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Historical Institutionalism and Economic Diversification: The Case of Malaysia

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Abstract

This paper argues that Malaysia's ability to diversify its economy and not be overly reliant on natural resource is due to the state's institutional character and its historical process. Malaysia's ability to avoid the resource curse rests on two factors. First, the path dependent nature of Malaysia's economic arrangement - the prior existence of a thriving private sector and the late entry of commercial oil production and – provides the state with increasing returns to economic diversification. Second, Malaysia's consociational arrangement imposes limits on policy options, giving the state little choice but to continue to adopt economic diversification strategies to keep to consociationalism's distributive qualities.

Keywords: historical institutionalism, path dependence, economic diversification, Malaysia

1. Introduction

There is a general agreement that states with abundant natural resources tend to do less well economically when compared to non-resource rich states. Many reasons can be put to this. An often cited reason is that over reliance on natural resources retards development of the private sector. In most cases, the state is the largest employer in resource rich states which effectively stultifies the growth of the private sector. These states struggle to develop durable growth sectors like manufacturing and services. Resource rich countries are also prone to carry out policies that distort the economy. In their effort to yield to public demand states often adopt suboptimal distributive policies that do more damage to the economy in the long run. Fuel subsidies for instance often benefit the non-intended group more. Indeed, large private vehicle owners enjoy more from cheaper petrol prices, the very ones that do not need such a subsidy. Finally, resource rich states have greater propensity to produce extractive institutions. Competition between elites over control of natural resources often produces extractive institutions that inhibits state's economic potential (Acemoglu, 2012). When the state is dominant - as normally the case with resource rich states - efforts at controlling resources also encourages rent seeking opportunities and resultant formation of a predatory state (Evans 1995). To sum, states with natural resources tend to suffer from an under developed private sector, a lack of financial depth, corruption and low domestic and foreign investment. (Gylfason, 2004).

Is it possible for states to beat the resource curse? One way to avoid the resource curse is for states to undertake administrative reforms by putting in place mechanisms to limit rent-seeking opportunities and allow for greater accountability and transparency. States can privatize the resource sector and/or distribute receipts from natural resources directly to the public. Attractive as this may be it is difficult to imagine resource-rich regimes –so accustomed to resource rents – embracing privatization and improving accountability. For most of these regimes proceeds from natural resource revenue helped sustain existing patronage and maintain regime legitimacy. In fact, resource rich states can still satisfy public demand for wealth distribution by employing creative policies without having to privatize and produce greater accountability and transparency. To appease a critical public the state could for instance transfer part of the income generated by resource rent in the form of lower taxes or no taxation. Without having to privatize natural resource assets the state can also mute public demand for transparency and accountability, authoritarian regimes by distributing natural resource receipts in the form of direct transfer to key areas like education, food and transportation.

Another way for states to avoid the resource curse is to go for economic diversification. Generating multiple revenue streams and economic capacities are sure ways to mitigate (not eliminate) economic distortions, help buffer the economy against external shocks and in the event produce more sustainable growth. Attractive as this development route is, resource-rich states often struggle to diversify. States' success to diversify their economies remains a function of idiosyncratic institutional qualities -- a product of individual state's political, social and economic character (Malik & Temple, 2009). Put differently, there is no one size-fits-all policy prescription to states' effort in avoiding the resource curse.

When it comes to diversifying its economy and avoiding the so-called resource curse, Malaysia is often singled out as a success story(Collier, 2006). Despite being endowed with tin and oil and gas, Malaysia has developed into a multi-sector economy driven by high technology and capital intensive industries. In fact, the country counts among the world's 20 largest trading nations. The oil and gas sector contributed only 19% of Malaysia's GDP in 2009 (Pemandu, 2010) (Note 1). Malaysia's main exports included electronics (34.5%), petroleum related products (9.9%), palm oil (9.3%) and chemical products (6.9%).

Malaysia's achievement in industrial output stands in contrasts with the experience of Ghana, a country which it shares something in common. At the time of independence, in 1957, both Ghana and Malaysia had near similar political and economic structures(Auty, 2000; Auty, 2001). Both are resource rich states and both inherit British institutions like a democratic political arrangement, an effective civil service and an education system that were relatively high among their immediate peers. But in the years after independence the two economies diverge in performance. If in 1957, Ghana's export made up almost 30 percent of its GDP by 1995 Ghana's export shrank to about 25 percent of its GDP. In the case of Malaysia, its export contributed almost 50 percent of its GDP in 1957 but by 1995 Malaysia's export contributed almost 95 percent of its GDP. Manufacturing also became Malaysia's main industrial output in the post independent years accounting for almost 33 percent of GDP. Malaysia's primary sector – which in 1957 took up almost 40 percent of its GDP – now only contributed 14 percent of Malaysia's GDP. For Ghana the agricultural sector remains the state's main output. In fact, agricultural output took up almost 46 percent of the country's GDP in 1995 while manufacturing output shrank to about 6 percent of the GDP. (Auty, 2000)

Malaysia's ability to diversify its economy invites obvious questions: How does one explain Malaysia's ability to develop multiple sector economy? How is it possible that Malaysia is able to rely less on natural resources and not to over- indulge in unproductive non-traded sector of the economy?

