

MALAYSIAN ECONOMIC DEVELOPMENT

Issues and Debates

Edited by

Har Wai Mun

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PREFACE

Since Malaysia achieved its independence in 1957, the economy has gone through a major structural transformation from heavy reliance on tin mining and rubber plantation to an industrial based economy. Most of the industrialization efforts, especially the development of heavy industries in Malaysia were kicked off using the big push approach through HICOM, a government funded agency. Such an approach has caused high financial and administrative burden to the government. Hence, in 1983, Malaysian then Prime Minister, Mahathir Mohamad announced the government's intention to embark on a privatization policy to ease public sector involvement in the economy. However, the privatization in Malaysia has resulted in both success and failure.

The progress of Malaysian economy is highly influenced by three critical factors namely public delivery system, foreign direct investments and financial markets. It is believed that the poor public delivery system has caused the slow down of the Malaysian's economy progress. As a result, Prime Minister, Abdullah Badawi, in year 2007, has instructed the public services and government-link companies to increase their efficiency level. In addition, foreign direct investments are important as they can contribute both financial and human capitals to the economy in Malaysia. Various investment incentives have been granted and special investment zones were developed such as the Iskandar Development Region (IDR) and the Northern Corridor Economic Region (NCER) in an attempt to attract foreign direct investments.

Last but not least, the development of financial markets is also essential to the Malaysian economy development. This is because vibrant and strong financial markets are needed to facilitate the absorption of foreign funds and domestic credit expansion. Lessons from the Asian Financial Crisis has resulted Malaysia to take steps in ensuring the efficiency and effectiveness of the financial market. These steps include restructuring of domestic banking system as well as merger of the Kuala Lumpur Options and Financial Futures Exchange (KLOFFE) and the Commodity and Monetary Exchange of Malaysia (COMMEX Malaysia).

This book focuses on issues and debates regarding Malaysian economic development. The effort of the undergraduate students from Universiti Tunku Abdul Rahman in writing the essays has contributed tremendously to the success of this book. The publication of this book has proven

the ability of the students in living up to Malaysia's golden jubilee independence celebration theme – *Malaysiaku Gemilang!*

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Har Wai Mun

10th August 2007

ABOUT THE EDITOR

Har Wai Mun, lecturer of economics at the Universiti Tunku Abdul Rahman received his Bachelor and Master degree in economics from the National University of Malaysia in 2000 and 2001 respectively. His articles were published in *Dewan Bahasa* magazines. To date, he has also co-authored three books, namely *Economics, Basic Quantative Techniques* and *Globalisasi, Media dan Budaya: Antara Hegemoni Barat dengan Kebangkitan Asia*.

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ROLE OF GOVERNMENT AND ITS AGENCIES IN PROMOTING INDUSTRIALIZATION

Shum Yoke Ling
Yap Tet Sing

Introduction of Government and Its Agencies

In Malaysia, government had been set up few policies and agencies to promote the industrial sector to the foreign investors and encourage domestic and foreign investment grow up. With promoting industrialization and capital inflow from foreign investment, it will boost up the economic growth and with the policies should ensure that Malaysia's rapid development towards achieving National Economic Policy and Vision 2020.

By the way, government has few supportive polices that maintain a business environment with opportunities for growth and profits have made Malaysia an attractive manufacturing and export base in the region. The private sector in Malaysia has become partners with the public sector in achieving the nation's development objectives. There are three main supportive government policies such as liberal equity policy, employment of expatriates, and attractive tax incentives (Siew Ee et al., 1987). (1) Liberal equity policy is the policy to allow foreign investors in Malaysia's manufacturing sector can hold 100% equity for all investment in new projects, as well as investment in expansion or diversification projects by existing companies irrespective of their level of exports. (2) Employment of expatriates is one of the supportive government policies for foreign companies in the manufacturing sector are allowed to employ expatriates where certain skill not available in Malaysia. With a foreign company paid-up capital above USD 2 million will be allowed up to 10 expatriate posts including five key posts that are permanently filled by foreigners. (3) Malaysia's government offer a low company tax rate is attractive at 27% and is applicable to both resident and non-resident companies. Malaysia also offers a wide range of tax incentives for manufacturing projects under the Promotion of Investment Act 1986 and the Income Tax Act 1967. The main incentives are the Pioneer Status, Investment Tax Allowance, Reinvestment Allowance, Incentives for the Setting-up of International/ Regional Service- based Operations.

Ministry of International Trade and Industry

Ministry of International Trade and Industry (MITI) is an agency of Malaysia and has a well organize to plan, legislate, formulate and implement policies on industrial development, international trade and investment. These policies would ensure that Malaysia's rapid economic growth and development towards achieving National Economic Policy and Vision 2020. MITI spur the development of industrial activities by encouraging foreign and domestic investment. This would enhance national productivity and competitiveness in the manufacturing sector. In order to promote Malaysia's exports of manufacturing products and services, by strengthening bilateral, multilateral and regional trade relations and cooperation to promote and safeguard Malaysia's interest in the international trade arena. The nation's vision would be realized as a successful, competitive trade and industrial nation; becoming a developed nation by the year 2020.

The functions of Ministry of International Trade and Industry are: -

- Secretariat to the committees on the formulation of the 3rd industrial master plan (IMP3)
- Coordinating, monitoring and evaluating the implementation and preparing report on the achievement of the IMP3 to the cabinet
- Monitoring the implementation of policies and programmes with regard to the industrial development, investment and trade
- Re-evaluating the effectiveness of programmes and policies with regard to industrial practices and trends of domestic and international industry, trade and investment
- Conducting research and development to encourage competitiveness and productivity with regard to industry, investment and trade
- Propose new initiatives and policies to enhanced the industrialisations, trade and investment
 - Publish:
 - Annual trade and investment report
 - Quarterly bulletin of industry, investment, trade and productivity in MITI's website
 - Quarterly bulletin on trade and economic information
- Managing the date base information on industry, investment and trade
- Preparing responses for Cabinet papers

Under MITI, there are five agencies which are Malaysian Industrial Development Authority (MIDA), Malaysian Industrial Development Finance (MIDF), Malaysia External Trade Development Corporation (MATRADE), National Productivity Corporation (NPC) and Small And Medium Industries Development Corporation (SMIDEC).

Malaysian Industrial Development Authority

The Malaysian Industrial Development Authority (MIDA 2006) is the government's principal agency for the promotion and coordination of industrial development in Malaysia. MIDA assists companies which intend to invest in the manufacturing and its related services sectors as well as facilitates the implementation and operation of their projects. The wide range of services provided by MIDA includes providing information on the opportunities for investment and facilitating companies which are looking for joint venture partners.

To further enhance MIDA's role in assisting investors, senior representatives from key government agencies are stationed at MIDA's headquarters to advise investors on government policies and procedures and investors are encouraged to discuss their project interests with MIDA officers. These representatives include officials from the Ministry of Finance, Ministry of Human Resources, Immigration Department, Royal Malaysian Customs, Department of Environment, Department of Occupational Safety and Health, Tenaga Nasional Berhad and Telekom Malaysia Berhad.

Besides that, MIDA also evaluates the following applications for projects in the manufacturing and its related services sectors: (1) manufacturing licenses, (2) tax incentives, (3) expatriate posts, and (4) duty exemptions on raw materials, components, machinery and equipment. In Business Information Centre (BIC), investors able to obtain that information regarding investment, trade, financing, productivity pertaining to the manufacturing and services sectors is available.

The functions of Malaysian Industrial Development Authority (MIDA) are:-

- to promote foreign and local investments in the manufacturing and services sectors
- to undertake planning for industrial development in Malaysia
- to recommend policies and strategies on industrial promotion and development to the Minister of International Trade and Industry

- to evaluate applications for manufacturing licences and expatriate posts; tax incentives for manufacturing activities, tourism, R&D, training institutions and software development; and duty exemption on raw materials, components and machinery
- to assist companies in the implementation and operation of their projects, and offer assistance through direct consultation and co-operation with the relevant authorities at both the federal and state levels
- to facilitate the exchange of information and co-ordination among institutions engaged in or connected with industrial development
- to further enhance MIDA's role of assisting investors, senior representatives from key agencies are stationed at MIDA's headquarters in Kuala Lumpur to advise investors on government policies and procedures

These representatives include officials from the Ministry of Finance, Ministry of Human Resources, Immigration Department, Royal Customs Malaysia, Department of Environment, Department of Occupational Safety and Health, Tenaga Nasional Berhad and Telekom Malaysia Berhad.

Malaysia External Trade Development Corporation

Malaysia External Trade Development Corporation (MATRADE 2007) was established since March 1, 1993 as the promotion arm of Malaysia's Ministry of International Trade and Industry (MITI) and aim to develop and promote Malaysia's export to whole world. MATRADE as a focal point for Malaysian exporters and foreign importers to source for trade related information. Besides that, MATRADE also providing market research information and relevant advice and assists Malaysian exporters to better position their products and services in the highly competitive global markets.

MATRADE assist Malaysian exporters by:-

- Channeling overseas trade enquiries to Malaysian businesses.
- Coordinating and facilitating business networking with foreign buyers during Malaysian participation in international trade fairs and trade and investment missions abroad.
- Organising promotional activities of Malaysian products and services in the countries where MATRADE overseas offices are located.
- Provide information on doing business in the overseas markets.

Likewise, foreign buyers can avail themselves of the services provided by MATRADE's overseas offices such as:

- Obtain accurate and reliable information about Malaysian capabilities, products and services.
- Seek assistance in organising business meetings in Malaysia.
- Help make connections with key decision makers in the public and private sectors in Malaysia.

The functions of Malaysia External Trade Development Corporation (MATRADE) are:-

- To promote, assist and develop Malaysia's external trade with particular emphasis on the export of manufactured and semi-manufactured products and services.
- To formulate and implement export marketing strategies and trade promotion activities to promote Malaysia's export.
- To undertake commercial intelligence and market research and create a comprehensive database of information for the improvement and development of Malaysia's trade.
- To organise training programmes to improve the international marketing skills of Malaysian exporters.
- To enhance and protect Malaysia's international trade investment abroad.
- To promote, facilitate and assist in the services areas related to trade

National Productivity Corporation

National Productivity Corporation (NPC 2005) formerly known as the National Productivity Centre, was established in 1962 NPC as a joint project between the United Nations Special Fund and the Federal Government, with the International Labor Organisation acting as its executing agency. NPC main aim on contribute significantly towards the productivity and quality enhancement to sustain the nation's competitiveness in global economy and be a world-class productivity and quality institution. By that, NPC providing value-added information on productivity, quality, competitiveness and best practices through research activities and databases, developing human capital and organisational excellence for building a knowledge-based society through training, systems development and best practices and nurturing innovative and creative culture through P&Q promotion and partnership programmes.

The function of National Productivity Corporation (NPC):-

In accordance with the provisions under Section 7 of the Act, the functions of the Corporation are as follows:

- To lead in the promotion and dissemination of productivity related information and issues;
- To establish an information and reference centre for productivity indices for the country and for management systems and case studies;
- To generate local expertise in the field of productivity, quality, management and entrepreneurship;
- To enhance the development of human resource both at the supervisory and management levels in the country;
- To advise on and coordinate the implementation of programmes and activities related to productivity and quality;
- To assess and certify supervisory and management training programmes, entrepreneurship programmes and productivity and quality management programmes conducted by the private sector for the public;
- To conduct training or other programmes relating to productivity, quality, management and entrepreneurship;
- To provide consultancy services relating to productivity, quality, management and entrepreneurship;
- To collect, produce and publish information on productivity, quality, management and entrepreneurship and other related matters;
- To carry on business undertakings for the purpose of the discharge of its functions under this Act with the approval of the Minister;
- To report annually to the Minister on the progress and problems of raising productivity in commerce and industry and to make recommendations on the manner in which such problems may be dealt with; and
- To do such matters and things as may be incidental to or consequential upon the discharge of its functions under the Act.

Small and Medium Industries Development Corporation

The establishment of Small and Medium Industries Development Corporation (SMIDEC 2005) on 2nd May 1996 was in recognition of the need for a specialised agency to further promote the development of Small and Medium Industries (SMIs) in the manufacturing sector through the provision of advisory services, fiscal and financial assistance, infrastructural facilities, market access and other support programmes.

Besides that, SMIDEC also strives to create resilient and efficient Small and Medium Enterprises (SMEs), able to compete in a liberalised market environment. The Corporation will promote SMEs to be an integral part of the country's industrial development capable of producing high value-added parts, components and finished products and also will serve as the national focal point for the overall development of SMEs in the country. SMIDEC to be the Leading Organisation in Developing SMEs that contribute to the Economic Growth and Enhancement of Malaysia's Competitiveness. Mission of SMIDEC is to transform SMEs to be Vibrant, Competitive and Resilient and to be Fully Integrated into the Manufacturing and Services Sectors.

SMEDEC has few strategic objectives, such as, (1) to create a healthy business environment that promotes and supports the establishment and growth of SMEs, (2) to foster the formation of a competitive and vibrant supply base to attract FDIs into the country, (3) to nurture high growth, resilient, innovative SMEs that adopt best business practices, (4) to enhance the technological, managerial, marketing, financial and entrepreneurial capabilities of SMEs to become globally competitive, (5) to encourage enterprises and entrepreneurs to harness technology and knowledge in developing high value-added products and services and moving up the value chain, and (6) to facilitate and assist SMEs to gain access to market by forging linkages and business opportunities network, both locally and internationally.

The functions of SMEDEC are:-

- To promote and coordinate the development of SMEs in Malaysia through:
 - Promotional activities
 - Establishment of Regional Offices
 - Related studies

- Collation of information into a comprehensive database
- To provide technical and advisory support services in collaboration with other related agencies involved in SMEs development through:
 - SME Development Programmes
 - SME Information and Advisory Centre
 - SME Expert Advisory Panel (SEAP)
- To forge industrial linkages between SMEs and large companies/Multinational Corporations (MNCs) through the:
 - Industrial Linkage Programme
 - Global Supplier Programme
- To implement, coordinate and monitor financial assistance schemes provided to SMEs through:
 - Soft loans
 - Grants
 - Other financial assistance such as venture capital and equity financing
- To collaborate with other local and international SME related agencies to develop SMEs through programmes such as:
 - Participation in international and regional cooperation meetings and for a
 - Skills enhancement programmes for employees of SMEs
 - Attachment programmes for employees of SMEs
 - Placement of foreign experts in selected SMEs

Generally, SMEs are defined into two broad categories:

1. Manufacturing, Manufacturing-Related Services and Agro-based industries

Small and medium enterprises in the manufacturing, manufacturing related services and agro-based industries are enterprises with full-time employees not exceeding 150 or with annual sales turnover not exceeding RM25 million.

2. Services, Primary Agriculture and Information & Communication Technology (ICT)

Small and medium enterprises in the services, primary agriculture and Information & Communication Technology (ICT) sectors are enterprises with full-time employees not exceeding 50 or with annual sales turnover not exceeding RM5 million.

Further details of both of the broad categories can be referred to the Appendix.

Government Agencies and Issues on Free Trade Agreement (FTA)

In 2005, Malaysia's total trade increased by 9.9 per cent to reach RM967.82 billion. It was the second highest growth over the last five years since Malaysia pursues regional and bilateral trading arrangements as the trade liberalisation policy. Thus, the objectives Malaysia in negotiating FTAs are to seek better market access by addressing tariffs and non-tariff measures; further facilitate and promote trade, investment and economic development; enhance the competitiveness of Malaysian exporters; and build capacity in specific targeted areas through technical cooperation and collaboration.

Therefore, Ministry of International Trade and Industry (MITI 2006) is coordinating the negotiations on market access, services, investments, Rules of Origin, capacity building and trade remedies. The Malaysia-US Trade and Investment Framework Agreement (TIFA) was signed on 10 May 2004 by Y.B. Dato' Seri Rafidah Aziz, Minister of International Trade and Industry and H.E Ambassador Robert B. Zoellick, United States Trade Representative (USTR), in Washington D.C. The objective of the TIFA is to enhance economic relations, especially trade and investment between Malaysia and the US. The Joint Council on Trade and Investment under the TIFA provides a forum for both countries to have dialogues and consultations to address issues on trade and investment and mechanism to explore capacity building initiatives to promote and facilitate trade and investment. It would strengthen the linkages between both countries' business communities by exchange views on each other's policies.

The World Trade Organisation (WTO) allows for free trade agreements (FTAs) to ensure tariffs are eliminated substantially on all trade among the members of the FTA. There are specific rules and disciplines are incorporated in such agreements. One of the important principles of a WTO consistent FTA is that all parties to the agreement must eliminate duties according to mutually agreed rules and timeframes. For an example, Rules of Origin (ROO) stipulate the conditions under which only products originating from parties to the FTAs benefit from preferential market

access. WTO provided both trade in goods and trade in services in FTAs to achieve quicker and higher levels of liberalisation that would create effective market access. Recently, Closer Economic Partnership (CEP) agreements are more comprehensive in scope and coverage for FTAs. Correspondingly, CEP agreements cover not only liberalisation of the goods and services sector but also include investment, trade facilitation, intellectual property rights (IPR) and economic and technical cooperation.

