withdrawn from other Asian NICs. However, US trade officials have warned Malaysia that the country is still "on trial" as a recipient of these GSP advantages because of allegations of human rights violations.

Besides concern over the potential erection of trade barriers, there is a broader fear about the prospect of a slowdown in the world economy in the next five years. The economies of Europe, the US and Japan are expected to experience a moderate slowdown in the early 1990s, which will put a brake on Malaysian exports after the surge of the late

1980s, which was helped by currency realignments. For Malaysia, where commodities continue to play an important part in export earnings, the prospect of a slowdown complicates the picture further by raising the possibility of a weakening of commodity prices.

Nevertheless, the short-term economic picture appears to be good and private capital is expected to play a greater role in determining the country's future in the wake of the government's privatisation drive. Soaring exports have enabled Malaysia to shift the current account into the black. Coupled with strong capital inflows and a clampdown on public sector expenditure, this has held back the need to borrow, limiting the rise of foreign debt, a position that will allow the government increased funds for domestic investment. Exchange rate policy does, however, present a potential difficulty. While the depreciating ringgit has been important to the surge in Malaysia's manufactured exports, it hinders the government's efforts to reduce the foreign debt and leads to imported inflation. It seems unlikely, however, that Malaysia will abandon its present policy of allowing the currency to float freely.

Looking beyond the immediate short-term perspective, there is no doubt that at some stage in the 1990s Malaysia will join the club of Asian NICs. Mahathir's belief is that it will happen by the turn of the century but most economic analysts expect that it will happen sooner, probably by 1995.

More significant than the timing, however, is the question of how well the country will be positioned as an NIC. Will investment, both domestic and foreign, be at a sufficient level to sustain the growth necessary for long-term prosperity? Will Malaysia be able to diversify and upgrade manufacturing sufficiently to compete effectively in increasingly protectionist markets? Will the world economy continue to expand or will a slowdown in demand suffocate ambitions of fuller industrialisation? It is the answers to these questions that will dictate Malaysia's successes or failures as a NIC, and the outlook varies considerably across sectors.

Agriculture

In 1990 agriculture is expected to be providing two million jobs, about one-third of total employment, compared to 40 per cent in 1980. Industry employs slightly more than one million Malaysians, about 17 per cent of total employment. By the end of the decade the gap is expected to become significantly less as the rural agricultural sector continues to become less labour intensive and as manufacturing activity increases.

The crucial questions for agriculture are the extent to which it can achieve a measure of diversification into downstream processing of products and the extent to which it can make linkages with industrial processing – for instance in the rubber goods sector and furniture. If this happens and Malaysia can retain far more value-added in the agricultural sector, then the economy will be better placed to avoid the effects of commodity price cycles.

Government programmes and incentives are targeted at large and medium-sized operations and particularly at food processing. Malaysia spends M$3 billion annually on food imports and food processing lags far behind agricultural production. The sector has wide scope for foreign investment. The big plantation companies are already leading the way in diversification, into food production and into downstream processing, particularly of rubber products.

On the downside are increasing labour costs and the lack of any accurate long-term forecasting. But the government's policy of deregulation and privatisation is intended to inject more funds from the private sector to provide investment. These efforts to revitalise the agricultural sector should begin to have an impact by the mid-1990s. A wide range of incentives exist in agriculture and the 1990s will see a gradually intensifying number of start-ups in a variety of projects. In forestry, Malaysia's top-performing non-fuel commodity sector, the export of raw material will accompany a decline in logging. Major opportunities exist for foreign partnerships in the manufacture of timber products, presently a very under-developed industry with low technology.

Industry and manufacturing

In the short term, Malaysia seems well positioned following a surge of foreign investment in manufacturing and exports. The spectacular increase in manufacturing has propelled it into first place as a contributor to GDP, improving above targets that were set for it for 1995. However, the outlook hinges on the role of domestic investment. While this continues to lag behind overall growth, it is questionable whether manufacturing's share of total output can be substantially increased. Although foreign investment has been drawn by the relative attractions of Malaysia vis-à-vis other South East Asian countries, it remains fickle and it is on domestic private investment that long-term growth and prosperity will rely.

One encouraging sign of growth from domestic sources is in the small- and medium-scale industry (SMI) sector. This currently accounts for about 10 per cent of total industrial output, and it is expected to play a growing role in the coming decade. This is again a lesson that has been learned from the Japanese and Korean experience. SMIs create employment, often outside traditional urban centres of manufacturing, they encourage diversification and they reduce foreign exchange outflows through import substitution as well as creating synergies through interacting with larger industries.