The questions are not entirely novel. Islam and Chowdury (1997) have explained that Malaysia's success in avoiding the resource curse is due to its ability to manage consensual democracy in a highly plural society. They argue that Malaysia's economic success is the result of a tacit agreement between Malaysia's politically dominant Malay actors and economically dominant Chinese actors. Under such an agreement the state (being Malay dominated) agrees not to over indulge in productive activities (Chinese domain) and in return the state is allowed to disburse resources to invest in the economic and human capital of the Malay majority. Paul Collier (2006) provides somewhat different argument to Malaysia's ability to move away from the "resource curse". He cites that Malaysia's ability to avoid a resource curse is due to its ability to get its macroeconomic right, its consistency in pursuing liberal market ideas and Malaysia's competence in handling conflict in the post-colonial period. (Collier, 2006)

Islam and Chowdury's functionalist explanation as well as Colliers' liberal argument bears some truth. There is little doubt that Malaysia's ability to diversify its economy is largely due to the nature of its consociational democracy and the country's ability to adopt appropriate macroeconomic policies. However both explanations need to be expanded. This paper believes that Malaysia's successful adoption of a diversification strategy is best understood when one adopts a historical institutional analysis. It argues that Malaysia's successful economic diversification strategy is the result of the state's institutional character and historical process. The paper will discuss two factors that contribute to Malaysia's success in diversifying its economy. It will demonstrate that Malaysia's ability to avoid the resource curse is due to the path dependent nature of Malaysia's economic policy (colonial as well as post-colonial periods) and the increasing returns nature of economic diversification that makes the oil and gas sector only as an add-on to Malaysia's already varied economic production structure. The paper will make the case that the Malaysian economy was already diversified with major revenues coming from primary products like tin, rubber and palm oil before oil and gas production became commercially viable. The paper will also argue that Malaysia's success in diversifying its economy is due to the character of the Malaysian political economy. It will explain that the path dependent nature of Malaysia's political economy demands that Malaysia adheres to a consociational arrangement that inadvertently limits Malaysia's economic policy option. It will demonstrate that despite its affirmative nature qualities Malaysia's New Economic Policy(NEP), ironically gives the state little choice but continue to pursue economic diversification strategy.

This paper is divided into several parts. The first part will discuss, in brief, historical institutionalism and the concept of path dependence. Next it will describe the Malaysian economy and how a diversified economy has paved the way for relying less on natural resources. The third part of the paper will describe the NEP and how it forces the state to expand, hence to continue to diversify the economy. The final part will describe Malaysia's response to its economic crisis in the 1980s, 1990s and in the year 2008. Malaysia's response to the crises is highlighted for two reasons. First, the crises demonstrate Malaysia's resolve in keeping to a liberal and expansive economy, encouraged of course by a thriving private sector and the increasing returns from a diversified economy. Second, the crises demonstrate the limits imposed by the NEP that only encourage the state to stay on the diversification path. The state understands that for the NEP to hold political and economic relevance, the Malaysian economy needs to be expansive. The paper will show that this is evident when, time and again, the state was prepared to change some of the terms in the NEP in order to allow for greater economic growth.

2. Historical Institutionalism and Path Dependence

Works on historical institutionalism place premium on context, historical moments and processes in order to understand policy outcomes. (Note 2) Historical institutional analysis seeks to explain large outcomes, asks "big" questions and believes that "detailed investigation" of carefully chosen case studies can provide a "powerful tool for uncovering the sources of change." (Note 3) The approach believes that institutional processes can best be understood if they are studied over time. (Note 4) Given such a nature, an integral part of historical institutional work is process tracing where historical episodes are linked in a sequential and meaningful way to offer explanation of a particular case. (Note 5)

Central to historical institutionalism is the concept of path dependence, a concept that is thrown to various definitions. Sewell (1996) defines path dependence as " what happened at an earlier point in time will affect the possible outcomes of a sequence of events occurring at a later point in time." (Note 6) Mahoney (2000) sees path dependence as "specifically those historical sequences in which contingent events set into motion institutional patterns or event chains that have deterministic properties." (Note 7) Levi (1997) perhaps provides a more lucid description of path dependence when she describes that once a state "has started down a track, the costs of reversals are very high." Path dependence, she says, entrenches certain institutional arrangements that effectively "obstruct an easy reversal of the initial choice." (Note 8)

What is path dependence and why do social, political and economic processes get stuck in a path dependent mode? Path dependence involves two things. First, in path dependence, making that initial choice is important and second, once a choice is made, self-reinforcing mechanism sets in where "each step in a particular direction makes it more difficult to reverse course." (Note 9) It is not that taking a reverse course is impossible. Rather, reversal is made increasingly difficult because the cost of reversal increases over time given actors' investment on resources. Perhaps two most important works that deconstruct the logic of path dependence are those carried out by economic historians Paul David (1985) and Brian Arthur (Note 10) (1994). Arthur suggests that path dependence is due to self-reinforcing mechanisms. He describes four self-reinforcing mechanisms that encourage path dependence. They are: large set up costs; learning effects, coordination effects and adaptive expectations. (Note 11) To put simply, the initial choice gets hard wired within an institutional setting and thus makes it harder for existing institutions to adopt alternative technology. (Note 12)