Besides that, Malaysia signed the Framework Agreement on Organisation of the Islamic Conference (TPS-OIC) on 30 June 2004 and ratified it as the Member States of the TPS-OIC on 23 August 2004. The objective of Trade Preferential System is to promote intra-OIC trade through exchange of trade preferences among Member States of OIC. The TPS-OIC aims to accord preferential tariff concession on selected goods among the participating OIC countries such as Protocol on the Preferential Tariff Scheme (PRETAS). PRETAS mainly deals with reducing tariffs under the Scheme as well as para-tariff and non-tariff barriers. Moreover, the PRETAS ensures that the safeguard measures such as anti-dumping, subsidies, countervailing measures are consistent with relevant WTO rules. The implementation of TPS-OIC would enable Malaysian exporters to gain preferential tariff treatment for selected products in the markets of the participating countries. It would also enable exporters to gain competitive advantage over similar products originating from non-participating countries.

In addition, Malaysia also make an preferential agreement with the United States of America (US) and it is known as Malaysia-United States FTA. The US is Malaysia's single largest trading partner while Malaysia is the 10th largest trading partner for the US. In 2006, trade with US was valued at RM170.8 billion and accounted for 16.0 per cent of Malaysia's global trade. The US remains an important source of foreign direct investment in the manufacturing sector in Malaysia. In 2006, the US was the 4th largest source of foreign direct investment with total investments amounting to RM2.5 billion. The Malaysia - US FTA aimed to promote investment flows and address non-tariff measures. This collaboration and cooperation would seek further market access for products of export interest to Malaysia to enhance competitiveness in specific sectors (MITI 2006).

Government Agencies and Issue on Development of the Halal Industry

Recently, Malaysia undertakes efforts to be the global halal hub and will be the base of operations for the industry. It is envisaged that by 2008, Malaysia will be the centre for the

production and distribution of halal products, halal service providers, reference on the Halal Standard and R&D on halal matters. Halal Development Corporation was initiated by the Prime Minister, and was established on 18th September 2006. The objective of HDC's establishment was to develop Malaysia as the international halal hub. HDC's main roles and functions include:

- a. Championing halal standards including in the audit process and halal certification endorsement to protect halal integrity.
- b. Streamlining and harmonizing the development of halal industry in Malaysia including the stakeholders, government and private sector.
- c. Managing and enhancing the development of halal products producers and the service providers.
- d. Encouraging the inward investment in the halal industry in Malaysia.
- e. Leveraging upon development of halal industry to enable Malaysian companies of halal products to be integrated into the global market.
- f. Developing and promoting Malaysian halal brand.
- g. Promoting halal products concept and services in Malaysia and global market.

In the Ninth Malaysia Plan (RMK-9), 2006-2010, Malaysia will be developed as a centre for the certification of halal products and the JAKIM certification will be promoted worldwide. Now, Jabatan Kemajuan Islam Malaysia (JAKIM) issued a status of halal certificates awarded to 808 companies based on the category of products, 42 companies based on the category of premises and 11 companies based on the category of abattoirs. In Ninth Malaysia Plan (RMK 9), a total of RM 112 million has been allocated by the government for the development of 5 halal park a halal hub. There are Kuala Muda in Kedah, Padang Besar in Perlis, Pasir Mas in Kelantan, Chendering in Terengganu and Gsmbang in Pahang have been identified to lead in the development of the halal food industry. The parks will be free from non-halal contamination and have requisite infrastructure and adequate shared facilities, including on-site water treatment plants, dedicated cool and cold chain facilities, and specialist test laboratories, as well as factory units for high capacity food processing and packaging activities and warehouses of various sizes.

Furthermore, the Malaysia Exporters of Halal Products Directory 2006 was a collaborative effort of MATRADE and JAKIM to identify certified halal products exporters. The directory comprise 200 profiles of halal products exporters of various food and non- food. These include frozen

food, meat products, spices and seasonings, cosmetics and pharmaceutical. The collaboration of MATRADE and Tourism Malaysia develop specific programmes to promote Malaysian halal food products overseas. This will also be encouraged with hotels and providers of food services. Besides that, the establishment of Malaysian halal food outlets overseas will encourage Malaysian halal food and non-food companies which have acquired marketing capabilities in order to expand their operations in identified markets.

On the other hand, Malaysia positioned as the reference centre for trade and investment promotion of halal products and services by designating Malaysia International Halal Showcase (MIHAS) as the international annual platform for halal trade. MIHAS 2007 will be held at Kuala Lumpur Convention Centre (KLCC) from 9-13th May 2007. This event will be organised by MATRADE and managed by Indah Profile Sdn Bhd. In conjunction with MIHAS 2007, MATRADE will also organise the programmes which are Incoming Buying Mission, Business Matching and Trade Facilitation Programme, Products Demonstration and Trade Dialogue by foreign countries.

By enhancing the awareness on Malaysia as the centre for halal products and services, Malaysia has to be developed as the centre for discourse and deliberations on issues related to halal products and services. Relevant experts from around the world will be brought together to make Malaysia the focus for halal-related knowledge and information. Towards this objective, the World Halal Forum will be made the annual international platform for such discourse. World Halal Forum 2007 will be from 7th to 9th May 2007 in Kuala Lumpur. This forum will gather outstanding speakers including market leaders to discuss on business and trade issues, with regard to Global Halal Industry. The objectives of World Halal Forum is to create a networking event to facilitate trade between the different players in the Global Halal Market, understand and solve challenges faced by the Halal industry and address the need for industry standards for Halal on a global scale.

Consequently, the Ministry of International Trade and Industry will coordinate the development and promotion of downstream activities. In particularly, MATRADE will undertake the promotion of the halal standard for products and services, SMIDEC will be responsible for the development and capacity building of SMEs and MATRADE and MIDA will undertake trade and investment promotion of halal products and services.

Government Agencies and Issues on Industrial Master Plans (IMP3)

Indeed, much of Malaysia's economic achievements to date are due to the careful formulation of objectives and policies. Over the last two decades, Malaysia has benefited from the implementation of two industrial Master Plans. The First Industrial Master Plan, 1986-1995 laid the foundation for the development of the manufacturing sector, which quickly became the leading growth sector of the economy. The second Industrial Master Plan, 1996-2005 deepened the development of the manufacturing sector which led to increased value-added activities, enhanced productivity, greater industry linkages as well as growth of manufacturing-related services. Third Industrial Master Plan (IMP 3) is the plan launched on August 18, 2006. IMP 3 plan will take the country to the year 2020, and will therefore provide the necessary impetus, and roadmap towards Malaysia which will achieve an Industrialized Nation Status. Third Industrial Master Plan cannot merely be a continuation of where the IMP2 left off, it is because old mindsets must be replaced by new attitudes and market driven strategies, and obsolete practices must give way to production and marketing approaches which can meet the ever changing demands of the market place, such as, in respect of standards and quality, environmental considerations, and competition. Besides that, Third Industrial Master Plan (IMP3) addresses issues related to balanced socio-economic development by identifying opportunities to reduce inter-ethnic disparities in entrepreneurship, ownership of productive assets and employment.

Third Industrial Master Plan (IMP3) aim to improve the country's global competitiveness across three key economic sectors, there are manufacturing, services and agriculture. In keeping with the first thrust of the national mission, which is to move these three sectors beyond the middle development stage to a more productive, value-added and knowledge-intensive stage. Malaysia must be supported by three strong economic pillars: first, a mature and broad-based manufacturing sector, second, an innovative and competitive services sector and third, a modern and dynamic agriculture sector.

Seven overall strategic thrusts to realise IMP3 include:

1. Strengthening Malaysia's position as major global trading nation:
 - Intensify exports of targeted growth areas;
 - Develop and promote Malaysian brands;
 - Enhance exports through compliance to international standards

2. Generating investment in targeted growth areas:
 - Promote investments and exports of products & services with growth potential;
 - Facilitate capable domestic companies, including GLCs, to expand into potential growth areas;
 - Establish fully equipped specialized high technology parks;
 - Develop Malaysia as regional hub for selected products and services, such as, Halal, biotechnology and automotive
3. Integrating Malaysian companies into regional and global networks:
 - Encourage industries to focus on core competencies and strengths within regional and global networks;
 - Facilitate collaborations between Malaysian firms with multinational corporations (MNCs) in Malaysia and MNCs operating outside Malaysia;
 - Undertake outsourcing, off-shoring and other forms of business practices
4. Ensuring industrial growth contributes towards equitable distribution and more balanced regional development:
 - encourage bumiputera commercial and industrial community to take advantage of new sources of growth in manufacturing and services sectors and increasing opportunities from outward investments;
 - enhance development of bumiputera human capital
5. Sustaining manufacturing sector's significant contribution to economic growth:
 - Accelerate shift towards higher value added products and activities and high technology and capital intensive activities, encourage development and promotion of 12 targeted industries;
 - Facilitate development of domestic and regional clusters and enhance contribution of total factor production to growth;
 - Promote knowledge based activities and application of advanced technologies and encourage mergers and acquisitions, consolidations and strategic partnerships
6. Match supply of talents and expertise with market requirements
7. Promote research based industrial cluster development

During the IMP3 period, Malaysia's government will collaborate with Malaysian-owned companies to intensify outreach and information sharing to enhance the appreciation by the

public of the processes of adoption and adaptation of environment friendly technologies and practices; encourage companies to utilize raw materials and energy more efficiently in their production processes; ensure the sustainable management and utilization of resources in the pursuit of agricultural and forestry development. Regulations and rules will be strengthened to encourage environment-friendly agricultural and forestry practices and minimize the negative impact of such activities on the environment. In this respect, research and application of appropriate technologies and innovations will continue to be emphasized; and provide appropriate support programmes to enable industry to adopt environment-friendly technologies.

Policy implications and Conclusion

Generally, “industrialisation” implies organisation of production in business enterprises, characterised by specialisation and division of labour, and transformation of capital such as the application of technology and mechanical power to development of large-scale production. With timely vision and industrialisation strategies such as the import-substitution in the 1960s and the export-oriented in the 1980s, there are two different achievements in industrialisation aspect and the key to the dramatic economic success of the 1960s through the 1990s. In fact, the export-oriented industrialisation has been major success in Malaysia. Perhaps the shifting from import-substitution to export-oriented, and the replacement of the NEP with the NDP was definitely a necessary option on industrial strategies and socio-economic progress in the 1970s and 1980s.

The export-oriented strategies provide industrial development incentives on industrial projects, investment programmes, employment and new pattern vis-à-vis public and private sector. These export promotion gives industries especially small-scale industries the opportunity to their markets enlargement, greater economies of scale achievement and comparative advantage forces in international markets. It indicates that the government has played an important role and taken the initiative in improving economic growth and standard of the living. Moreover, those MITI policies implication and strategies would make a lot of investment opportunities to Malaysia in attracting manufacturing investments in high technology, knowledge-based and capital-intensive projects successfully has been due to a combination of factors such as an educated and productive workforce, excellent infrastructure and a conducive business environment. Malaysia's strategic location also makes her a logical choice for Multinational Corporations (MNCs) seeking to establish regional operations including operational headquarters, regional offices and representative offices in the ASEAN region.

The objective of the 1990s is to attain a full recovery and pursue a full transformation of the economy into an industrialized country in the next millennium. Indeed, this was the tone set by Dr Mahathir Mohamad in his vision of Malaysia in the year 2020. As a result, MATRADE as a vehicle to fulfill this vision to export-oriented growth emanating from manufactured exports in the highly competitive global markets (Okposin et al., 1999).

Appendix

Detailed definition of SMEs by size is:

<u>Category</u>	<u>Micro-enterprise</u>	<u>Small enterprise</u>	<u>Medium enterprise</u>
1. Manufacturing, Manufacturing-Related Services and Agro-based industries	Sales turnover of less than RM250,000 OR full time employees less than 5	Sales turnover between RM250,000 and less than RM10 million OR full time employees between 5 and 50	Sales turnover between RM10 million and RM25 million OR full time employees between 51 and 150
2. Services, Primary Agriculture and Information & Communication Technology (ICT)	Sales turnover of less than RM 200,000 or full time employees less than 5	Sales turnover between RM200,000 and less than RM1 million OR full time employees between 5 and 19	Sales turnover between RM1 million and RM5 million OR full time employees between 20 and 50

PROTON PROJECT: HISTORICAL AND CONTEMPORARY DEVELOPMENT

Woo Lai Yan
Yap Fei Fong

Introduction

PROTON was established on 7 May 1983 as a private limited company under the name Perusahaan Otomobil Nasional Sdn. Bhd. (PONSD) and was subsequently listed on the Main Board of the then Kuala Lumpur Stock Exchange (now Bursa Malaysia Securities Berhad) on 26 March 1992 as Perusahaan Otomobil Nasional Berhad (PONB). Proton Holding Berhad (PHB) which was incorporated on 28 July 2003 assumed the listing status of PONB on 16 April 2004 pursuant to a Scheme of Arrangement under section 176 of the Companies act 1965. PROTON has three primary national policy objectives: (1) To spearhead the development of component manufacturing industries. (2) To acquire and upgrade technology and industrial skills within the automotive manufacturing industry, and (3) To strengthen the international competitiveness of Malaysia's industrial capability (Proton Holding Berhad, 2006).

History of Proton

Based on technology and parts from Mitsubishi Motors, production of the first model, the Proton Saga began in September 1985 at its first manufacturing plant in Shah Alam, Selangor. Initially the components of the car were entirely manufactured by Mitsubishi but slowly local parts were being used as technologies were transferred and skills were gained. The 100,000th Proton Saga was produced in January 1989 (Todd 1989). Until the end of the 1990s, the car's logo featured the crest from Malaysia's coat of arms, featuring a crescent and a fourteen-pointed star. The new Proton logo features a stylized tiger head. In 1993, a model called Proton Wira was introduced based on the Mitsubishi Lancer/Colt. More than 220,000 units were sold between 1996 and 1998 (Sorabjee et.al., 1999). Proton Perdana, based on the Mitsubishi Galant/Eterna, was first produced in 1995, intended for higher end market.

By 2002 Proton held a market share of over 60 per cent in Malaysia, which was reduced to barely 30 percent by 2005 and is expected to reduce further in 2008 when AFTA mandates reduce import tariffs to a maximum of 5% (Wikipedia 2007a). An important milestone in the Malaysian automotive industry was the introduction of Proton WAJA in May 2000, which represents the first Malaysian designed car to be manufactured and actually affordable for local

customers. With the acquisition of Lotus technologies in 1996 from ACBN Holdings (a company owned by the same person who owned Bugatti), Proton has gained an additional source of engineering and automotive expertise. This led to the production of Proton Gen-2 which was code name Wira Replacement Model (WRM) before the launch. The Gen-2 is the first of cars to be manufactured and assembled at the new manufacturing plant in Tanjung Malim, Perak which is part of Proton City development project. The plant was opened in 2004.

On June 8, 2005 Proton introduced the second model to be manufactured in Tanjung Malim, the 1,200 cc 5-door supermini, the Proton Savvy. Both the Gen-2 and Savvy, were models that MG Rover was looking to rebadge when the British firm entered into collaboration talks with Proton. However these joint-venture talks were unsuccessful and MG Rover subsequently collapsed. In 1996, Proton acquired a 63.75% stake in Lotus Group International Limited for 40.64 Million Pounds Sterling (Wikipedia 2007a). A later PriceWaterhouse Coopers audit would find that the CEO, Yahaya Ahmad, had inked the agreement on October 16, 1996. The agreement was presented to the board for approval on 27 November 1996. As part of the purchase agreement (signed prior to board agreement), there were restrictions placed on Proton's ownership of Lotus. One of the restrictions was a prohibition on diluting ACBN's remaining shareholding for a period of five years. This restricted Proton in its operation of the Lotus business and required Proton to guarantee a 40 million pound loan in 2000.

In October 2004, Proton announced that an understanding has been reached with Volkswagen AG of Germany to establish a strategic partnership. Under the tie-up, the two carmakers are expected to exploit each other's strengths. Proton would gain access to Volkswagen's superior technical capabilities and technology. In return, Volkswagen may utilise Proton's spare capacity at the latter's Tanjung Malim to assemble cars for export to the South-East Asian market, where the German auto giant has a weak presence. Furthermore, the tie-up may see Volkswagen assist in distributing Proton vehicles in China while Proton does the same for Volkswagen in South-East Asia. Nonetheless, none of the parties announced detailed and concrete plans for the partnership.