Malaysia will be looking again at Japan and Korea where large industry has played an active role in the growth of SMIs through financial support, technical assistance and quality control. Malaysia's SMIs have typically been under-capitalised and are lacking in technical and marketing know-how, and they are being studied with a view to recommendations that could be incorporated into the Sixth Malaysian Plan.

Another area in which there is likely to be a changed emphasis is that of heavy industry. After the misguided publicly-funded venture into heavy industry at the start of the 1980s, intended as a short-cut to NIC status, the 1990s will see heavy industry developing along different lines. The major projects, all to be carried out on a privatised basis, will be less glamorous and many of them will focus on the downstream use of Malaysia's hydrocarbon resources, particularly PETRONAS' ventures in petrochemicals and plastics which are projected to save M$15 billion in imports within a 15-year period of completion of the plants in 1992. Although the nature of the projects may have changed from the large-scale turnkey undertakings of the 1980s, foreign partners will continue to be involved in most major projects.

Crucial to the industrialisation strategy of the 1990s will be diversification away from electronics and textiles. Here again foreign partners will be needed for funding and for technology transfer. The highest priority will be given in the rubber industry, particularly tyre manufacturing. At present Malaysia manufactures only a tiny proportion of the world's total supply of rubber products, while being the world's biggest natural rubber producer. In Malaysia's long-term industrialisation after the year 2000, rubber-based industries, particularly tyre-making, are projected to have the greatest promise.

Besides diversification, the manufacturing sector in Malaysia will rely for growth on its export markets, rather than on the limited domestic market. Increased competition in Malaysia's traditional markets is inevitable in the 1990s and thus the development of regional markets will be crucial. Malaysia has the advantage of being a part of the Asia-Pacific region, which is the fastest-growing in the world. With GDP in the region forecast to equal that of the US by the turn of the century, Malaysia is strategically placed on the threshold of these major growth markets.

ASEAN, formed primarily to foster political unity between its members, is unlikely to become a significant force in strengthening of economic cooperation and assisting in the development of Malaysia's external trade. In the 1990s Malaysia's hopes of penetrating new markets will necessitate looking beyond the boundaries of the ASEAN group and focusing on the wider markets of the Pacific Rim countries.

Transport, tourism and communications

Transport will be the big spending sector in the 1990s with many business opportunities and expansion. Malaysia is conscious of the need to update much of its infrastructure if the economy is not to be held back by bottlenecks on the distribution side. In port development, growth will be modest until 1995, but will be followed by planned expenditure of M$1.4 billion between 1995 and the year 2010. The first half of the 1990s will see the completion of a massive highway along the entire length of Peninsular Malaysia at a total projected cost of M$4.5 billion. And in aviation Malaysia Airlines will spend M$5.5 billion on its new fleet. The decade will be a period of modernisation, expansion and privatisation of domestic airports. Communications growth is likely to be slower in the 1990s after the ambitious targets set for the 1980s, which have created an adequate infrastructure in this area.

The lucrative tourism sector presents one of the biggest opportunities for growth in the 1990s, and considerable efforts will be made in this sector with the aim of streamlining the industry and competing more effectively for a bigger share of the more than US$10 billion tourists spend each year in the ASEAN countries.

Energy

A switch from oil-based energy to natural gas will be the single most important event of the 1990s. Malaysia's energy programme will ensure that the country's considerable reserves of natural gas are used to reduce the cost of energy and to reduce Malaysia's exposure to world energy price movements.

Natural gas presently provides Malaysia with about 18 per cent of its primary energy needs. By the year 2000 it will account for 40 per cent of energy requirements. The biggest consumers will be the power generation sector with the main power stations at Port Kelang, Port Dickson and Pasir Gudang switching from oil to gas after the completion of Peninsular Gas Utilisation scheme by which natural gas will be piped from fields offshore Terengganu on the east coast.

A high success rate in exploration coupled with generous production sharing contracts will guarantee continued expansion of exploration activity on the part of foreign oil companies well into the new century. The oil companies are projected to spend US$2.5 billion on exploration between 1989 and 1993. Malaysia is likely to sign more long-term contracts to supply natural gas to her industrialised neighbours and to move into more downstream industrial activity.