David's and Arthur's works have been extensively borrowed by social scientists. One of the best efforts at incorporating David's and Arthur's works to public policy is the ones carried out by Paul Pierson (2004). (Note 13) Pierson argues that the source of path dependence and self-reinforcing mechanism lies in the nature of public good. He explains that the non- excludable and non-rivalrous nature of public good give rise to collective action problem, opacity in political decisions and the development of institutional density that encourage self-reinforcing mechanisms. To put briefly here, policy makers are always confronted with collective action problem when making policy decisions and that due to opacity in assessing policy outcomes, policy decisions are often made with less than perfect information. These factors when combined with the existence of a dense network of institutions most always means that policy changes (in the short term) are usually incremental or small in nature but produce large outcome over the long term. (Note 14) In the Malaysian case, the collective action dilemma of public policy and the increasing returns nature of economic activities contribute to the state's ability to remain on the economic diversification path. We will elaborate this below.

Though path dependence gives the impression that the state is limited by the type of institutions it inherits, it does not necessarily mean that states are caught in institutional stasis. Change happens when there are inherent ambiguities and gaps that exist by design or one that emerges over time between formal institutions and actual implementation" (Streeck & Thelen, 2005: 19). Institutional change exists, but in most cases, change, when viewed from the short run, is incremental in nature; change is ‘transformational’ when viewed over the long term. There is a growing literature that accounts for such institutional change. Streeck and Thelen (2005) for instance do not see change as drastic but describe that "rather than abrupt and discontinuous, transformative change often result from an accumulation of gradual and incremental changes."

The historical institutional narrative fits this paper’s explanation on Malaysia’s success at diversifying its economy. Malaysia’s economic diversification effort is a function of timing, sequence and path dependence. Its success in diversifying the economy rests on the timing of the state’s discovery of oil and the path dependent nature of Malaysia’s economy that encourage a diversification strategy. The character of Malaysia’s political economy also facilitates the diversification process. Malaysia’s consociational democracy or power sharing arrangement - which is itself a product of the state’s historical process – also imposes limits on Malaysia’s policy options. Arendt Lijphart’s (1996) description of Malaysia’s power sharing arrangement, which he called consociationalism, refers to the presence of multiple ethnic groups who are prepared to come together in a political arrangement despite retaining their identities through agreements reached between leaders of these groups who have support of their ethnic communities. Consociationalism works when governing elites understand the perils of political, social and economic fragmentation and hence work on maintaining cohesion and stability among its political constituents(Lijphart, 1996). (Note 15) Malaysia’s New Economic Policy encapsulates the spirit of consociationalism which inadvertently imposes limit on Malaysia’s economic option. To sum up, the the path dependent nature of Malaysia’s economic structure and the state consociational institutional legacy has made it possible for Malaysia to embark on a diversification strategy and hence avoid the so called “resource curse.” Existing institutions provide Malaysia’s policy actors with mental maps over economic, social and political realities that encourage path dependence and the need to make incremental policy changes that lead to the maintenance of economic diversification. (David, 1985; North, 1990; Pierson, 2004). We look now at the Malaysian economy.

3. The Malaysian Economy

Malaysia’s economy has stayed diversified not only because it has embarked on the right policies but also due to the fact that a confluence of events has allowed the country to have a varied economic production. Historically, the Malaysian economy has never been dependent on a single source of economic production. Under the British colonial period, the Malayan economy was one of the most laissez-faire economies and Malaysia is still among the world’s freest trading economies. In the nineteenth century, the Malaysian economy relied on exports of primary products, like tin, rubber and palm oil. Tin, especially, dominated Malaysia’s (then called Malaya) economic output. Malaya became the world’s largest exporters of tin. In the early twentieth century Malaya’s tin output contributed to more than half of world’s tin production. Even as late as 1979, Malaysia accounted for 31% of the world’s tin output producing 63,000 tonnes of tin ores. Malaysia now hardly exports its tin. The drop in production due to dwindling tin deposits, low tin prices and high operating costs meant that tin are now only used for domestic electronic and tinplating industries. (Drabble, 2000)

Besides tin, rubber and oil palm, the Malaysian economy increasingly relied on the manufacturing sector in its post-independence years. At the time of independence Malaysia’s manufacturing sector contributed only 11 percent of GDP but by the late 1960s manufacturing began to emerge as Malaysia’s main industrial output. The early 1970s saw Malaysia aggressively targeting foreign manufacturing firms. It set up 5 export-processing zones to promote cluster production networks and to reduce costs. To keep to an open economy Malaysia reduced tariffs and non- tariff measures. The country’s effective rates of protection (ERPs) at the time stood between 35-40 percent which was far less than in most developing economies. The ERP on manufacturing however declined to 23 percent in 1982 and dropped further to 17 percent in 1987 (Ghee & Woon, 1994; Auty, 2000). Malaysia’s effort to boost industrial output bore results. If the 1960s saw Malaysia’s industrial output making up a mere 6.3 percent of the GDP, by the 1980 the country’s industrial activities rose to about one fifth of total GDP. By 1990 manufacturing made up almost 60 percent of Malaysian exports as opposed to only 12 percent in 1970. (Drabble, 2000: 189) And if in 1968, manufacturing made up a meager 13 percent of Malaysia’s GDP, by 2007, manufacturing contributed more than 30 percent of the GDP. Given the varied economic structure, it is not a surprise that the state is less reliant on natural oil and gas receipts. It’s already diversified economic production gives Malaysia the flexibility and room to be less reliant on natural oil and gas in the later years.