In December 2004, Proton purchased a majority share in MV Agusta of Italy. MV Agusta is the manufacturer of MV Agusta, Husqvarna, and Cagiva motorcycles. A year later, Proton sold off its 57.7% share in MV Agusta to Italy's GEVI Spa for a token of 1 Euro. Due to heavy debt by

MV Agusta, the selling enabled Proton to write off the losses off its book. But the buyer would assume the 107 million Euro (\$174 million) in debt (Wikipedia 2007a).

On January 13, 2006, Volkswagen announced that negotiation of the partnership has failed because VW's plans were different and crashes with the terms and condition that Proton offered. VW are more interested to own Proton Holding than a strategic partnership. Despite this, Malaysian news has announced Volkswagen AG has signed an agreement to buy a 51% stake in Proton on January 26, 2007. Official announcement from the two companies was expected February 8, 2007 (Wikipedia 2007b). The deal still has yet to be finalised as of June 2007. In June Datuk Seri Abdullah Ahmad Badawi has asked Proton Holdings Bhd to start talks with other carmakers on a partnership because Volkswagen AG is not interested. Later on the Khazanah Malaysia Bhd, main share holder of Proton Holding said talks with Volkswagen AG still on.

In 2006, Proton's sales dropped 30.4% from 166,118 in 2005 to 115,538 for the Malaysia market, with a later report indicating a 55% fall of sales to 962.3 million ringgit, its lowest in at least seven (Wikipedia 2007a). This allowed Perodua to overtake Proton as the country's largest passenger carmaker for the first time, with a 41.6% market share, while Proton's market share fell from 40% in 2005 to 32% in 2006 (Wikipedia 2007a). In the period ending December 31, 2006, Proton has also suffered three consecutive quarterly losses. Compared to a profit of 86.5 million ringgit in 2005, the car company lost 281.5 million ringgit in 2006. Proton blamed discounts from rivals. Total losses in 2007's financial year climbed to \$169 million.

The Issues and Challenges Facing Proton

In the coming years, more and more problems and challenges will face Proton due to many reasons. One of them is the saturated car market in Malaysia. The ratio of adult to car is at 2.4:1. Meaning, the supply of cars now exceeds the demand because there simply lesser number of people to buy that many cars. This lowers profit margins because the unsold cars are kept in the warehouse which is needed to pay for the storage fee. This will raise costs.

Secondly, Proton is facing pressures by Asean Free Trade Agreement (AFTA) and World Trade Organization (WTO) in which Malaysia is a member of these two organizations on the issues of lowering or removing tariffs and other non-trade barriers. As in the 1980s, Malaysia poured

billions into companies including Proton to turn the predominantly agriculture and commodities-based economy into a manufacturing powerhouse. With Japanese help, Malaysia nurtured Proton behind stiff protective barriers ranging from 140 to 300 percent on foreign cars (Chee, 2003). But globalization is now forcing Malaysia - Southeast Asia's biggest passenger car market with annual sales of 487,000 vehicles to change. After 20 years in the business, Proton is unable to match the quality of foreign competitors - something that is exposed with the lowering of import barriers.

Under AFTA, Malaysia is required to reduce import tariffs on automobiles and auto-related products imported from other ASEAN nations to between 0 percent and 5 percent by 2005. As result, Proton cars are facing competition arising from as import tariffs have to be brought down, and vehicles made or assembled in ASEAN countries will be able to enter Malaysian markets more easily. In addition, Malaysia also needs to liberalize its market under the auspices of the WTO, to which the country is a party. Under the WTO, Malaysia is required to phase out several measures that are considered unfair trading practices to protect the local automobile industry. Thus, in a few years from now, Malaysia and other developing countries could be asked to brace themselves to face a new flood of cheap imports. That is good news for consumers who will enjoy more choice and cheaper prices.

However, it may spell trouble for Proton that is unable to compete without the shield of tariffs due to its low technology knowledge. It will have to reduce sales or and retrench staff. The workers may find it hard to be re-employed if all the other industries are also affected by tariff cuts. Consumers may benefit from cheaper and better-quality imports, but those who lose their jobs and cannot find other equally well-paying jobs will have no or less income with which to buy the cheaper products. This could make the economy and consumers worse off instead.

Thirdly, competition among the same industry gives even a more complicated issue to Proton. Competitions come for different parties. The first one would be the competition between Proton and domestic competition, Perodua Malaysia (partnered with Daihatsu). This has compounded Proton's problems by coming up with this second national car to add variety for consumers but actually contributed to the problem because the two government-funded carmakers cannibalize each other. To further rub salt in Proton's wounds, rival national carmaker Perodua's market share inched up from 30 to 32% over the same period while its share market slipped to 44% from 48% in 2005 (Netto, 2005).

Proton is also facing competition with foreign countries. For example, it has been struggling to match its Japanese and South Korean rivals, and has seen its share of the domestic market fall dramatically (Starkie, 2005). In addition, Proton is likely to find it even harder to maneuver through the bumpy road that lies ahead because it is now easier for these countries to penetrate the local market as import duties are lowered. Some of these cars are cheaper, have better features and are technologically advanced. Nissan and Hyundai in particular have chipped away at Proton's market share by introducing locally produced models at competitive prices Starkie (2005).

Moreover, Mitsubishi, who once had a joint venture with Proton has now returned to add more misery to its former trainee. It is back with a vengeance in the Malaysian market with familiar models such as the Lancer and Colt, which once flooded the streets of Malaysia in the 1980s, in addition to its Evo IX – raising competition to Proton.

Fourthly, the technology used to manufacture cars is not advanced enough compared to other more established foreign cars such as Honda and Toyota as skeptics feel that Malaysia also does not have solid auto engineering and design base to ensure that Proton gets off to a running start (Netto, 2005). Thus, it is always going to be heavily reliant on foreign technology (Netto, 2005).

Furthermore, Malaysia, with a population of 26 million, simply does not have a large enough domestic market to achieve economies of scale. It needs to sell at least double its current production level of over 150,000 cars (Netto, 2005). The reality is that, Malaysia simply does not have a comparative advantage, a competitive edge or a large enough domestic market to sustain the venture. Despite its pricing advantage, Proton will soon face uphill technological and innovation battles in defending its dominant market share as a result.

Fifthly, Proton continues to struggle with high production costs that make local cars relatively more expensive than many foreign cars without tax and tariffs despite the protection. Proton spends a significant amount on research and development (R&D) and royalties paid to Mitsubishi for the use of its engine. Still producing only 200,000 units after 15 years, its volumes are too low to support stand-alone operations (Chee, 2003).

Also, although Proton has a huge pile of cash reserves, these are being used up for research and development, some of it via its Lotus design arm in the United Kingdom. Such Research and Development (R&D) costs have to be spread over a relatively small production output, raising the cost per unit. Losing this competitive edge when facing up against global giants will cause Proton to face huge problems in penetrating foreign markets and meeting exacting standards. In the past, it has had to sell its cars at close to cost to try and gain a foothold in these markets.

Sixthly, Proton faces brand image problem. Ever since its Mitsubishi days, Proton has been plagued with niggling finishing problems - the most well known being its unreliable power windows (Netto, 2005). Proton may think that such minor detail will not be a big thing to worry about but because of such bugs, they have cost Proton's image to deteriorate, especially at a time when there is a growing perception that its rival, Perodua, offers better value for money. In truth, one of the biggest problems Proton faced was its image as a "national car" drenched with patriotism and the politics surrounding it. This prevented decision makers from selling off a substantial or controlling stake in the company for fear of losing national pride.

What is more, Proton has to use locally sourced components as a form of national service to support local component makers, so it was unable to be as competitive as its rivals, which could source cheaper components from elsewhere.

Moreover, the quality of Proton poorer than other foreign cars making the consumers lose confidence in Proton thus, is losing not only brand image but also customer loyalty. A good example is Gen 2. The basic assembly work is fine, but there are some glaring flaws in components and cabin parts that point to the inexperience and incompetence of Malaysia's supplier companies according to the comments of a few bloggers (paultan.org, 2005). As a consequence, the car has to be marked down over mismatched plastics, faulty switches, scratched gearknobs, and general squeaks and tizzes that reduce sales revenue. This negative public perception is the greatest obstacle to increasing sales and penetrating foreign markets, and Proton needs to change the mindset and improve after-sales service.

Seventhly, the threat of substitute products also causes Proton's sales to drop. With the improvement of well-developed infrastructure in Malaysia, consumers substitute their transportation modes to public transportation such as LRT, KTM, and buses thanks to

Malaysia's Prime Minister Datuk Seri Abdullah Ahmad Badawi on his instincts to keep on improving the public transport making it easily accessible to consumers. Consumer can go to their destination by public transportation with cheaper cost and they can save a lot of time from the traffic jams. This actually indirectly gives competition to Proton as another mode of transportation.

Eighthly, Proton lacks efficiency in producing new models. According to Chee (2003), in an industry where the average lifespan of a car before another new model emerges is two to two-and-a-half years, Proton is not producing new models fast enough to meet consumer expectations. With non-national make cars hitting the market well due to attractive pricing and models, Proton is losing out. Thus, unless Proton bucks up, such as by introducing new models quickly, the company will see its market share slip further.

Ninthly, Proton became the number-one car only because government intervention imposed a warped import tax regime that tacked tariffs ranging from 140 to 300 percent on to foreign cars and priced them well out of the reach of ordinary Malaysians (Chee, 2003). Thus opportunity costs - the money foregone by consumers who either have to pay the tariff on other brands they would prefer to drive or buy Proton - are estimated by analysts to be even higher.

Proton has averaged sales of about 105,000 cars per year through the 1990s, analysts say, surviving on the high tariff rates. Consumers on average overpay by at least RM15,000 per Proton car, partly because of royalties paid to Mitsubishi (RM16 billion over the decade) and about RM20,000 per non-Proton car (RM17 billion over the decade) (Chee, 2003). However, once the tariff barriers are removed. Proton will face massive problem in sales.

Tenthly, with World Trade Organization tariff cuts loom, Malaysians are rich enough to buy other brands despite the high tariffs - the national car is in increasing trouble. Malaysia's consumers increasingly want something else as a result. Their tastes and preferences change as they opt for better quality and technological cars from overseas at competitive price. Part of it is that competing non-national brands such as Toyota, Honda and Kia have cut costs to the bone, generated dramatic efficiencies and pushed promotions hard in order to get at Malaysia's lucrative car market.

Policy Implications and Recommendations

In light of the increased competition and liberalization within the domestic automotive industry, rapidly changing trends and industry challenges, Proton has to re-strategise how it should compete. It is clear that Proton can utilise its limited resources more efficiently via strategic collaborations rather than going it alone. Proton does not have the luxury of time to develop the necessary range of products from scratch. Consequently, the previous operating strategy to develop multiple platforms in-house has to be revamped to reflect current challenges. Thus, policies on the pursuit of strategic alliances with international partners for mutual benefit are required. For example, the company has so far identified China, the Middle East and North Africa as key export markets, and is currently negotiating for joint ventures. According to Chee (2003), it has entered into a joint venture with Goldstar in China and hopes to start produce 30,000 and 100,000 cars in 2004 and 2005 respectively whereas in Iran, Proton's joint venture aims to sell 30,000 units per year. It has also submitted a bid to buy an assembly plant in Morocco to spearhead its thrust into the Northern African market.

Moreover, a deal with Volkswagen (VW) which is still in a process would give Proton access to German technical and management know-how to better face an onslaught from Japanese and Korean automakers who are eating into its market share by assembling cars in Malaysia while Volkswagen will get an opportunity to grow its market share in Asia, which accounted for just 6.6% of its 5.1 million sales 2005 (Malaysia Today, 2005). This Europe's No. 1 auto maker has plants in China and India, and by buying into Proton, it will get access to plants here capable of making up to 380,000 cars a year that can be increased to one million units (Malaysia Today, 2005). Additionally, Proton had also entered into a Memorandum of Understanding with Jinhua-Youngman Automobile Limited on 23 May 2006. This collaboration is particularly significant from a business standpoint as it provides Proton with the opportunity to improve its revenue generating capabilities from the licensing of some of the Group's technologies. More importantly, this collaboration will also assist in introducing Proton's products to China, one of the most vibrant automotive markets in the world.

Apart from that, Proton had also signed a Memorandum of Understanding with Petroliam Nasional Berhad (Petronas) which aims at exploring the possibility of further developing Petronas' large capacity engines for use in Proton's cars. In all these relationships, Proton will

seek to establish partnerships that are mutually beneficial and which will optimize stakeholder value.

Meanwhile, the second policy that has taken place is to reduce costs in order to enhance profit. Kim Eng Research points to the initiatives Proton has taken to defend its domestic market share and grow its export markets (Chee, 2003). Firstly, it plans to cut cost by 30 percent by designing its own car, using its own Campro engines for all future new models and procuring quality components from cheaper sources. This is in addition to annual savings of over \$50 million a year on payment of royalties to Mitsubishi for their engines. The use of its own engines also reduces the effect of yen fluctuation on its earnings. Kim Eng Research estimates that every 1 percent appreciation in the yen translates to a 1.4 percent drop in Proton's earnings. The engine and transmission (which typically account for about 25 percent of the cost of a car) are currently imported from Japan. With the use of the Campro engines, the transmission will be the only major imported component, thus reducing its yen exposure drastically.

In addition, the establishment of Proton's Tanjong Malim plant (coined as Proton City) is also expected to cut costs and improve quality. The plant has the initial capacity to produce 100,000 units annually with the potential to churn out as many as one million cars, hopefully providing Proton the ability to reach the economy of scale it needs. This is in comparison to just 230,000 units produced by its plant in Shah Alam yearly. Certainly, Proton is not going quietly. The company and the government intend to do their best to prove conventional auto economics wrong - in a time when there is a worldwide glut in automobile production. Proton has already ventured into Iran to make a series of sales presentations to Iranian institutions in a move to market its R&D and technical capabilities to improve Proton's sales. This strategy of tapping into new market is a way to ensure Proton's position safely.

To stay afloat in a sea of competition, Proton is striking back with the release of its latest model, a slick 1.2 liter Proton Savvy, with automated-manual transmission, which touts German quality controllers at its plant and a tough, sturdy image. A replacement for its Renault-powered Tiara model is also on the cards, with an eye on the China market. It will take a thorough and deeper revamp to steer Proton in the right direction - even if it means swallowing gulps of national pride and allowing Volkswagen to lead the way.

In order to boost sales, it must come up with more interesting models to compete with new non-national passenger cars that feature next-generation automotive innovations such as intelligent automatic gearboxes and variable-timing engines. Proton is officially launching Proton Satria Neo. This new product is a representative of Proton joint-efforts with Lotus Engineering. This will also bring income for Proton as the quality is better and has more marketing appeal. A slow and competitive automotive industry has contributed towards the drop in the sales of Proton cars.

Next, to offset lost revenues from lower import tariffs, Minister of International Trade and Industry Rafidah Aziz has said that higher excise taxes for cars are likely to be introduced to protect Proton (Chee, 2003). If not, it is expected to lose market share dramatically if such barriers pressured by AFTA and WTO are implemented. These are the steps taken by the government and various parties to ensure Proton's sustainable growth.

As the government and related parties are trying their best to strengthen their exports and form joint ventures with more established automobile companies to overcome the sales decline suffered by Proton, we recommend additional measures to resolve the problems facing Proton as mentioned in earlier in this paper.

Firstly, Proton should revamp its product components to provide the benefits consumers want. Thus, the management of Proton needs to integrate the components that make up a product effectively. This includes the quality, design and branding. Proton needs to communicate with its consumer about how they have improved their car quality and always try to be innovative and differentiated from other competitors to gain back customer loyalty. Quality control on vendors is also crucial to ensure that they do not supply bad or below-standard parts to manufacture the cars. This gives them a car they can trust, brands that are reliable, and brands that are in a position to offer them the best value for money and after sales support.

In addition, it is important for Proton to understand consumer behaviour and identify the target markets because it can then help Proton to make better marketing decisions, and identify emerging trends in consumer marketplace. Awareness of these trends is essential for quickly recognizing and responding to problems and opportunities with sound marketing strategies. For example, nowadays Malaysians are getting more well-to-do, thus, Proton should create a more luxurious car to cater to their standards.

Moreover, Proton should paint a more positive perception of the brand among car buyer and existing Proton car owners. A brand image is important for Proton not just to create awareness on their products but also to change consumers' minds about the quality of Proton is as good as others. They should let consumers aware that the quality and performance have improved unlike the previous products to change their views and perceptions on Proton as evidence of the recently launched Satria Neo that had fulfilled these criteria. Likewise, complaints on spoilt accessories of the car such as power windows need to be immediately remedied to let consumers know that Proton is always improving itself to gives them maximum satisfaction and better services.

Proton also needs to consider the cost improvements focused not only by joint venture and others as mentioned above but also in entire network's ability to operate in a more productive and efficient manner thus further reducing wastage or unnecessary costs. Improvements in quality and factories efficiency will further contribute to cost savings. The decrease in cost will provide Proton with a higher profit to offset their losses. By reducing the cost of production, Proton can deal directly with the raw material distributor so that they can cut of the cost for the middle man and some transportation cost.

Finally, employee, representative and business partners must equip with the right knowledge and skills. Training provided employee and representative for upgrading their skills-sets and technical knowledge, as well as inculcating a positive mindset to create more quality and standard cars to enable Proton to compete fairly with others. Then comes the part where promotion plays an important role. Promotion must be actively carried out to increase awareness of consumers locally and internationally. The message of the new launching of a car and its benefit has to be made sure that it is communicated clearly to the target market. Such publicity will attract more customers to buy Proton cars.

Conclusion

The automotive industry has played an important role in the development of the manufacturing sector in Malaysia. With the successful implementation of the first National Car Project, the industry has to widen its perspective to take on the challenges ahead. Besides gearing up its operation to meet the anticipated growth in the sector, the industry has to strengthen its competitiveness through greater emphasis on product and market development. The industry

also has to carve a niche in the export market and foster closer linkage with the target destinations. To ensure that the year ahead will be better despite the challenges, Proton will focus on operational efficiency, cost competitiveness and introduction of new models whilst embarking on more aggressive and focused marketing campaigns.

These focus areas will enhance prospects of sales and cash flow, which will help to improve the company's position and restore its financial performance. Proton also needs the support of all its business partners, especially its vendors and dealers, to work together to overcome the current difficulties. The result will be an efficient sales and vendor network with a strengthened brand position.

**SPECIAL INVESTMENT ZONES: ISKANDAR DEVELOPMENT REGION (IDR)
WITH REFERENCE TO KUALA LUMPUR STRUCTURE PLAN 2020 (KLSP)**

Chan Sook Heng
Teoh Hoay Ban

Background of IDR

In July 2005, the Federal Government had asked Khazanah Nasional Berhad (Khazanah) to conduct a feasibility study for the development of a special economic zone in South Johor. This zone later came to be known as the Iskandar Development Region (IDR). A Special Projects Team (SPT) was formed in Khazanah to undertake the task of preparing a Comprehensive Development Plan (CDP) for the IDR's development. Senior officers from the Federal Government and the Johor State Government were seconded to the SPT for this purpose. The SPT team also included outside consultants and subject matter experts in fields such as town planning, real estate, economic and financial planning, environmental planning, legal and regulatory, marketing, business process reengineering, social policy, strategy, and local government.

In October 2005, Khazanah presented to the National IDR Planning Committee, a Conceptual Outline Plan for the IDR. The Committee was jointly chaired by the Prime Minister and the Johor Chief Minister, with Khazanah acting as the secretariat for the Committee. The Committee concluded that there was strong economic, social and developmental rationale to create the IDR. After a 12-month comprehensive study, IDR was officially launched by His High Royal Highness the Sultan of Johor, and witnessed by the Prime Minister and the Chief Minister of Johor on 4 November 2006. This marks the beginning of an exciting and dynamic phase of South Johor's economic development as outlined in the form of the CDP (Naser Ismail 2007).

IDR covers 2,217 square kilometers of land area, between Senai Airport and the ports of Tanjung Pelepas and Pasir Gudang. IDR is one of the key engines of growth identified under Ninth Malaysia Plan ("9MP") for the development of the Malaysian economy. Iskandar Regional Development Authority (IRDA) was established on 17 February 2007 under the IRDA Act 2007 (Act 664), to establish policies, direction and strategies, and acting as a one-stop centre to coordinate and facilitate the development of IDR. IRDA is committed in providing application an efficient response time and will look to set new benchmarks in this area.

Following the release of the CDP in November 2006, the plan was formally adopted by IRDA at its inaugural meeting in February 2007. The special purpose catalyst investment agency of the region, SJIC, is in advanced stages to commence operations in the middle of this year. In the meantime Khazanah is spearheading the evaluation and coordination of investments in catalyst projects in the region. To demonstrate its long term commitment to develop the IDR, more than RM 4 billion has been allocated by the Government under 9MP to build the hard infrastructure for the region such as new highways, sewerage system and river cleaning, as well as soft infrastructure such as in the RM330 million allocation to enhance security.

Development will be initially focused in concentric circles in the waterfront areas around Johor Bahru and Nusajaya, and the logistics centers of Port of Tanjung Pelepas, Pasir Gudang and Senai Airport. IDR's unique ecological beauty and location of being near the southern tip of the Asian continent with easy access to logistics facilities makes it suitable for a global rim city to be developed within. IDR will have a special focus on services, such as the creative industries, education, financial advisory and consulting, healthcare, logistics and tourism. The development of IDR will be led by the private sector and foreign direct investments. The Iskandar Development Region (IDR) is set to become Southern Peninsular Malaysia's most developed region, where living, entertainment, environment and business seamlessly converge within a bustling and vibrant metropolis. The IDR is located in Johor, the southern gateway to Peninsular Malaysia; IDR is only six to eight hours flight radius from Asia's burgeoning growth centers such as Bangalore, Dubai, Hong Kong Seoul, Shanghai, Taipei and Tokyo. South Johor is accessible by four ways; air, land, rail and sea. The available Senai International Airport provides easy access by air travel. By road, Kuala Lumpur is just a three-hour drive while Singapore's Changi International Airport is just a 55 minutes drive. Rail travel is also available. IDR is flanked by three major ports, the Pasir Gudang Port, Port of Tanjung Pelepas and Tanjung Langsat Port (IDRA 2007a).

IDR aims to be a sustainable region of international standard. The beacon of new growth, IDR will spur economic developments that actuate Malaysia's global potential. Recognizing the need for sustainable development, social and environmental issues features heavily on its agenda. IDR's commitments to these causes are evident in its manifestation within the IDR Master plan. IDR is the ideal place to do business within the Johor-Singapore-Indonesia (JSI) Triangle. It offers state-of-the-art physical infrastructure and a world-class business environment like

excellent logistical facilities, cyber cities, and central business administration. South Johor as a whole complements Singapore's growth strategy with an environment that provides an alternative "quality of life" that is not readily available in the Island State. Recognizing South Johor's strategic importance to national development, the Federal Government supports the State in respect of planning, implementation, coordination, control, management, finance and promotion to ensure the success of the Iskandar Development Region (Khazanah Nasional Bhd 2006a).

Vision and Main Objective of IDR

The CDP's vision is for "A World Class Sustainable Conurbation¹ of International Standing". In line with this, its key objective is "to create a sustainable conurbation which has taken into consideration the needs of all stakeholders involved, either directly or indirectly, and will enhance the quality of community's life without compromising the local environment and its ecology".

Core Goals and Principles of IDR

"Livability and Sustainability" is the core framework of the plan and a number of associated goals have been defined for IDR, and they are:

- IDR commits to providing equal opportunity to all its local population and stakeholders to share in its livability i.e. in economic growth, adequate housing, environmental protection, efficient mobility, public safety, public health and recreation.
- IDR's focus on Quality of Life for its people must be economically healthy, with a broad mix of employment opportunities that will enhance livability as neither can progress without the other.
- IDR must emphasize on quality built environment where developments build to human scale and to high standards of attractiveness in order to be more livable. This means that in the design of its built environment, such as buildings, streets, parks and neighborhoods, priorities must be given to people's safety, comfort and quality of life.

¹ According to the Encarta Dictionary Tools, "conurbation" means urban sprawl: a large urban area created when neighboring towns spread into and merge with each other.

- IDR must manage its natural environment and be especially sensitive to protecting natural resources that provides a foundation for livability. Clean water, clean air and protected natural resources must be its abiding goals.
- IDR should build on its strong cultural environment, which includes the arts, humanities and the educational instruments.
- IDR must also capitalize on its strategic geographical location, as the southern growth hub of Malaysia and also the growth node for Singapore, Malaysia and Indonesia.

With this clear and defined purpose, IDR's central vision of providing a livable and sustainable conurbation will first and always be to provide a development that accommodates the quality of life desired by the current and future citizens of IDR. Thus, the CDP will balance these needs against economic growth, environmental quality, social and community development that will make the region a world-class conurbation. The CDP is prepared in anticipation of changes to ensure that growth is managed in a manner that provides a sustainable pattern of development and a positive quality of life for the IDR citizens (Khazanah Nasional Bhd 2006b). Although the Iskandar Development Region (IDR) is the recently plan that Malaysia government should focus on however the previous plan as Kuala Lumpur Structure Plan 2020 (KLSP 2020) also should be focus on simultaneously. Even though these two plans are focusing and developing for next decade but there are some differences between IDR and KLSP 2020.

Kuala Lumpur Structure Plan 2020

The preparation of the Kuala Lumpur Structure Plan 2020 is undertaken in the conviction that most of the policies of the 1984 Kuala Lumpur Structure Plan (KLSP 1984) need to be revised due to unprecedented economic boom and rapid changes in the last 20 years. Some of the major developments that have taken place were not expected in the structure plan. Development such as the Multimedia Super Corridor (MSC), the Kuala Lumpur International Airport (KLIA) at Sepang and the transfer of federal government administrative functions to Putrajaya are expected to stimulate and influence future changes and growth. With globalization gathering pace, Kuala Lumpur will encounter more challenges within a new international development era. The nation's capital should be made ready for a competitive international role in the world of the 21st Century. In the light of hangs in the last twenty years and anticipated changes in the near future for a holistic development and good governance, it is timely to prepare a new structure plan for Kuala Lumpur.

The Kuala Lumpur Structure Plan 2020 (the Plan) contains the vision, goals, policies and proposals to guide the development of Kuala Lumpur (the City) over the next 20 years. It does not contain proposals for detailed physical planning for any specific area. Detailed physical proposals shall be relegated to a subsequent stage of the development plan, that is, the local plan. The Plan contains details of all the relevant separate components that make up the City, that is, its economic base and population, land use and development strategies, commerce, tourism, industry, transportation, infrastructure and utilities, housing, community facilities, urban design and landscape, environment and special areas. These components, though in discrete parts, are interrelated and mutually contingent. Policies and proposals for each of these components are therefore, directed towards their composition into an integrated whole, that is, the efficiently functioning, progressive and felicitous city. This Plan needs to be translated at a local planning stage by which identification and implementation of projects should be supported with phasing programs, financial allocation and management (Mohmad Shaid Mohd. Taufek 2000a).

Vision and Goals of Kuala Lumpur

The development of Malaysia is now guided by the national agenda and Vision 2020 that envisions Malaysia as a fully developed country economically, socially, politically and spiritually by the year 2020. Embodied in this vision is the aspiration of achieving excellence, glory and distinction. A critical factor in attaining this vision is the sustenance of rapid economic growth which is achieved mainly through growth in the export oriented secondary and tertiary sectors. Malaysian industries must be able to compete successfully in the global markets through a more effective application of science and technology as well as a more imaginative utilization and marketing of the country's inherent and acquired advantages and strengths with respect to natural, human, financial and cultural resources.

Kuala Lumpur, being the premier city of the nation, must contribute strongly to the attainment of the ideal embodied within Vision 2020 and its aspirations. The development vision for Kuala Lumpur must therefore be consistent with, and reflect the underlying principles of Vision 2020 while being appropriate to the City's own particular role in the nation's development. The vision for Kuala Lumpur that is consistent with the national vision is: **KUALA LUMPUR - A WORLD-CLASS CITY**. The vision of 'A World-Class City' encapsulates the ambition to make Kuala Lumpur a city that will assume a major global and sub global role for the benefit of all its

inhabitants, workers, visitors and investors. Kuala Lumpur will strive to establish the highest quality living, working and business environment benchmarked against the best in the world. This is necessary if it is to attract and retain national and international investors as well as skilled and professional workers, both local and foreign.

As a world-class city, Kuala Lumpur must also ensure that the infrastructure, environment, city management and cultural, social and community facilities meet the highest expectations of the majority of its residents, workers, visitors and investors. The four principal constituents of a world-class city are a world-class working environment, a world-class living environment, a world-class business environment, and world-class governance. In order to achieve the vision of A World-Class City, five goals are identified:

Goal 1: To enhance the role of Kuala Lumpur as an international commercial and financial centre.

Goal 2: To create an efficient and equitable city structure.

Goal 3: To enhance the city living environment.

Goal 4: To create a distinctive city identity and image.

Goal 5: To have efficient and effective governance.

The vision and goals for Kuala Lumpur have been formulated with the aim of creating a sustainable city. City Hall Kuala Lumpur (CHKL) shall ensure that the planning of the City shall strike a balance between physical, economic, social and environmental development. Local Agenda 21 shall be adopted to encourage citizen participation towards creating a sustainable society. This is in line with government policies of implementing sustainable development strategies as stipulated in the Habitat Agenda of the Rio Declaration (Mohmad Shaid Mohd. Taufek 200b).

Population of Johor and Kuala Lumpur

To developing the IDR plan the government should also look into the population, age proportion, and the employment as well. Johor's population, estimated at 3 million in 2004, is projected to grow to 4.4 million by 2020. However, based on sources from Department of Statistics and assumptions derived from the existing number of housing units in Kuala Lumpur, it is estimated that the population for Kuala Lumpur in 2000 was 1.42 million people. The KLSP 1984

projected that the population for Kuala Lumpur for the year 2000 was 2.2 million with the employment of 1.4 million.

In terms of ethnic breakdown; in Johor the Malays (Bumiputeras) comprise 54%, Chinese (33%) and Indians (6%). The following table shows the prediction of Johor's population growth from year 2000 to year 2020, source from Johor State Investment Centre (JSIC):

Table 1: Johor's population, 2000-2020

District	2000	2005	2010	2015	2020
Johor Bahru	1,159,079	1,370,738	1,613,221	1,880,729	2,170,423
Batu Pahat	353,129	382,175	412,469	440,559	466,106
Muar	348,662	373,587	398,766	421,189	441,024
Kluang	272,161	295,373	319,629	342,193	363,270
Kota Tinggi	199,024	212,558	206,104	238,130	248,311
Segamat	188,968	198,142	206,577	213,443	218,213
Pontian	149,647	160,722	171,291	180,781	189,369
Mersing	69,947	73,920	77,766	80,896	83,606
Total	2,740,617	3,067,215	3,425,823	3,797,920	4,180,322

There has been a reversal in net in-migration of about 9,000 persons per annum between years 1975 to 1980 to a net out-migration of about 4,280 persons per annum for the period 1991 to 1997. The out-migration is clearly not a result of lack of employment opportunities but is partly due to the shortage of affordable housing. Kuala Lumpur has experienced a movement of people to the suburbs and outlying towns, who, nonetheless, commute daily back into the City to work. While the Kuala Lumpur City (KLC) grew rapidly, the City itself experienced a slower population growth. The following graph shows the net migration in Kuala Lumpur from year 1975 to 1997 and indicates the changing trends in the migration.

Age Structure of Johor and Kuala Lumpur

Johor's population is relatively young, with 50% of the 3 million people in 2004 falling into the 15 to 44-year age group. This is an asset as the State pushes for rapid industrial development. Thus, this is a good opportunity for government to develop the IDR. However, for Kuala Lumpur due to the continuing decline in the birth rate has resulted in the decline in the proportion of young people below 15 years old from 33.0 percent in 1980 to slightly less than 27.0 percent in 2000. Commensurately, the working age group of 15-59 increased from 63.0

percent in 1980 to 67.0 percent in 2000. The old age group, 60 years old and above has increased from 4.0 percent in 1980 and 1991 to 6.0 percent in 2000.

Table 2: Composition of Population by Age Structure, 1980 – 2000

Age Group	1980		1991		2000	
	No.	%	No.	%	No.	%
0-14	303,471	33	391,220	31	384,453	27
15-39	459,805	50	618,380	49	654,994	48
40-59	119,549	13	189,300	15	299,019	21
60+	36,784	4	63,100	5	85,434	6
Total	919,610	100	1,262,000	100	1,432,900	100

Source: Department of Statistics. Note: The aged population is defined as 60 years old and above by the National Social Policy, 2004.

By looking into the age structure of the city population, it needs special policy and approach on aspects related to housing, facilities and opportunities for all ages including the teenager, youth and aged. The issues are the impact of young population and the increasing proportion of aged population. Besides, the City Centre population has decreased from 156,980 in 1980 to 128,720 in 2000. During the same period, and the percentage of the City's population living within the City Centre compared to the City as a whole has dropped from 17.1 percent to 9.0 percent. This has set back the optimization of the infrastructural investment put in place over the last two decades (Mohmad Shaid Mohd. Taufek 2000c).