It is also a big help that oil and natural gas industry was a late entrant to Malaysia’s industrial output. Given oil and gas industry’s late entrance, the path dependent nature of Malaysia’s economic structure made it easy for Malaysia to rely less on the resource for economic growth. Malaysia was not in a rush to rely on natural oil and gas when petroleum was found in large quantities off the east cost of Peninsular Malaysia in the 1970s. Initially there was tepid interest in Malaysia’s oil deposits due to lack of technological capabilities and low oil prices. In fact, experts saw little in the country's ability to produce significant oil and gas production output, even when oil was discovered in Sarawak (Sarawak only became a member state of Malaysia in 1963) as early as 1911. (see figure 1). A senior official of a continental oil company remarked that " it would appear that we do not have another Middle east, or even another North Sea, but an area where relatively small discoveries are the norm" (Gale, 1981).

The low expectation on oil and gas output plus the varied economic production gave Malaysia the luxury to map a comprehensive oil management strategy. In 1974, Malaysia introduced the Petroleum Development Act that gave birth to Malaysia's Petroluem Nasional Berhad or PETRONAS. Under the act, PETRONAS is given custodial rights to Malaysia's petroleum resources where it will retain ownership and management control in exploration, development and production of oil resources. Malaysia also mapped out a sustainable oil management strategy when it introduced the National Depletion Policy in 1980, the purpose of which was to manage oil production. Under the policy oil production - at the time - was limited to no more than 270,000 barrels per day.

The important point here is that the multiple sources of revenue - from exports of rubber, tin, palm oil and increasingly manufacturing - gave Malaysia no urgent need to aggressively pursue and rely on oil and gas reserves. The late entrant of the oil and gas industry plus Malaysia's already diversified private sector gave the country the latitude to rely less on oil and gas revenue. In fact one can argue that path dependence dictates that the increasing returns from earlier diversification process have made it costly, unproductive and perhaps impossible for Malaysia to unwind its diversification effort. It can also be said that the insurance that came with oil and gas revenue gave Malaysian policy makers added flexibility to design more ambitious Malaysia's industrialization strategy. (Note 16)

We now turn to another aspect of Malaysia's political economy that facilitates further Malaysia's economic diversification. Though the introduction of the New Economic Policy is seen by many as a step back to Malaysia's economic growth, the introduction of the NEP, ironically, imposed further discipline to Malaysia's economic diversification effort. We turn to this next.

4. The New Economic Policy: Is the NEP Part of Malaysia's Problem or Is the Policy Part of Malaysia's Solution at Maintaining a Successful Economy?

An appraisal of Malaysia's economy in the post – colonial period is not complete without mentioning the New Economic Policy (NEP). The NEP (Note 18) is a document meant to serve Malaysia's economic and also political and social objectives. Implemented in 1970 following the bloody racial riot on 13 May 1969, the NEP had two objectives. The first was to restructure the economy and society and eliminate the identification of economic function with a particular ethnic group and the second, to eradicate poverty irrespective of race. The NEP target that come 1990, equity distribution among the *bumiputeras*(Malays), non-*bumiputera*(non-Malays) and foreigners must be in the ratio of 30:40:30 respectively which stands in contrast to the equity distribution in the 1970, where the ratio of *bumiputeras* (Malays) to *non-bumiputera* (non-Malays) and foreigners stood at 1.9: 23.5:60.7 respectively.

There is no short of literatures that detail the distortionary capacity of the NEP (Gomez & Jomo, 1997; Lee, 2010). It may indeed be true that state intervention and the affirmative nature of the NEP only encourage suboptimal allocation of economic and political resources. But what is equally confounding is that the affirmative action nature of the NEP did little to compromise Malaysia's liberal economic arrangement. How is it possible that the NEP, given its so-called distortionary qualities, allow Malaysia to raise the wealth of all ethnic groups, not just the *bumiputeras?* As the table below suggests the drop in poverty among Chinese and Indians are equally impressive as the drop in poverty among *bumiputeras.* In 1970 26 percent of Chinese were considered poor but by 1990 only 6 percent of Chinese were deemed poor. To add, despite having an interventionist policy in the form of the NEP Malaysia stands among the top twenty most competitive nations which only suggests that the state has kept managed to maintain a competitive economic regime with an open and diversified economy.