Workforce and Main Labor Trends of Johor and Kuala Lumpur

The active workforce in Johor was increased by 2.43% per year between 1991 and 2000. During this 9 year period, a total of 256,900 job opportunities were created, while unemployment dropped from 3.3% in 1991 to 2.3% in 2000. The availability of manpower, in fact, is projected to grow further by 2.88% between now and 2020. Unemployment is also projected to decline from 2.3% in 2000 to 2.0% in 2020. The total current employment in Kuala Lumpur is estimated at around 838,400 and the economic structure of Kuala Lumpur and the entire KLC, in terms of broad sectoral distribution of employment. The tertiary or service sector forms the largest component of employment in Kuala Lumpur representing about 83.0 percent of the total compared to 71.0 percent in the KLC. Based on the Eighth Malaysia Plan, it is estimated that Kuala Lumpur accounts for the major portion or 58.0 percent of the service sector jobs within the KLC. The tertiary sector comprises finance, insurance, real estate & business services,

wholesale & retail trade, restaurant & hotel, transport, storage & communication, utilities, personal services and government services. The secondary sector, which comprises manufacturing and construction, represents only 16.0 percent of employment in Kuala Lumpur compared to 26.0 percent in the KLC. The employment to population ratio in Kuala Lumpur is higher at 59.0 percent compared to 41.0 percent in the remainder of the KLC and 40.0 percent in the country as a whole. The problem is the manufacturing component of employment has declined to 10.5 percent of total employment in 2000 from 16.8 percent in 1980, leading to a reduction in the range of employment opportunities in the manufacturing sector. The labor trends in Johor shows that there is significant migration of labor from rural to urban areas due to job opportunities in manufacturing, services and other primary employment sectors. However, there is population imbalance due to disparities in the status of development of the various Johor districts. Job availability is mainly concentrated in developed districts such as Johor Bahru, Muar, Batu Pahat and Kluang. Demand for skilled labor is on the rise as Johor aims for more high-tech, capital intensive and export-orientated industries (Mohamad Shaïd Mohd. Taufek 2000c).

Initial Incentive and Support Package (ISP)

There is an announcement by the Prime Minister, Dato' Seri Abdullah Badawi regarding the initial incentive and support package ("ISP") for Iskandar Development Region ("IDR") in Prime Minister's keynote address at Invest Malaysia 2007 on 22 March 2007, which is released by Iskandar Regional Development Authority (IRDA).

Objective and Scope of ISP

The development of IDR requires a substantial amount of investment given the bulk of the development is targeted to be undertaken over the next 15 years. Developing a comprehensive ISP to attract private investors to invest these monies over the short-to-medium term is critical to kick start the development of IDR. The ISP is structured to encourage early investment.

To spearhead the development of concentrated hubs within IDR, certain zones within the flagship zones in IDR which require investments of several billion ringgits in gross development value will be granted special incentives. The location of these zones and other details will be announced by IRDA in the third quarter of 2007. Two zones have been initially identified for such development by Khazanah National Berhad ("Khazanah"). Khazanah, and subsequently the South Johor Investment Corporation Berhad ("SJIC"), is currently in the midst of finalizing the investment of approximately RM4 billion for the first zone.

Development initiatives targeted in IDR

IDR will pay a special focus on the services sector, in line with the Government's policy to increase focus on value-added and knowledge intensive activities in the country. Commercial development initiatives identified for the development of IDR would include activities approved by IRDA within six targeted sectors in IRDA-approved zones, referred to as qualifying activities. These six targeted sectors are amongst the six services-based pillars listed in the Comprehensive Development Plan ("CDP"), and are as follows:

- (i) Creative industries
- (ii) Educational services
- (iii) Financial advisory and consulting services
- (iv) Healthcare services
- (v) Logistics services
- (vi) Tourism related activities

Incentives available

For IRDA-status companies will enjoy:-

- (i) Exemption from the Foreign Investment Committee rules;
- (ii) Freedom to source capital globally;
- (iii) The ability to employ foreign employees freely within the approved zones, depending on the amount of space occupied in these zones;
- (iv) "Exemption from corporate income tax for a period of 10 years from commencement of operations for activities within the zone and outside Malaysia, provided these operations commence before the end of 2015"²;
- (v) Exemption from withholding tax on royalty and technical fee payments to non-residents for a period of 10 years from commencement of operations.

Foreign knowledge workers in IDR will be able to import or purchase a duty free car for their personal use. This incentive is similar to that offered under the Malaysia My Second Home program. All incentives will be given subject to the applicant fulfilling certain criteria, which

² This incentive is for six special industries.

will be determined by IRDA. IRDA will be the authority which assesses the background of the applicant and endorses the application for submission to the relevant authorities. Detailed guidelines will be released by IRDA in due course. In lieu of exemption from the Foreign Investment Committee rules, IRDA-status companies will be required to make a contribution to the Social Projects Fund. As outlined in the CDP, the fund will be administered by IRDA for social welfare development in IDR, including Bumiputra development. The nature of this contribution will be assessed and communicated by IRDA at the same time that the ISP entitlement is granted. Whilst companies will be free to employ foreign employees in these zones, IRDA expects Malaysians to make up the large majority of the workforce. The CDP projects that 817,500 additional jobs will be created in the region in the period up to 2025. IRDA is confident that with this initial ISP, these projections are well within reach. Companies undertaking activities in sectors other than the targeted sectors will continue to be eligible for the current incentives that exist in the country. In view of the dynamic nature of the business environment, the Malaysian Government and IRDA will constantly be reviewing the incentives offered to ensure needs of investors and businesses are met, and that the package is globally competitive (IRDA 2007a).

Challenges and Issues of Developing IDR

It is commendable effort by the Malaysian Government to establish the Iskandar Development Region (IDR), which promises great potential for the region. Given Johor's strategic location in the Indonesia-Malaysia-Singapore growth triangle, the proposed development region - an area encompassing 2,217 square kilometers, which is three times (3x) the size of Singapore – appears long overdue.

The proposal to create a “Shenzhen” for Malaysia looks good on paper. The city of Shenzhen, next to Hong Kong, offers a glimpse of the vast amounts of investment dollars that could flow into the IDR if it lives up to its potential. The Shenzhen special economic zone (SEZ) of China is 2,020 sq km, slightly smaller than the IDR, and it managed to attract over US\$30 billion in the past two decades, helping create GDP of nearly 493 billion renminbi (S\$97 billion) in 2005. Shenzhen was declared China's first SEZ in 1980, and the central government ensured the province was governed by special policies. Flexible measures aimed at securing foreign investment involved incentives and relaxed rules on international trade. It became China's fastest growing city for nearly three decades and, from 2001 to 2005, saw an economic expansion that

averaged 16 per cent. However, it will be overly simplistic to assume guaranteed success purely from a Blueprint created by Atkins, United Kingdom (UK)'s leading town planning consultant and a strategic comparison with Shenzhen.

The success of IDR depends critically on several factors, which at this point of time, leaves much to be desired. These factors are as follows:

(1) Foreign Investment

Most importantly, IDR's success is critically dependent on foreign investment or a projected RM382 billion over the next 20 years. This amount is more than the entire RM245 billion foreign direct investments (FDI) the whole country received over the past 20 years. Just as Hong Kong became Shenzhen's largest source of investment, the success of IDR will be equally dependent on investment from Singapore. However, Singapore's investment in Johor has dropped to an alarming level. In the first eight months of 2006, Singaporean investment in the state stood at only RM208.9 million.

This is only a mere 11 percent of the total investment from Singapore in 2005, according to statistics given by the Johor State Investment Centre (JSIC). Last year, the Singaporean investment stood at RM1.9 billion. Furthermore, it is not just the investment from across the Causeway that has gone down. The FDI into the state too has hit a stumbling block. Until August in 2006, FDI to the state stood at RM2.4 billion - just 44 percent of the total amount which flooded in last year. Even in 2005, when Johor received record FDI at RM5.9 billion, this amount is a far cry from an average of RM19.1 billion required to make IDR a success.

(2) Crime & Safety

JSIC senior manager Mohamed Basir Mohamed Sali when interviewed by Malaysiakini at the end of last year said that "Singaporeans think Johor is not a safe state, but actually this issue was played up by the media in both countries... Yes, we have some security problems, but they do not involve the whole state, they are limited in certain areas, Johor is still as safe as candy." The continued denial of the existence of one of the most serious problems facing the country at this point of time does not bode well for the economic success of the IDR. The crime index in the country released by the Royal Police Force has worsened from 156,315 cases in 2003 to 226,836 cases in 2006 – a sharp rise of

45.1% in the past three years when the police force had set the target of reducing the crime index by five per cent each year. In the past three years, violent crime had skyrocketed by 85.8 per cent from 22,790 cases in 2003 to 42,343 cases in 2006, with rape cases registering the highest increase of 65.5 per cent – reaching an average of 6.7 women raped daily in 2006 compared to an average of four women raped daily in 2003. In 2003, averages of 1.5 persons were murdered daily; but in 2006, this has increased to an average of 1.65 persons murdered daily. Hence it is unsurprising that both investors and tourists, particularly from Singapore has been dissuaded or at best, lukewarm towards investing and spending their dollars in Johor. Letters in the Singapore Straits Times for example, as recently as 4th April, have called Johor Bahru as a “cowboy town”.

(3) A Mega-Property Development Project?

Many skeptics who fear the plan could degenerate into just another exercise in grandiose real estate development. At this point of time, the entire project appears focused almost entirely on real estate development. The recent abolishment of the real property gains tax points was directed at increased property purchase and transactions for land in the IDR. One of the leading developers in IDR, UMNO-linked UEM Land's plans this time around is nothing if not grand. Besides a theme park, education-city and medical hub - all three Khazanah-owned and driven - UEM Land's main developments include a logistics cluster, an international destination resort with an eco-based theme park, state administrative centre and a waterfront project at Puteri Harbour. Mr Talhar, who is also group chairman of CH Williams, Talhar & Wong, cautioned against too much emphasis on property. “Real estate accommodates meaningful economic activities. Economic activities have to come first. Land per se doesn't produce economic activities,” he rightfully argued. The Government must learn from the lack of success at Cyberjaya, which was a special economic zone dedicated to high-technology related activities such as software development. Similarly, we must learn from the total failures of Bio-Valley and E-Village which were dedicated to biotechnology and multimedia content creation respectively. Despite having investment millions in these projects, their emphasis on construction and property development without a properly thought out strategies for the actual projects have resulted in their failures. Otherwise, some of the IDR plans for

another dedicated ICT-hub, theme park and medical hub might just end up as ghost towns.

(4) Government Policy Consistency

The decision by Malaysia's Foreign Investment Committee (FIC) to deny the sale of a building to Singapore's Great Eastern is only an example of policy inconsistency and the lack of transparency. Great Eastern had proposed to acquire Wisma Denmark from bumiputera businessman Ibrahim Mohamed for RM150 million and believed it had the deal in the bag. But after months of waiting for FIC approval, the parties were finally informed the proposed acquisition was rejected, with no reasons given. In Johor for example, the existing massive property glut is a result of state policy requiring at least 40 per cent of all development projects be sold to bumiputeras, and the subsequent stamping of those titles as such. Hence unless the state gives its approval, a bumiputera wanting to dispose of his property can only sell it to a fellow bumiputera, and these secondary titles and conditions have depressed market demand. The question then is whether the continuation of such a policy will result in more project failures within the IDR.

(5) Unequal Treatment of Foreign Investors vs. Local Investors

While the Government has recently trumpeted its move to remove the 30% bumiputera quota requirement for investments in the IDR, closer scrutiny leaves much to be desired. The proposed waiver of the NEP's 30% equity requirement would only involve investments in two specified areas in the IDR, encompassing a small area of 1,780 hectares and with the caveat that foreign investors there must have business dealings outside the country. This means that such a policy is not applicable to local investors, and by definition, local non-bumiputera investors. The policy is perplexing because domestic investments can bring equal amounts of economic returns and contributions to the region and country when compared with foreign investors. Hence the discriminatory policies practiced by the Government clearly marginalise local non-bumiputera businessmen.

The five points highlighted above are not the only challenges and issues facing by our government's while plan to make IDR a success. However, they clearly demonstrate the uphill

battle which the government faces and the lack of political will which is necessary to make the project a success. Barisan Nasional NEP-guided government has been obsessed with the hardware of development – property, heavy industry, mega-infrastructure projects, ports, bridges and airports - but neglected the human software needed to compete in a modern global economy (Tony Pua 2007).

From the Singapore's recently news, the Minister of Singapore, Lee Kuan Yew noted that based on the meetings with Singapore other ministers had shown a great interest in investing in the IDR and the Minister stated that Singapore government will support the Iskandar Development Region (IDR) as both the island republic and Malaysia are bound to gain from the multi-billion ringgit project. Besides, from a wider perspective, Singapore government believes it is good for the two countries, with Malaysia savoring the spin-offs from Singapore's economic growth, and similarly Singapore.

The Minister, Lee Kuan Yew also noted that the internal politics and protests to Singaporeans investing in IDR are to exploit the issues and to erode support to Prime Minister's Datuk Seri Abdullah Ahmad Badawi's leadership and the cooperation in the development region, and Singaporean companies intending to invest in the IDR cannot expect privileged treatment from Malaysia just like the "generous treatment" accorded by China to investors from Hong Kong in Shenzhen province. Thus, Datuk Seri Syed Hamid Albar said Singapore companies must abide by the Malaysian government's terms if they wanted to invest in IDR and Syed Hamid also noted that Malaysia government welcomed anyone who wanted to invest in the IDR, regardless of whether the investor was from Singapore or any other country.

Therefore, besides Singapore, Malaysia's Prime Minister, Datuk Seri Abdullah Ahmad Badawi wants more Chinese investment in Malaysia. Thus, Prime Minister has called for more trade activities between China and Malaysia as the present investment figures do not reflect their strong relations. Prime Minister said that although China's global trade last year stood at some US\$1.7tril, (RM5.86tril), only 2% involved direct trade with Malaysia and in terms of investments, Prime Minister also noted that Malaysia had about US\$320mil (RM1.1bil) worth of direct investments in China but received less than US\$30mil (RM103.5mil) in return. However, Prime Minister claimed given the strong and long-serving diplomatic ties, Prime Minister believed that it is only natural for Malaysia and China to enhance existing trade, business and investment cooperation and hope that will have more trade both ways. Moreover, Prime Minister

noted that China was in a solid position to increase its overseas investment, as the country was the world's fourth-largest economy with a GDP of about US\$2.7tril (RM9.31tril) and also emphasize to welcomed Chinese investors to the Iskandar Development Region (IDR), and Prime Minister stated that successful investments in international markets were a new source of growth for corporations and entrepreneurs that were previously confined to the domestic economy, and added that Chinese corporations were well positioned to take advantage of the many trade and investment opportunities materializing in the Asean region.

China Council for the Promotion of International Trade (CCPIT) vice-chairman Yu Ping noted Malaysia was their major partner in the Asean region and said that Chinese entrepreneurs were confident that bilateral trade between the two countries would reach US\$50bil (RM172.5bil) by 2010. Last year, bilateral trade between the two countries recorded a new high of US\$37bil (RM127.6bil). Thus, Prime Minister revealed that there was specific request from Chinese businessmen for the IDR to be promoted in China (Nelson & Beh 2007).

Conclusion

The IDR is a significant plan for Malaysia government since the government investing huge amounts on it and expecting this plan brings a higher standard living to the citizens in terms of the economy development, education, employment and so on. In order for the IDR development to succeed it will naturally require participation and investment from foreigners and particularly Singaporean and Chinese. Thus, the government has to resolve the above issues and do more to attract foreign investments such as reduce crime drastically, be more consistent in formulating and implementing policies, curb the speculation on the land prices, human capital development and retention and so on. Besides, the government is highlighting the importance of human capital in the economic growth and development of the country, thus, if the government is serious about raising the quality of human capital, much more needs to be done to create a holistic and integrated plan that will honestly appraise and critically examine the quality of Malaysia's educational institutions so that can achieving the objectives and goals of IDR and the Vision 2020 with unwavering supports from the government and local citizen, IDR shall be an example of "Malaysia Cemerlang, Gemilang, & Terbilang".

SPECIAL INVESTMENT ZONE: LABUAN AS MALAYSIA INTERNATIONAL OFFSHORE FINANCIAL CENTER

Liew Wui Kiong
Lee Guan Chen

History of Labuan

Before 14th century, Labuan was part of Majapahit Empire. After the incident, Sultan of Brunei took over Labuan as their territory until the year of 1846 and then ceded to the British in that particular year and thus Labuan Island became a Crown Colony in the year 1848. Additionally, Labuan was established as a free port and become strategic re-fueling station for British steamships. It was made a part of North Borneo on 1 January 1890, then on 30 October 1906 joined to the Straits Settlements. The first White Rajah of Sarawak, James Brooke was appointed commander-in-chief and Governor of the new territory (Elizabeth, 2005). During World War II, Labuan was occupied by Japan from December 1941 to June 1945 and governed as part of the Northern Borneo military unit by the Japanese 37th Army. Labuan was renamed Maida Island (Maeda-shima island) after Marquis Toshinari Maeda, the first commander of Japanese forces in northern Borneo. In June 1945, Australian forces retake island in Operation Oboe Six.

In 15 July 1946, Labuan joined to British North Borneo and was under British military administration which in turn became a part of Malaysia as the state of Sabah in 1963. In 1984, Labuan was ceded by Sabah to the federal government and made a federal territory. In 1990, it was declared an international offshore financial centre and free trade zone.

Labuan as International Offshore Financial Centre

Offshore banking can only be carried on in Labuan by an offshore company or a foreign offshore company incorporated or registered for that sole and exclusive purpose, and by an office, branch or subsidiary of a licensed Malaysian bank. In October 1990, Labuan was become an international offshore financial centre. Labuan marvels in year 2002 included a series of a series of very well received road shows in mainland China, Hong Kong and other regional centre, the result shown 30% raise in company registrations amount. After few years' of shrinkage continuity, ten new banks existed in Labuan territory and the emergence of the Labuan Financial Exchange became a regional centre for debt issuance.

However, the most significant highlight was the recognition by international financial community which determines Labuan in the path of becoming an Islamic banking and finance world centre. On 15 February 1996, Labuan Offshore Financial Services Authority (LOFSA 2004) was established as a single regulatory agency for the whole offshore centre. Companies can make use of Malaysia's more than 60 double tax treaties, and the island has become the preferred conduit for FDI (Foreign Direct Investment) into a number of local countries including Korea and Malaysia itself.

The number of new offshore companies incorporated in Labuan IOFC (International Offshore Financial Centre) increased from 486 in 2002 to 494 in 2003 and rose again in 2004 and 2005. In 2005, 532 offshore companies registered in Labuan IOFC, thus, the end of December 2005 shown the total of 5152 registered offshore companies which existed in Labuan. Inclusive, 3067 of these companies were operating companies who came from 80 countries such as ASEAN (Association of South East Asian Nations) and Pacific Region. As a result, Labuan IOFC reputation is tremendously rose and reflected as international stature.

In 2005, the number of offshore companies registered in Labuan IOFC rose by 532 bringing the total of registered offshore companies to 5,152 as at end-December 2005. Out of this, 3,067 were operating companies. The offshore companies originated from almost 80 countries, reflecting the international stature of the Labuan IOFC. Offshore insurance activities continued to be a key business activity in Labuan IOFC. A total of 12 new licences were approved in 2005, bringing the total number of licences to 112. There was also progress in captive insurance, an area of focus for LOFSA, with the approval of eight new captive insurers in 2005, bringing the total number to 29. Shares held by foreigners increased from USD105.9 million in 2004 to USD134.4 million in 2005, in line with LOFSA's objective of attracting more foreign investments as a strategy towards enhancing the capacity of the insurance industry in Labuan (LOFSA 2006).

The offshore banking industry in Labuan IOFC remained vibrant with a total of 59 offshore banks operating during year 2005. Out of this, ten are investment banks. The offshore banking industry recorded profit before tax of USD241.5 million for the year under review. There was greater participation of non-residents businesses in both deposits and loans, in line with

LOFSA's efforts of encouraging more "out-out" business in the Labuan IOFC. There was also expansion in other offshore business activities. The establishment of nine new offshore leasing companies in 2005 brought the total number of offshore leasing companies to 69, whose transactions mainly emanated from the leasing of aircrafts, vessels and equipment relating to oil and gas. In offshore fund management, in 2005 three new private funds were given consent and one was revoked due to non-compliance, bringing the total number of registered private funds to 18. Two of these funds are *Shariah*-compliant. The fund management industry was serviced by 17 fund managers.

Furthermore, over 300 financial institutions were existed in Labuan IOFC in the year of 2006. These financial companies was providing a wide-ranging financial services in both conventional and Islamic sectors, those services such as offshore banking, investment holding, investment banking, insurance and insurance-related activities, trust, fund management and leasing. As a result, the offshore companies established on Labuan in 2006 included 112 insurance companies, 68 leasing companies, 60 banks, and 30 trust management companies. Other significant financial events and transactions conducted out of the Labuan IOFC in 2006 included (Lowtax.Net 2007):

- (a) The listing of USD750 million world first exchangeable equity-linked sukuk
- (b) USD505 million finance for purchase of aircrafts by a regional airline
- (c) USD2.6 billion private funds for investments in the region
- (d) USD1.1 billion lease structures for financing capital goods in the oil and gas, and aviation industries
- (e) USD3.5 billion debt securities issuance by corporations
- (f) USD1.1 billion investments through Labuan companies into various countries
- (g) USD3.4 billion capital (non-securities) rose through Labuan companies

Below is the table of Labuan economy growth from year 1991 to year 2000. The total GDP is increased from the past, the result shown that Labuan economic performance is increasingly upgraded and improved.

Table 1: IOFC business activities in Labuan Island

Sector	1991 GDP %	1995 GDP %	2000 GDP %
Agriculture	2.8	2.3	1.7
Mining (Gas Petroleum)	61.4	52.5	41.3
Manufacturing	8.8	12.1	15.2
Construction	3.3	4.5	6
Transportation / Store / Communication Services	4.4	6.1	8.3
Contractors / Retail / Hotel / Restaurant	7.2	8.9	11.2
Finance / Insurance / Real Estate / Services	5.7	7.1	9.2
Community / Personal Services	6.4	6.5	6.7
Total (%)	100	100	100
Total GDP	145.26	196	288.3

Labuan Offshore Banking

Since the Asian crisis incident in year 1998, Bank Negara Malaysia liberalize the entry barrier for banking industry and simultaneously Labuan also face the same situation as their offshore bank entry mode also been liberalize by Bank Negara Malaysia. The action allows foreign investors getting saturate in Labuan offshore industry. Thus, the economic performance is increasingly improved. In year 2003, offshore banking industry achieve 48.8% rose in pre-tax profit which amounting to USD166.8 million which show an increased from year 2002 which is USD112.2 million. The offshore banking industry reached the profits before tax of USD241.5 in the year of 2005.

Additionally, three new banking licenses were approved in 2003 and this action increased the number of licensed banks to 65 in year 2004. The activities of these new banks contributed to a significant increase in the total assets of the offshore investment banking industry, from USD6.6 million in 2002 to USD66.8 million in 2003. In 2004, the total number of offshore banks was 57, including investment banks. Inclusive, 15 were domestic-owned banks, consisting of 12 subsidiaries and three branches, and 42 were foreign-owned banks, comprising eight subsidiaries

and 34 branches. In year 2004, total deposits of non-bank customers was rose by 71.4% and the result is show the improvement from the year 2003 which total deposits only USB3.7 billion. Additionally, Malaysian-based offshore banks recorded 83.9% (USD4.2) deposits growth in year of 2004, compared with USD2.3 billion in 2003. Foreign offshore banks also reported an increase in total deposits, growing by 50.6% from USD1.4 billion in 2003 to USD2.1 billion in 2004 (LOFSA 2005: 38).

Furthermore, offshore banking can only be carried on in Labuan by an offshore company or a foreign offshore company incorporated or registered for that sole and exclusive purpose, and by an office, branch or subsidiary of a licensed Malaysian bank. In addition, offshore banks are conducting wide range of financial activities, which consists the management of investment portfolios, accepting foreign currency deposits, borrowing or lending money to Malaysian residents, provide loans to foreign investors to purchase properties situated within Malaysia, approve loans to non-residents, securitization, leasing, investment banking, Islamic banking and others. In the path to promote Islamic finance in Labuan IOFC, many strategic efforts has be implement with purpose to further developing Islamic banking in Labuan, simultaneously, strengthen Malaysia's position as an international Islamic financial hub.

At the year of 2005, three full – fledged Islamic offshore banks and three Islamic investment banks started to operate in Labuan. In the end of 2005, the absolute amount of Islamic banking assets was accounted to USD708.9 million which show a positive difference from 2004 (USD678.7 million). In year 2006, the numbers of offshore banks reduce to 53 banks, including investment banks, operating in Labuan IOFC. Inclusively, there were 15 Malaysian-owned banks, consisting of 11 subsidiaries and four branches, and 38 were foreign-owned, comprising seven subsidiaries and 31 branches. The offshore total assets rose by 15.5% from USD18.3 the year 2005 to USD21.1 billion in 2006. In addition, offshore banks average assets improved 22.1% to USD398.3 million which shown a difference from year 2005 (USD326.3 million). In 2006, there still full-fledged Islamic offshore banks operating in Labuan IOFC which consist of four investment banks. Total assets of the industry were USD1.1 billion, which representing 5.3% of total assets of the offshore banking industry. Last but not least, Malaysia financial leaders estimate that Islamic banking will be able to obtain 20% more assets in local banking industry in future.

Year 2006 is the tenth year anniversary of establishment of LOFSA. Initiatives undertaken and measures implemented thus far have positioned Labuan IOFC as a leading offshore financial centre in the Asia-Pacific region. The growth of offshore companies has been steady since 1996 with a continuous inflow of approximately 500-600 companies being incorporated annually. Labuan IOFC has consistently ensured that the quality of companies admitted into the Labuan IOFC are maintained. This has led to Labuan being recognised as a reputable and credible IOFC, home to top-ranked financial institutions. As an integrated IOFC, Labuan offers a wide range of financial products and services, ranging from offshore commercial banking, investment banking, insurance and insurance-related services, investment holding, trust, fund management, leasing and factoring. Labuan IOFC is also emerging as an important regional Islamic financial centre.

In order to gain more attraction of offshore institutions into Labuan IOFC, LOFSA will emphasis more on developing greater depth and breadth in selected portfolios, business segments and geographical markets. Highly targeted incentives will be introduced for areas that are identified with strong growth potential for Labuan IOFC and preventing any obstacles from impeding Labuan's IOFC from developing even further and more developed. For the next five years till 2010, LOFSA's goal is to develop Labuan IOFC as an 'out-out' regional offshore financial centre. The focus is to increase the percentage of non-resident ownership of offshore companies and non-resident business to 70% from the present 50%. The number of offshore companies operating in Labuan IOFC is expected to grow at least 10% per annum.

The general objective to be a regional financial centre will be supported by several underlying targets. By 2010, total loans and deposits in the offshore banking sector is targeted to increase by 15%. Gross premiums for offshore insurance and assets leased are expected to increase by the same quantum. Capital market activities will also be further encouraged. Growth in corporate advisory services for cross-border merger and acquisition exercises and passive investment transactions and its ancillary funding requirements will be given emphasis. To increase the aggregate size of assets under management (AUM) domiciled in Labuan IOFC, the various forms of fund management such as fund of funds, and private equity will be encouraged together with the introduction of innovative asset classes derived from the various regional markets.

Offshore Insurance

Since the development of Labuan IOFC, many foreign investors started to operate their business in Labuan territory. In year 2003, 13 new licenses has approved during the year, which including five reinsurers, four captives, one underwriting manager and three insurance brokers. In the same year, total industry assets significantly grow at 30.4% and resulting amount of USD914.0 million, which show an increase from year 2002 (USD701.0). Additionally, offshore general insurance and reinsurance industry gain 19.5% gross premium growth which from RM 341.6 million (2002) to RM408.2 million (2003). During the year of 2003, Malaysia IOFC has approved seven new licenses to operate insurance related business activities in Labuan. Those insurance companies included two reinsurers, three captives and two insurance brokers. However, there were three licensees give up their licenses which each from reinsurance, captive and broking business. Besides, four new captives were established in Labuan IOFC, but two discontinued their business activities because of certain reasons. Thus, the total number of captives increased from 21 to 23, and the gross premium from captive business amounted to USD17.4 million, which cause an increase of 26.1% from USD13.8 million in 2002.

As a total, the net increase of licenses was from 103 in 2003 to 106 in 2004. Besides, the 48 insurance and insurance-related licensees were originated from the ASEAN and Pacific region, which consist of Malaysia (31), Singapore (6), Australia (6), Indonesia (3), Brunei (1) and Thailand (1). The rest of the licensees were originated from the United Kingdom, the United States of America, Hong Kong, Germany, Bermuda, Sweden, Ireland, Japan, France, British Virgin Islands, Denmark and others. The result shown that Labuan IOFC was successfully attracts many foreign countries investors to operate their business in Labuan. Besides, more than two-third of insurance and insurance-related organization were foreign owned and the size of foreign shareholding rose to 34.8% (2004) from 29.6% in year 2003. The result shows a favorable outcome in terms of Malaysia IOFC's objective which purposely to attract more international insurers.

At the end of 2005, there were 112 licensed insurance companies operate their business in Labuan IOFC and at the end of 2006, the total approved licensees in offshore insurance and insurance related activities increased to 123. Besides, 18 new licenses approved in year 2006 which included eight insurance brokers, six reinsurers, two captives and two underwriting managers.

In 2006, Lloyd's of London (Lloyd's) was granted an underwriting manager's license through its Labuan subsidiary. Lloyd's presence would enhance the insurance industry business in Labuan IOFC. However, during the year 2006, seven licensees surrendered their licenses, of which three were insurance brokers, two captives, one reinsurer and one direct insurer.

Conclusion

The Labuan IOFC will continue to play an important role in complementing the Malaysian onshore financial sector and LOFSA, as the authority entrusted with the development and administration of Labuan IOFC remain committed towards providing a conducive regulatory and operating to develop Labuan into a successful offshore centre.

FDI AND ECONOMIC GROWTH: AN EMPIRICAL STUDY ON MALAYSIA*

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Definition of Foreign Direct Investment

Foreign direct investment is international capital flows in which a firm in one country creates or expands a subsidiary in another. It involves not only a transfer of resource but also the acquisition of control. There is several advantages bring by foreign direct investment. The most important benefit for a country from foreign direct investment is creating more employment especially for under developed country. In addition, technology transfer is another benefit for the host countries. When the foreign factories are set up in their countries, they will expose to higher technology production and efficiency in management. Once in future, they able to produce goods and services as competitive as foreigners do.

Besides that, insufficient funds for investment are a reason to need foreign direct investment. Usually many less-developed countries lack of fund for investment. Foreign direct investment can help them to develop their country and improve their standard of living by creating more employment. According to Mohd Nazari Ismail (2001), he finds that foreign direct investment play a significant role in the Malaysian economy especially in the electronic industry. In addition to creating more jobs and generating export, the foreign multinationals have also contributed to the development of the technical capabilities of the locals. This is through the process of technology transfer.

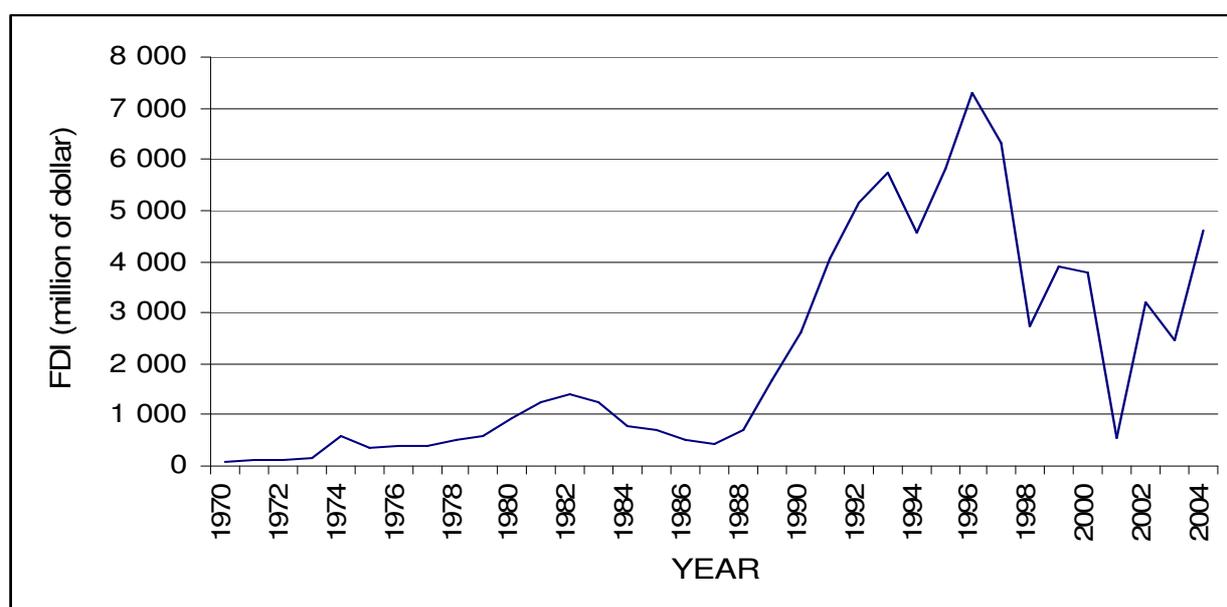
Trends and Patterns of FDI Flow in Malaysia

Figure 1 presents the trend of FDI inflow to Malaysia, during 1970 to 2004. For the past two decade, Malaysia was receiving a lot FDI. FDI stock in Malaysia starts to grow up slowly by 1970s. FDI inflows had increased almost twenty-fold during 1970s to 1990s, from \$94 million dollar in 1970s to \$2.6 billion dollar by 1990s, although there was some fluctuation between the years. Even though the FDI was increased over the year, however, since the early of 1990s, there have been several periods of slowdown. In 1993, FDI drop drastically dropped drastically due to a slowdown in investments from two main sources of investments for Malaysia - Japan and

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Taiwan. One of the main reasons for this slowdown is the rise in wage rates in Malaysia relative to other Asian countries (such as China, Vietnam and Indonesia). The total FDI flows in Malaysia was peaked at 1996, when it achieve \$7.3 billion dollar. The financial crisis of 1997 that affected most of the Southeast Asia also serves to reduce FDI into Malaysia. Since the early of 2000s, the FDI flows in Malaysia tend to inconsistent and fluctuate randomly, however it also achieve an average inflows of US\$3billion per year.