Table 1. Incidence of Poverty by ethnic group in Malaysia 1970 and 1990 (%)

	1970	1990
Bumiputeras	65.0	20.8
Chinese	26.0	5.7
Indian	39.0	8.0
Overall	49.3	15.0

Source: (Drabble 2000) p. 278

Is the NEP part of Malaysia's problem or is the policy part of Malaysia's solution in maintaining a successful economy? The argument above suggests that there are other qualities in the NEP that have allowed Malaysia to reduce poverty and keep an open and diversified trading environment. While not fully dismissing the distortionary character of the NEP, this paper argues that the philosophy behind the NEP has helped ensure that Malaysia continue to maintain a liberal and diversified economic regime. This is because the consociational spirit behind the NEP has meant that the policy could only be legitimate if it can keep to its redistributive promise. Malaysia's policy makers know this. The state has maintained the fact the NEP must be built on fairness; a policy that is meant to alleviate poverty and improve the living standards of all Malaysians, not just the *bumiputeras*. Malaysian elites know too well Malaysia should continue to employ liberal economic policies and not place excessive restrictions on non- *bumiputeras* and foreign investors because social and political peace can only come with an ever expanding economic cake. It certainly helps that the path dependent nature of Malaysia's economic production structure made it easy for the Malaysian economy to stay on the diversified course.

The peculiar nature of the NEP in disciplining Malaysia's economic diversification process is understood by Malaysian policy makers. The need to keep to the consociational pact was evident during the formative years of the NEP. When the NEP was introduced in 1970, the state reassured the investing community that the NEP was an attempt at empowering local capacities not an outright nationalization strategy. It made clear that the NEP only targeted 30 percent *bumiputeras* ownership with the rest of the 70 percent of total assets being held by non-*bumiputeras* and foreigners.

5. The Financial Crises and Willingness to Improvise the Sacred Cow

The Malaysia state has - time and again - gestured that it is prepared to amend terms of the NEP and review priorities to *bumiputeras* because it knows too well that only with an expanding economy can the NEP's larger interest be served. There were numerous occasions that saw the state amending terms of the NEP to make room for economic expansion. The obvious ones were Malaysia's handling of the economic crisis in the 1980s, 1990s and the recent global crisis in 2008. The crises tested Malaysia's commitment between keeping to terms in the NEP or seeking creative ways to expand and diversify the economy. And in all three occasions, Malaysia showed that it was prepared to tweak conditions in the NEP to allow for economic recovery.

Malaysia's handling of the financial crisis highlight two important things. First, the crises demonstrate that Malaysia understands the increasing returns of a diversified economy. It is prepared to keep to a liberal and expansive economy and encourage a thriving private sector. Second, the crises show that the Malaysian state is willing to make changes to the original terms of the NEP in order to allow for greater economic growth. It understands that only with an expanding Malaysian economy can it justify the NEP's relevance. We look now at the three economic episodes.

5.1 The 1980s

The recession in the 1980s tested Malaysia's resolve at keeping to a liberal and diversified economy. It threatened, for the first time, the relevance of the NEP and Malaysia's commitment to the NEP's redistributive character. The Malaysian economy contracted by 1 percent in 1985 hurt by falling commodity prices of tin, petroleum and rubber (Doraisami, 2012). In 1986, growth was a mere 1.2 percent with unemployment hitting a high of 8.1 percent. And in that year, Malaysia's debt stood at 112 percent of its GDP.

The economic woes during this period saw the state revisiting existing economic policies including the NEP. The review of the NEP invoked strong political reactions which saw bitter fights between members of the dominant ruling Malay party UMNO. UMNO was split between two camps. The first camp advocated the 'pro-growth' strategy that called for less state intervention and a review of some aspects of the NEP. The second camp was 'pro-distribution' and called for preservation of Malaysia's economic restructuring process. In the end, the 'pro-growth' team, under the then Prime Minister Mahathir Mohamed won the political contest.

Under the pro-growth strategy, Mahathir made changes to the NEP to restore economic growth. The Mahathir administration modified the highly unpopular Industrial Coordination Act (1975) – an act that required small Malaysian firms to provide for thirty percent *bumiputera* (Malay) ownership and foreign firms to have no more than 30 percent equity. Under a new act, smaller firms were relieved from such quota imposition. (Note 17) Mahathir also introduced the Promotion of Investment Act in 1986 which gave further incentives to foreign investment by excluding foreign investors from NEP quotas. Foreign firms were also exempted from providing for 30 percent bumiputera equity ownership on condition that 50 percent of its output was exported or sold to companies in the newly established Free Trade Zone (FTZs) (Leete, 2007).

The changes made by the Mahathir regime produced desired results. Relaxation of the NEP rules saw Malaysia attracting many manufacturing companies which continued to be the main driver of the economy contributing substantially to employment, export and overall industrial output. Exemptions from the NEP rules drew industries in electrical and electronics, metals, chemical and petroleum (Leete, 2007). By the end of the 1980s, Malaysia had established some 10 Free Trade Zones (FTZs) and most of the companies that operated from the FTZs were foreign-owned companies - mainly Japanese and American companies.

The 1980s saw further diversification in the Malaysian economy. This was the period when Malaysia rode on the privatization wave sweeping most parts of the world. By early 1990s, thirteen state enterprises were privatized, involving companies from telecommunications, television, utilities to airlines. The privatization effort gave further boost to the stock market raising some 201 billion ringgit in market capitalization. So strong was the expansion of the private sector that credit to the private sector was 160 percent of GDP. By 1996, total market capitalization in KLSE was 16 times that in 1987 (Doraisami, 2012).