Figure 1: FDI Inflows to Malaysia, (in million dollars) 1970-2004



Source: United Nations Conference on Trade and Development (UNCTAD), various issues.

In general, Malaysia is the second fastest growing economy in the South East Asian region with an average Gross National Product (GNP) growth of eight-plus percent per year in the last seven years. Since independence in 1957, Malaysia has moved from an agriculturally based economy to a more diversified and export oriented one. The Malaysian market is fairly openly oriented, with tariffs only averaging approximately fifteen percent and almost non-existent non-tariff barriers and foreign exchange controls. With a stable political environment, increasing per capita income, and the potential for regional integration throughout the Association of South East Asian Nations (ASEAN), Malaysia is an attractive prospect for FDI.

The key success factor of the FDI contributes to the economic growth in Malaysia because of the good environment. If the environment not suitable, it will not encourage foreign investors come to invest. Good favorable conditions make investors face fewer problems because all investors

can run their business conveniently in order to make more profit with life safety. Few vital clues for foreign direct investment include political stability, economic stability, lower wages, and easy accessibility to plentiful raw material, special rights, and person safety.

Long term political stability makes foreign investors confident with their businesses will succeed and remain profitable. Besides, economic instability like inflation, foreign exchange fluctuation and economic crisis also another important environment factor for investor to consider because can cause the business lose without knowing in advance.

Furthermore, foreign investors try to search the country with lower wages to reduce average cost of production and hence strongly persuade foreigners to invest in that country. A country with plenty of raw materials necessary for the production attracts investors more than a country without it and personal safety also vital to foreign investors because life is more valuable than money, nobody like to take risk as being killed or kidnapped in foreign country.

Objective of Study

The main objective in this paper, therefore aims to study the relationship between FDI and economic growth in Malaysia for the period 1970-2005, using time series data. The rest of the paper is structured as follow: Section 2, there will have review on the empirical literature done on FDI and economic growth. Section 3 will be the data and methodology. Section 4 will be the result and interpretation and finally is Section 5 will be the findings from this study.

Literature Review

Foreign direct investment (FDI) has played a leading role in many of the economies of the region. There is a widespread belief among policymakers that foreign direct investment (FDI) enhances the productivity of host countries and promotes development. There are several studies done on FDI and economic growth. Some of the studies testing the relationship between FDI and economic growth while some are find out the causality between two variables. Their findings are varies from different method use on their research such as some of the researchers found that FDI has a positive effect on economic growth. For example is Balasubramanyam et al (1996) analyses how FDI affects economic growth in developing economies. Using cross-section data and OLS regressions he finds that FDI has a positive effect on economic growth in

host countries using an export promoting strategy but not in countries using an import substitution strategy.

Olofsdotter (1998) provides a similar analysis. Using cross sectional data she finds that an increase in the stock of FDI is positively related to growth and that the effect is stronger for host countries with a higher level of institutional capability as measured by the degree of property rights protection and bureaucratic efficiency in the host country. Besides that, Borensztein et.al (1998) examine the effect of foreign direct investment(FDI) on economic growth in a cross country regression framework, utilizing data on FDI flows from industrial countries to 69 developing countries over the last two decades. Their outcome of this study is that FDI is an important vehicle for the transfer of technology, contributing relatively more to growth than domestic investment. However, the higher productivity of FDI holds only when the host country has a minimum threshold stock of human capital. Thus, FDI contributes to economic growth only when a sufficient absorptive capability of the advanced technologies is available in the host economy

Another study based on developing economies is Borensztein et al (1998) that examines the role of FDI in the process of technology diffusion and economic growth. The paper concludes that FDI has a positive effect on economic growth but that the magnitude of the effect depends on the amount of human capital available in the host country. In contrast to the preceding studies, De Mello (1999) only finds weak indications of a positive relationship between FDI and economic growth despite using both time series and panel data fixed effects estimations for a sample of 32 developed and developing countries.

On the other hand, Zhang (2001) and Choe (2003) analyses the causality between FDI and economic growth. Zhang uses data for 11 developing countries in East Asia and Latin America. Using cointegration and Granger causality tests, Zhang (2001) finds that in five cases economic growth is enhanced by FDI but that host country conditions such as trade regime and macroeconomic stability are important. According to the findings of Choe (2003), causality between economic growth and FDI runs in either direction but with a tendency towards growth causing FDI; there is little evidence that FDI causes host country growth. Rapid economic growth could result in an increase in FDI inflows.

There is further study done by Chowdhury and Mavrotas (2003) which examine the causal relationship between FDI and economic growth by using an innovative econometric methodology to study the direction of causality between the two variables. The study involves time series data covering the period from 1969 to 2000 for three developing countries, namely Chile, Malaysia and Thailand, all of them major recipients of FDI with different history of macroeconomic episodes, policy regimes and growth patterns. Their empirical findings clearly suggest that it is GDP that causes FDI in the case of Chile and not vice versa while for both Malaysia and Thailand, there is a strong evidence of a bi-directional causality between the two variables. The robustness of the above findings is confirmed by the use of a bootstrap test employed to test the validity of the result.

In addition, Frimpong and Abayie (2006) examine the causal link between FDI and GDP growth for Ghana for the pre and post structural adjustment program (SAP) periods and the direction of the causality between two variables. Annual time series data covering the period from 1970 to 2005 was used. The study finds no causality between FDI and growth for the total sample period and the pre-SAP period. FDI however caused GDP growth during the post –SAP period.

Finally, Bengoa and Sanchez-Robles (2003) investigate the relationship between FDI, economic freedom and economic growth using panel data for Latin America. Comparing fixed and random effects estimations they conclude that FDI has a significant positive effect on host country economic growth but similar to Borensztein et al (1998) the magnitude depends on host country conditions. Carkovic and Levine (2002) use a panel dataset covering 72 developed and developing countries in order to analyse the relationship between FDI inflows and economic growth. The study performs both a cross-sectional OLS analysis as well as a dynamic panel data analysis using GMM. The paper concludes that there is no robust link running from inward FDI to host country economic growth.

Data and Methodology

This section describes the econometrics methods that we use to access the relationship between FDI and economic growth. We use simple ordinary least square (OLS) regressions and the empirical analysis is conducted by using annual data on FDI and economy growth in Malaysia over the 1970-2005 periods. We use annual data from IMF International Financial Statistics

tables, published by International Monetary Fund to find out the relationship between FDI and economic growth in Malaysia case.

OLS framework

$$\text{Growth}_i = \alpha + \beta \text{FDI}_i + \varepsilon_i \quad (\text{i})$$

Where the dependent variable, Growth, equals to real GDP growth or real GNP growth, and FDI is gross private capital inflows to a country. We use both GDP and GNP for dependent variables in order to test the robustness of the findings. From the equation above, the positive sign of coefficient for FDI represent that there is positive relationship between FDI and economy growth. If there is an increase in FDI inflow, there will led and enhance the economic growth in Malaysia. In contrast, if the FDI is negative correlation to economic growth, it will not help in GDP growth in a country. The hypothesis is stated as below

Hypothesis1:

$$H_0: \beta = 0$$

$$H_1: \beta \neq 0$$

The null hypothesis $\beta = 0$ (there are no relationship between foreign direct investment (FDI) and real gross domestic production(RGDP)) or real Gross National Income(RGNI) against its alternative $\beta \neq 0$, if less than lower bound critical value (0.05), then we do not reject the null hypothesis. Conversely, if the t-statistic value greater than 5 percent critical value, then we reject the null hypothesis and conclude that there are significant relationship between independent variable and dependent variable.

Diagnostic Testing

On the other hand, we also apply the diagnostic testing to test the series whether the series are free from autocorrelation, heteroscedasticity and normality problem.

Hypothesis 2:

H_0 : There are autocorrelation between members of series of observations ordered in time.

H_1 : There are not autocorrelation between members of series of observations ordered in time.

Hypothesis 3:

H_0 : There are constant variances for the residual term.

H_1 : There are no constant variance for the residual term.

The null hypothesis from hypothesis two and three are do not existing autocorrelation and heteroscedasticity against its alternative do existing autoregression and heteroscedasticity. If the computed p-value is greater than 0.05 significant levels, then we do not reject the null hypothesis and conclude that there does not existing autocorrelation and heteroscedasticity. Conversely, if the computed p-value is less than 0.05 significant levels, the we reject the null hypothesis and conclude that there are existing autocorrelation and heteroscedasticity problem.

Unit Root Test

The first step of constructing a time series data is to determine the non-stationary property of each variables, we must test each of the series in the levels (log or real GDP or GNP and log of FDI) and in the first difference (growth and FDI rate).

First, the ADF test with and without a time trend. The latter allows for higher autocorrelation in residuals. That is, consider an equation of the form:

$$\Delta X_t = \beta_1 + \pi_1 X_{t-1} + \sum_{i=1}^n \rho_1 \Delta X_{t-i} + e_{1t} \quad (\text{ii})$$

However, as pointed out earlier, the ADF tests are unable to discriminate well between non-stationary and stationary series with a high degree of autoregression.

In consequences, the Phillips –Perron (PP) test (Phillips and Perron, 1988) is applied. The PP test has an advantage over the ADF test as it gives robust estimates when the series has serial correlation and time-dependent heteroscedasticity. For the PP test, estimate the equation as below:

$$\Delta X_t = \alpha + \pi_2 X_{t-1} + \varphi \left(t - \frac{T}{2} \right) + \sum_{i=1}^m \varphi_i \Delta X_{t-i} + e_{2t} \quad (\text{iii})$$

In both equations (ii) and (iii), Δ is the first difference operator and e_{1t} and e_{2t} are covariance stationary random error terms. The lag length n is determined by Akaike's Information Criteria (AIC) (Akaike, 1973) to ensure serially uncorrelated residuals (for PP test) is decided according to Newley-West's (Newley and West, 1987) suggestions.

Hypothesis 4:

H_0 : Series contains a unit root

H_1 : Series is stationary

In ADF and Phillips Perron tests, the null hypothesis of non-stationarity is tested the t-statistic with critical value calculated by MacKinnon (1991). The outcome suggests that reject null hypothesis which can conclude the series is stationary. Both ADF and PP test are applied following Engle and Granger (1987) and Granger (1986) and subsequently supplemented by the PP test following West (1988) and Culver and Papell(1997).

Besides that, Kwiatkowski, Phillips, Schmidt, and Shin (1992) introduce such a test, and do it by choosing a component representation in which the time series under study is written as the sum of a deterministic trend, a random walk, and a stationary error. The null hypothesis of trend stationary corresponds to the hypothesis that the variance of the random walk equals zero. As one could expect, their results are frequently supportive of the trend stationarity hypothesis contrary to those traditional unit root tests.

Hypothesis 5:

H_0 : Series is stationary

H_1 : Series contains a unit root

In KPSS test, the null hypothesis of stationarity is tested. The outcome suggests that do not reject hypothesis which can conclude the series is stationary. Besides, testing for stationarity is so important in time series data is to avoid spurious regression problem and violate of assumption of the Classical Regression Model.

Results and interpretation

Economic growth rates (y) are calculated in logs of real gross domestic product (GDP) or gross national income (GNI). Likewise, FDI equals to FDI inflows as a share of GDP are calculated in the logarithms form respectively for Malaysia.

The empirical results are reported in three steps. First we test for the order of integration for both GDP and FDI in Malaysia. In the second step, we difference the data to test the relationship

between FDI and economic growth to avoid spurious regression problem. Finally, we conduct the simple Ordinary Least Square (OLS) test to seek the relationship between FDI and economic growth in Malaysia.

To stage the unit root test, the order of integration of the variables is initially determined using the Augmented Dickey-Fuller (ADF) tests. The unit root tests are performed sequentially. The result show that LGDP or LGNI and the LFDI series in Malaysia are I(1) series. The null hypothesis of a unit root is not rejected. To check the robustness of the ADF test results, Phillip-Perron test and KPSS test are applied. The results are shown in Table 1 and 2 on the level form and first difference form. Given the results of the ADF and Phillips Perron tests, it is concluded that all variables in this study are integrated of order one except for KPSS test, all variables are not stationary at first difference since the limitation of the data collection, so the results from KPSS test are not consistent with the ADF and Phillip Perron test. These three unit root tests are employed to make any estimated relationship between the growth and FDI inflow for Malaysia would not be spurious.

Table 1: Results for Natural Logarithms of RGDP

Augmented Dickey-Fuller, Phillips-Perron and KPSS tests for unit root on the natural logarithms of RGDP, RGNI and FDI of Malaysia for the period 1970-2005.

Variable	with trend			without trend		
	ADF	PP	KPSS	ADF	PP	KPSS
RGDP	-3.227769(2)***	-2.334931	0.060595	-0.542715(1)	-0.539018	0.753368*
RGNI	-1.191497(1)	-2.321315	0.059503*	-1.191497(1)	-0.477104	0.753646*
FDI	-1.776404(1)	-2.930883	0.088275	-1.776404(1)	-1.689033	0.565574***

Table 2: Results for natural First Difference of RGDP

Augmented Dickey-Fuller, Phillips-Perron and KPSS tests for unit root on the first difference of RGDP, RGNI and FDI of Malaysia for the period 1970-2005.

Variable	with trend			without trend		
	ADF	PP	KPSS	ADF	PP	KPSS
RGDP	-5.605030(1)*	-5.605030*	0.058555	-5.575995(1)*	-5.575995*	0.064374
RGNI	-5.133702(1)*	-5.138243*	0.053253	-5.133702(1)*	-5.147958*	0.055984**
FDI	-7.254716(2)*	-7.269095*	0.060207	-7.383230(2)*	-7.585536*	0.060583

For instance, to test the relationship between FDI inflow and growth, ordinary least square (OLS) method is used to estimate it.

Estimate Model for the Malaysia Growth Function:

I) Estimate Model

Dependent variable: Δ LRGDP

Variable	Coefficient	t-Statistic
Δ LFDI	0.046072	2.468048**
C	0.063571	5.740936*

(I) Model Criteria / Goodness of Fit

R-squared	0.173583
Adjusted R-squared	0.145086
F-statistic	6.091259*

(II) Diagnostic Checking

a) Autocorrelation (Breusch-Godfrey Serial Correlation LM Test)

F-statistic	1.503516 [0.240381]
Obs* R-squared	3.106538 [0.211555]

b) ARCH Test:

F-statistic	1.755810 [0.195860]
Obs* R-squared	1.770219 [0.183355]

c) Jarque-Bera 0.543344[0.762104]

Estimate Model for the Malaysia Growth Function

II) Estimate Model

Dependent variable: Δ LRGNI

Variable	Coefficient	t-Statistic
Δ LFDI	0.044877	2.431024**
C	0.063488	5.797811*

(I) Model Criteria / Goodness of Fit

R-squared	0.169290
Adjusted R-squared	0.140644
F-statistic	5.909879**

(II) Diagnostic Checking

a) Autocorrelation (Breusch-Godfrey Serial Correlation LM Test)

F-statistic	1.181906 [0.322065]
Obs* R-squared	2.495526 [0.287146]

b) ARCH Test:

F-statistic	1.641160 [0.210676]
Obs* R-squared	1.661028 [0.197465]

c) Jarque-Bera 0.603123[0.739662]

Note: Lag length given in () and probability value stated in [].

*,** and *** indicate significant at 0.1, 0.05 and 0.01 marginal level.

For Breusch-Godfrey Serial Correlation LM Test, we are testing for correlation at the 0.05 significant level.

For ARCH Test, we are testing for heteroscedasticity at the 0.05 significant level.