The 1980s also saw Malaysia embarking on heavy and chemical industries (HCI). The promotion of HCI was part of the state's effort to broaden the economic base and emulate the economic success of developmental states like Korea and Japan. Under its "look east policy", Malaysia introduced heavy industries like auto making, steel manufacturing, cement, machinery and equipment and petrochemical industries. The state also set up the Heavy Industry Corporation of Malaysia (HICOM) which allowed the flow of foreign funds, specifically from Mitsubishi and Honda, to spearhead the new industrialization drive.

Even though Malaysia's decision to move into heavy industries drew heavy criticisms but as Sanjay Lall rightly points out one cannot take away the fact that the development of this sector - unproductive as it may be - has added depth and width to the Malaysian economy. Indeed, in time to come embarking on high industries would hold Malaysia in good stead as such industries involved the acquisition of high technology, injection of huge capital investment and the development of skilled labour - factors that would give Malaysia comparative advantage especially in heavy industries. (Lall, 1995)

The tweaking of the NEP and the introduction of new economic structure in the 1980s bore the desired results. After recording sluggish growth of just 1.2 percent in 1986, the coming years saw Malaysia posting impressive growth. Between the years 1988 – 1990 the economy grew at the impressive rates of 8.9, 8.8 and 9.8 percent respectively. Malaysia's response to its economic condition in the 1980s was not an exception. The 1990s would also see the state tweaking further the economic structure just so to grow and diversify the economy as well as keep the legitimacy of the NEP. (Note 19)

5.2 The 1990s and Malaysia's Response

The Asian financial crisis that began in late 1997 threatened to undo Malaysia's promising growth posted. The early 1990s saw the Malaysian economy revving at an impressive average annual growth rate of 8 percent. Between the years 1990-1995, Malaysia's manufacturing exports grew at an annual rate of 20 percent. Unemployment was also at its lowest. In 1995 Malaysia's unemployment rate stood at 3.1 percent, the lowest since independence. (Leete, 2007: 90-92)

The Asian crisis again tested Malaysia's commitment to maintaining a liberal economy. The Malaysian economy began to fall apart in the summer of 1997. In 1998, the country's real GDP fell by a massive 7.5 percent. By the middle of 1998, its stock market lost more than 50 percent of its value with the Malaysian ringgit falling to its lowest points against major currencies. By the middle of 1998, the ringgit depreciated some 40 percent to the US dollar. (Leete, 2007: 120)

The crisis threatened the relevance of the NEP (now called the New Development Policy, NDP). To economic commentators, the crisis only confirmed their argument that Malaysia's economic malaise was the result of years of political patronage, cronyism and corruption brought by the highly interventionist NEP. To its critics, the crisis gave strong reasons for Malaysia to do away with the NEP and take on the International Monetary Fund more liberal economic prescription.

Malaysia's move to limit the financial contagion however fell short of the IMF's full prescription. Instead of taking the IMF's prescription pill, Malaysia took its own initiative. Then Prime Minister Mahathir Mohamad, feared that a full IMF solution would seriously threaten the economy and tear at Malaysia's social and political fabric as well as put the state's defence of the NEP increasingly tenuous.(Mahathir, 2000). Malaysia's initial reaction was to increase interest rate and limit access to credit. The increase in rates was to improve credit ratings and to stem further weakening of the ringgit, curb inflation and prevent outflow of capital outflow. In the summer of 1998, it introduced the highly unpopular capital control which made the trading of the ringgit offshore to be illegal. And in a bid to stabilize the economy and make the quickest of recovery, Malaysia set up two state asset and credit managing companies - *Danaharta* and *Danamodal*. Both companies were tasked to do a corporate rescue of local firms and financial houses, both *bumiputeras* or non-*bumiputera* owned, to provide liquidity and stabilize domestic companies' credit positions.

Despite criticism from the international community, Malaysia's unorthodox approach worked. In the three years after the crisis, the electronic sectors, petroleum and palm oil sectors recovered. (Lau, 2005: 152). Diversification grew apace. By the year 2000 Malaysia's GDP grew by 9 percent spearheaded by an increase in manufacturing output specifically in electronics. After 1998, Malaysia began to accumulate huge surplus with its external current account making up 13 percent of GNP. Though Malaysia's handling of the crisis had its fair share of critics, Kaplan and Rodrik (2001: 31) however argue that "Malaysia would have fared even better if they had imposed capital controls sooner." We turn now to another episode, the 2008 global financial crisis that entrenched further Malaysia's diversification strategy.

5.3 The 2008 Global Crisis

Malaysia's response to the global financial crisis of 2008 demonstrates yet again its commitment to keep to an open, diversified economy. The crisis threatened Malaysia's growth momentum. In 2009, the economy contracted 1.7 percent, a far cry from the average annual growth rate of more than 5 percent in the five years prior to the crisis. The year 2009 also posed added challenge to the ruling Barisan Nasional (BN), whose rule of more than 50 years came under serious threat from Malaysia's opposition law makers after the opposition pact denied the incumbent BN party of the two-thirds majority in the 2008 election.

In the face of yet another crisis, Malaysia continued to be persuaded by the overriding need to keep the growth momentum with the state knowing too well that only with continued expansion of the economy can it justify the relevance of the NEP. But more important, the crisis again shows that Malaysia is prepared to make further changes to the NEP so long as the overall objectives of the NEP remain intact.

The gloomy economic outlook a plus a fragile political scene, saw the government making effort to maintain Malaysia's growth trajectory. To jump start the economy, in 2009 Malaysia announced two fiscal stimulus packages that gave greater attention to construction and infrastructural projects. There was further tweaking of existing NEP guidelines to attract foreign investments. Foreigners are now allowed to buy commercial properties above RM500 000 without approval from the state's Foreign Investment Committee (FIC). The services sector also saw further liberalization. By 2015, the state will allow 70 percent foreign ownership of the sector. The state has agreed to remove the 30 percent *bumiputera* equity requirements for 27 services sectors. In addition, the state has also set aside some RM 2 billion to be made available to private companies for capacity building projects in new growth sectors like biotechnology, healthcare and education.

Thus far, the economy seems to be responding well to the stimulus packages. In 2010, the economy registered growth of 7.2 percent before slowing down a little in 2011 when it posted growth of 4 percent. For the full year 2012, the economy grew more than 5 percent. A more important point here is that the economy has become more varied as it is spearheaded not only by traditional sector like manufacturing and construction but increasingly by the services sector, specifically finance and insurance. In 2011, for instance, services made up more than half of total GDP with finance and insurance contributing 17 percent. (Note 21)

The year 2013 also saw the state making unpopular policies to maintain a vibrant economy. Fresh from winning the election in mid-2013, the new government took the bold move of pushing through unpopular but necessary economic reform. The last few months of 2013 saw the government cutting back on fuel and sugar subsidies and announcing the introduction of the goods and services tax in April 2015. Subsidies on goods such fuel, sugar and cooking oil cost the government some RM 42.4 billion in 2012 – a huge amount that is equivalent to Malaysia's budget deficit. (Note 22) In early September 2013 it announced a 20- sen rise for RON95 petrol and diesel fuel, the first increase since 2010. A few days later, it announced an increase of 15- sen for RON 97 petrol. Amid concerns of potential inflation, Prime Minister Najib defended the government's decision stressing that reducing state subsidy was necessary given a challenging external environment. Not doing so, he said, would mean a growing fiscal deficit that could pose greater medium term risks. Clearly the moves were highly unpopular but the policies are testaments to the state's commitment and preparedness to do tough but necessary reforms for the greater good of invigorating the economy. (Note 23) This is made possible because Malaysia's institutional qualities have been designed in such a way that Malaysians are largely aware of the need to continue to expand and diversify the economy.

6. Conclusion

By making the historical institutional argument, this paper demonstrates that the prior existence of a thriving private sector and the late entry of commercial oil production had made it easy for Malaysia to diversify its economy. Increasing returns logic dictates that rewinding a thriving private sector was a non-option. This paper shows that the path dependent nature of Malaysia's economic arrangement has made it easy for Malaysia to continue its diversification strategy.

The path dependent nature of Malaysia's political arrangement also dictates that Malaysia adheres to a consociational arrangement that inadvertently limits Malaysia's policy option. Consociationalism gives the state little choice but to continue to adopt a diversification strategy. In other words, the NEP (a product of consociationalism) - far from limiting Malaysia's diversification strategy - only serves to promote it further. The constant need to conform to Malaysia's consociational arrangement and its redistributive qualities forces the state to ensure that the economy stays expansive and diversified, even at the expense of tweaking some of the terms of the NEP. Though a neo-liberal could argue that the NEP is an evil that fosters economic distortion and creates suboptimal allocation of resources (Gomez & Jomo, 1997), it is could also be said that the NEP is a necessary evil because it gives Malaysia no other choice other than to maintain a diversified economy. As Drabble points out, without the NEP and its target of eradicating poverty and tackling income inequality "it is unlikely that Malaysia's development experience would have been anywhere near as successful as we have seen." (Note 20)

Table 2. Percent share of GDP

Year	Agriculture	Forestry	Mining	Industry	Services
1960	47	n.a.	7.3	6.3	43.5
1970	30.8	17.6	6.3	13.4	51.3
1980	22.8	n.a	10.0	20.0	47.2
1990	19.4	n.a.	9.8	26.8	44.2

Source: Drabble (2000) in p. 188. Selected Years, Ministry of Finance (1990)

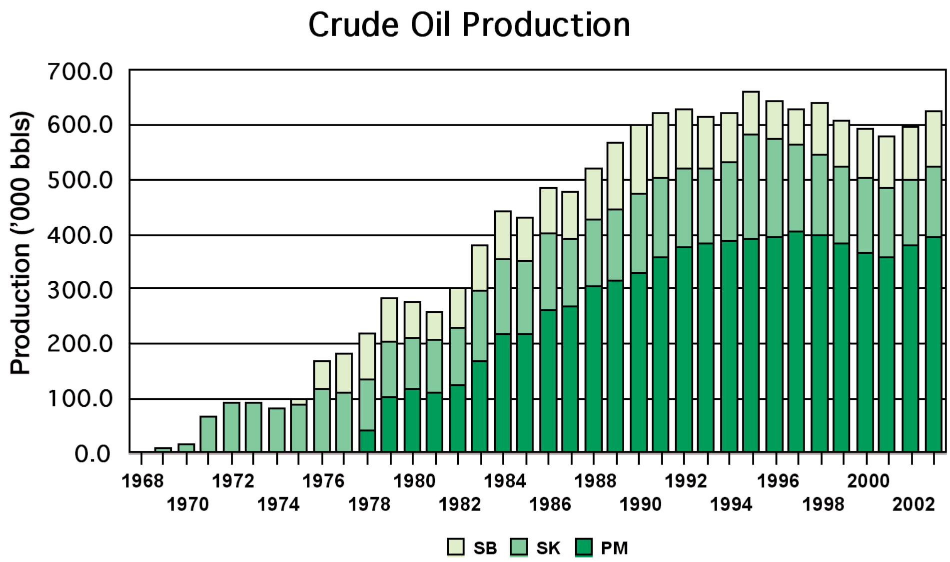

Figure 1.

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Notes

Note 1. Economic Transformation Programme Handbook, Chapter 6.

Note 2. George, A. and A. Bennett (2005). Case Studies and Theory Development in the Social Sciences. London, MIT Press. 207.

Note 3. Pierson, P. (1993). "Review: When Effect Becomes Cause: Policy Feedback and Political Change." World Politics 45(4): 595-628.

Note 4. Ibid. p. 596.

Note 5. Goldstone, J. A. (2006). Comparative Historical Analysis and knowledge accumulation in the study of revolutions. Comparative Historical Analysis in the Social Sciences. J. a. D. R. Mahoney. Cambridge, Cambridge University Press. 9.

Note 6. Sewell, W. H. (1996). Three Temporalities: Toward an Eventful Sociology. Ann Arbor, University of Michigan Press. 245-280

Note 7. Mahoney, J. (2000). "Path Dependence in Historical Sociology." Theory and Society 29: 507-548.

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Note 9. Pierson, P. (2004). Politics in Time: History, Institutions and Social Analysis. Oxford, Princeton University Press. 21.

Note 10. David, P. A. (1985). "Clio and the Economics of QWERTY." The American Economic Review 75(2): 332-337, Arthur, W. B. (1994). Increasing Returns and Path Dependence in the Economy. Ann Arbor, University of Michigan Press.

Note 11. Read Arthur, W. B. (1994). Increasing Returns and Path Dependence in the Economy. Ann Arbor, University of Michigan Press. 112 The four features highlighted are large set up or fixed costs. Given the large amount of investments and high fixed costs, individuals and organisations have higher incentives to stay on a particular technology or stick to a particular options; Learning effects is a phenomenon to show that once we are good at something we tend to better at innovating it rather than seek something entirely new; coordination effects relates how current adoption of techniques would encourage the tying up with other related techniques to make to make it more attractive; adaptive expectations relates to how the adoption and prevalence of an option will limit our future choices, as we tend to not want to pick future 'wrong" choices and would hatch our bet on choices that would be "successful". Read Arthur, W. B. (1994). Increasing Returns and Path Dependence in the Economy. Ann Arbor, University of Michigan Press. 112.

Note 12. Krasner, S. (1988). "Sovereignty: An Institutional Perspective." Comparative Political Studies 21: 66 - 94., Thelen, K. A. (2006). How Institutions Evolve. Comparative Historical Analysis in the Social Sciences. D. R. Mahoney James. Cambridge, Cambridge University Press.;Pierson, P. (2000a). "Increasing Returns, Path Dependence, and the Study of Politics." American Political Science Review 94: 251 - 67. and North, D. C. (1990). Institutions, institutional change, and economic performance. Cambridge; New York, Cambridge University Press.

Note 13. Pierson, P. (2004). Politics in Time: History, Institutions and Social Analysis. Oxford, Princeton University Press.

Note 14. Ibid. 34.

Note 15. Lijphart's (1996) consociationalism refers to the presence of multiple ethnic groups of equal proportion of political power that are prepared to come together in a political arrangement despite retaining their identities through agreements reached between leaders of these groups who have support of their ethnic communities.

Note 16. In fact, in the 1980s, official views held that Malaysian oil reserves could be exhausted in 13 years if the state maintained oil production at 200,000 barrels per day.

Note 17. Under the ICA of 1975, firms with over $100,000 in shareholders' fund and more than 25 workers must obtain a licence where they have to reserve at least 30 percent equity for bumiputeras. Under the revised scheme, only firms with over $2.5 million shareholders' fund and more than 75 workers would have to reserve 30 percent bumiputera equity.

Note 18. The NEP was replaced with another document the New Development Policy (NDP). But analysts tend to use the two terms interchangeably.

Note 19. By the year 1990, the NEP was replaced by the New Development Policy (NDP). Commentators however still refer the NDP as the NEP, mainly because the NDP still retains the essence of the NEP.

Note 20. See Drabble (2000) p. 290.

Note 21. In Malaysia Economic Report 2012/2013, Department of Statistics and Ministry of Finance, Malaysia.

Note 22. Malaysia budget deficit for 2012 was 4.5% of GDP which amounts to RM42 billion.

Note 23. Eileen Ng (2014) Barisan risks losing further urban support with 20% toll rebate removal.