The result from diagnostic checking show the model does not suffer from autocorrelation and heteroscedasticity and the series is normally distributed. It can conclude that result from both equations are reliable, where their computed t-statistics are greater than t-critical value in 5 percent level, therefore, we can conclude that there is sufficient evidence to show that there are significant relationship between economic growth and foreign direct investment inflows (FDI) in Malaysia. Since the sign is positive, so there is positive relationship between these two variables in Malaysia. FDI has direct positive impact on RGDP because when FDI rate increase by 1 %, this will lead the growth rate increase by 0.046072%. Furthermore, FDI has direct positive impact on RGNI because when FDI rate increase by 1 %, this will lead the growth increase by 0.044877%.

Therefore, the results obtained are consistent with our expected results which mentioned in the previous section, where FDI inflows will contribute to the economic growth in Malaysia.

Conclusion

As a conclusion, foreign direct investment has continued to play a significant role in the Malaysia's economy. Through the empirical result, the analysis shows that there is a positive relationship between the FDI and economic growth which the relationship is found to be significant. The robustness of the result has been test using GNI as dependent variable. These findings have important policy implication where the government has to concern the importance of the FDI contributed to economic growth.

Economy development of a country can be achieve by encourage more foreign direct investment, which it can help to create more employment in the country. In addition, advance technology in production will trained more skilled labor; therefore it will enhance the productivity and fulfill the satisfaction and demand from the consumers.

But, there is negative effect on domestic producer, because they losing the market power, since the foreign investor become monopoly in the market. This indirectly will make the domestic

producer facing the difficulties to survive in the market in the long term as foreign companies can achieve economy of scale with advance technology.

Therefore, government should impose the relevant policies likes joint venture in order to give opportunities to the domestic producer become one of the part and enjoy the profit together with foreign direct investors. This will benefit to local partner as they are expose to higher technology.

Besides, government plays an important role in maintaining political stability. Because if a new government come in with highly different policies, foreign direct investors need to adjust their strategies in accordance with those new policies. In some cases, bribery may start and causing higher costs to investors. This will decelerate the growth in a country. Furthermore, economic instability likes higher inflation and fluctuation in exchange rate in a country also one of the important factor to discourage foreign direct investments.

FOREIGN DIRECT INVESTMENT AND FOREIGN OWNERSHIP ISSUES

Ooi Sze Yin
Ho Onn Nie

Introduction

Among the Southeast Asian countries, Malaysia has greatly pursued in attracting Foreign Direct Investment (FDI). In this respect, it has constantly striven to maintain the competitiveness of FDI determinants, including the legal infrastructure. Various policy instruments and institutions have been deployed. Today, Malaysia is encountering fresh challenges as FDI flow seems to have dwindled in the region. To counter this phenomenon the Government of Malaysia (GOM) has enhanced the utility of the existing determinants and is constantly considering new strategies to attract FDI. The GOM encourages FDI by providing a number of incentives, particularly in export-oriented high-tech industries and “back office” service operations. The GOM also hosts international trade shows and advertises broadly to attract FDI. Many United States (U.S.) multinational companies have operations in Malaysia, including Intel, Microsoft, Dell, Motorola and the like.

Restrictions and Limitations of FDI Ownership in Malaysia

In order to promote the manufacturing sector that has a focus on high-value-added products, the GOM has imposed several restrictions on FDI. It was implemented in order to control the overcrowding of foreign entities, reduce labor shortages and to promote domestic industries. All foreign manufacturing activity must be licensed. Technically, foreign ownership of 100% equity is not allowed. In summary, the following industrial guidelines apply (Rajenthiran 2002)³:

- For FDI projects exporting at least 80% of production, no equity conditions are imposed;
- For FDI projects exporting 51-79% of their production, foreign-equity ownership of up to 79% is allowed, depending on the level of technology involved, potential spin-off effects, size and location of the investment, and extent of local value added in production.
- For FDI projects exporting 20-50% of their production, foreign-equity ownership of 30-51%

³ Note that technically, all firms require a company license to operate in Malaysia – according to the Industrial Co-ordination Act 1975, manufacturers with paid-up capital of RM2.5 million or more or at least 75 full-time paid employees must obtain a manufacturing license from the Ministry of International Trade and Industry (MITI)/Malaysian Industrial Development Authority (MIDA).

is allowed, depending on similar factors as above; and

- For FDI projects exporting less than 20% of their production, maximum of 30% foreign-equity ownership is allowed. If the firm's products are in a priority sector or involve advanced technology, foreign equity of up to 100% is allowed.

In furtherance to the preceding, the operationalization of the above-mentioned, affirmative action policy is translated as follows (Heritage Foundation, n.d):

- FDI level of foreign equity of 70-100%, the balance of the equity is reserved for *bumiputras*;
- FDI levels of foreign equity less than 70%, then 30% should be reserved for *bumiputras*; and
- In the event that the *bumiputra* quota is not taken up the authorities may allocate part of such balance to non-*bumiputras*.

The Foreign Investment Committee (FIC) guidelines are applicable as follows (U.S. Department of State, n.d)⁴:

- Any proposed acquisition by foreign interests of any substantial fixed assets;
- Any proposed acquisition of assets or any interests, mergers and takeovers of companies and businesses in Malaysia by means which will result in ownership or control passing to foreign interests;
- Any proposed acquisition of 15% or more of the voting by any one foreign interest or associated group, or by foreign interests in the aggregate of 30% or more of the voting power of a Malaysian company or business;
- Control of Malaysian companies or businesses through any form of joint-venture agreement, management agreement and technical assistance agreement or other arrangement;
- Any merger or take-over of any company of business in Malaysia or foreign interest; and
- Any other proposed acquisition of assets or interests exceeding in value RM\$5 million whether, by Malaysians or foreign interests.

⁴ The FIC is placed under the purview of the Prime Minister's Department and its secretariat is based on the Economic Planning Unit of the Prime Minister's Department. Undoubtedly, the FIC plays a vital role in promulgating FDI policies

What the FIC guidelines seek to promote and/or achieve:

- Against the existing pattern of ownership, any proposed acquisition of assets or interests, merger or take-over should result directly or indirectly in a more balanced Malaysian participation in ownership and control;
- The proposed acquisition of any assets or interests, merger or take-over should lead directly or indirectly to net economic benefits being derived by the nation in *bumiputra* 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, research and development;
- The purpose acquisition of any assets or interests, merger, or take-over of companies and businesses should not have adverse consequences in terms of national policies in such matters as defence, environmental protection, or regional development; and
- The responsibility of proving that the proposed acquisition for many assets or interests, merger to take-over of companies and businesses *are not against the national interest* is on the acquiring parties' concerned (emphasis added).

Modus Operandi

Related to the foregoing is the entry of FDI via the mode of mergers and acquisitions (M&As) mechanism. Undeniably, Malaysia has, over the years, strengthened the laws relating to the securities market, both conceptually and functionally (Rider 1994). However, the current policy of FDI entry via M&As is by and large restrictive (UNCTAD 2000).

Firstly, the approval of the FIC is compulsory insofar as all M&As involving foreign entities are concerned. Reportedly, the FIC administered the affirmative action policy strictly. From a commercial perspective, this would limit the business choices and strategies of foreign entities.

Secondly, in the light of the affirmative action policy, foreign investors more often than not become minority shareholders – which inevitably focus the issue of corporate governance in a

paramount context. Logically, abrogating the affirmative action policy, which is hard to foresee but cannot be ruled out completely, can to a certain extent redress this concern.

Non-Fiscal Incentives

Generally, financial arrangements for the purposes of FDI are rather flexible and market-oriented. The following salient features are worth mentioning (Mohamad 2000, p46/7):

- Non-resident controlled companies can obtain any amount of forward exchange contracts, guarantee facilities, and short-term trade financing facilities for a period of 12 months.
- Non-resident controlled companies may borrow a total sum of RM\$10 million without the prior approval from the central bank;
- In general, foreign entities that borrow in excess of the said RM\$10 million in Malaysia should ascertain that their domestic borrowing does not exceed their capital funds by more than three times – the central policy here is to instill long-term commitment;
- All exports proceeds are required to be repatriated back to Malaysia within six months from date of export;
- However, all foreign borrowings must satisfy a prevailing regulatory proviso – 60% of all foreign borrowing must be from Malaysian-owned banking institutions.

Case Studies

The FIC, as a general rule, would prefer equity ownership to be distributed as follows: 30% foreigners, 30% *bumiputras*, and 40% non-*bumiputras*. However, an element of flexibility is exercised in cases involving FDI in high technology and value-added product sectors. In addition, pursuant to the ‘Statement of Bold’ measures, Malaysia has effectively allowed 100% foreign equity ownership for FDI entry between 31 July 1998 and 31 December 2003 in all manufacturing sectors, except for seven specified activities. However, the reversal of policy must be seen in the light of the Asian crisis, when FDI inflows rapidly dwindled in the region. Realistically, in the face of tense competition for FDI at the present time, it is questionable as to

whether equity restrictions should continue. Corollary to this, the utility of the affirmative action policy is also questionable.

Furthermore, even within the manufacturing sector, the GOM seems to limit foreign participation in the automobile sector. Malaysia attained ASEAN approval in May 2000 to defer reducing tariffs for completely built-up automotive products, which is relatively high.

In order to encourage high capital and technology and to prevent labour intensive investments, the GOM imposed a formalized system of 'capital investment per employee' (CIPE) with the threshold is set at RM\$55,000 – accordingly, CIPE values below this sum will generally not be approved except for certain exceptions. Arguably, from a legal point of view, this scheme also goes against the principle of 'national treatment'.

The GOM intervenes directly when considering technology transfer agreements involving foreign parties. This is done to ensure that such agreements do not impose unfair and unjustifiable conditions or restrictions on Malaysians. It follows that such agreements must compulsorily define: the technological content and principal features of technology; the training aspect of local personnel; the royalty's sum and method of payment; and infringement and dispute governing law, which must be Malaysia law. It can be argued that such direct government intrusion is tantamount to contravention of the principle of freedom of contract, wherein business parties should be free to enter business transactions without any undue influence or duress. Conversely, the GOM may argue that such administrative intervention is necessary in order to safeguard public and economic interests.

Conclusion

In general, the service sector is, to a large extent, restricted to foreign participation. The finance sector is opened to a limited extent, but professional services, by and large, are closed to FDI. Interestingly, foreign banks must incorporate their local operations as properly capitalized Malaysian public companies with a local board of directors responsible to the Central Bank. It should be noted that the recently announced the 'Eight Economic Plan' foresees further gradual liberalization of the service sector. In line with the policy to promote the information technology sector, the telecommunication sector has been partially liberalized. The General Agreement on Trade in Services (GATS) and the ASEAN Framework Agreement on Services (AFAS) poses

new challenges for the GOM in the context of liberalizing and promoting its services sectors. Certainly the recent partnership of Port of *Tanjong Pelepas* with foreign shipping companies such as *Maersk* and *Evergreen* in providing shipping services is a step in the right direction.

PRIVATIZATION IN MALAYSIA: DEBATES AND ISSUES

Cho Ruo Hui
Ng Yoon Sin
Choo Wai Ling
Wong Kai Fei

In 1983, Malaysian then Prime Minister Mahathir Mohamad's announcement of his government's intention to embark on a privatization policy represented a dramatic reversal of preceding Malaysia government policy although it was very much consistent with his own personal ideological and policy preferences as well as the then new wave of conservative market reforms beginning in the West with the election of the Thatcher Government in the United Kingdom in 1979. The Malaysian Government has identified five different policy objectives for its privatization policy, of which contributing to the New Economic Policy (NEP) has arguably been the most important. The objectives are: (i) relieve the financial and administrative burden of government, (ii) improve efficiency and productivity, (iii) facilitate economic growth, (iv) reduce the size and presence of the public sector in the economy and (v) help to meet the objectives of New Economic Policy.

The NEP, first announced in 1970, sought to create the conditions for "national unity" by reducing poverty and reducing inter-ethnic disparities, especially between the indigenous, mainly ethnic Malay Bumiputras and the ethnic Chinese, usually referred to in Malaysian discourse as "restructuring society". Under the NEP, the state actively acquired and held, in trust, shares on behalf of the Malay community, while nurturing a Malay business class through loans, subsidies, employment and training. The NEP can be viewed as part of the government's redistributive programme, whereby the expansion of the public sector was to increase the Malay share of capital until such time when private Malay capital accumulation could take over. Privatization represented the formal transfer of these resources to a Malay capitalist class and greatly accelerated this redistribution process. The ultimate aim of the NEP and privatization was the creation of a viable Malay capitalist class (while not disregarding non-Malay or foreign investment), which could contribute to economic growth, although growth was a prerequisite for redistribution in the first place.

Generally, privatization has been defined in terms of the transfer of enterprise ownership from the public to the private sector. More generally, privatization refers to changing the status of a

business, service or industry from state, government or public to private ownership on control (Wikipedia 2007d). The term sometimes also refers to the use of private contractors to provide services previously provided by the public sector. Privatization can be strictly defined to include only cases of the sale of 100 percent, or at least a majority share of a Sale of Equity (SOE), or its assets, to private shareholder. Full or complete privatization would therefore mean the complete transfer of ownership and control of a government enterprise or asset to the private sector. In Malaysia, such privatizations are not the norm as various government agencies and investment arms such as Khazanah and Employee Provident Fund (EPF) hold prominent stake in equity or management.

Therefore, in Malaysia, the term 'privatization' is often understood to include cases where less than half of the assets or shares of SOEs are sold to private shareholders. In fact, privatization is usually understood to also include cases of partial divestiture where less than half of the assets or shares of SOEs are sold to private shareholders, with the government retaining control through majority ownership. Before 1992, besides contracting-out, leasing and build-operate-transfer arrangements, privatization in Malaysia included nine official divestitures by the Economic Planning Unit, and nine sales of relatively small enterprises by UPSAK, the Unit for Monitoring Government Agencies and Enterprises, charged with reforming ailing SOEs. Of the former, there had only been three full divestitures – involving Sports Toto, the Security Printing Branch of the Government Printers and MAS, which was totally divested in early 1994. The other five - Kelang Container Terminal (KCT), Airod, Tradewinds, MISC, and Sarawak Cement Manufactures – only involved partial divestiture with the government retaining control, even without majority ownership. However, in the case of KCT, a management contract was awarded to the new minority partner (Jomo and Tan 1999).

The Malaysian government officially announced its commitment to privatization in 1983. The objective was to relieve the financial and administrative burden of the government and to reduce the size and presence of the public sector in the economy. The policy also tried to promote competition, to improve efficiency, to increase productivity, and to facilitate economic growth through private entrepreneurship and investments (Alavi 1998). From the initiation of the privatization policy through 1990, a total of 37 projects were privatized. The momentum picked up in 1991-1995 when a total of 204 projects were put in private hands. The number of privatized projects dropped to 68 during 1996-1998, mainly due to the economic slowdown that

hit Malaysia in the second half of 1997. There are several major methods of privatization in Malaysia, but those of significance are shares issued privatization (SIP) firms. These entities, such as Tenaga Nasional Berhad (the national power generator and distributor), Malaysian Airline System Berhad (the national airline), and Telekom Malaysia Berhad (the national telecommunications provider), are huge and highly visible, and they could be privatized only through a public share issue (Qian & Tong 2002).

The Privatized Projects

For roads, the North-South Expressway project was awarded to United Engineers (Malaysia) Berhad (UEM)⁵ in 1988. The Expressway was expected to need investment of RM 3.2 billion from the private sector; however, it actually cost more than RM 6 billion. It was privatized through Build-Operate-Transfer (Naidu 1995: 204). For ports, the first port to be privatized was Klang Container Terminal (KCT). It was initiated by the Klang Port Authority (KPA). The majority of shares of KCT (51%) were sold to a private company, Konnas Terminal Kelang Sdn Bhd in 1986. In August, 2000, NCB Holdings Bhd (which is now called as “Northport”) was restructured involving KCT, Klang Port Management Sdn Bhd (KPM) and Kontena Nasional Berhad (KN). It was privatized through lease and sale of assets (Naidu 1995: 206). The telecommunications Department (JTM) was the telecommunications services were provided by the government. The provision of telecommunications services and network of JTM was taken over by Syarikat Telekom Malaysia Berhad (now is Telekom Malaysia) in January 1987. In 1990, a portion of the government’s equity in the company was divested to the public through a public flotation. The government still is the majority shareholder and continues hold the “golden share” which makes government sanction necessary on all major policy decisions of Telekom Malaysia. It was privatized through sale of equity (Naidu 1995: 206 & 207).

In September 1990, the National Electricity Board (NEB) was privatized. The assets of NEB were transferred to Tenaga Nasional Berhad (TNB). The government divested 30% of its share in TNB to the public by way of a public flotation on 28 May 1992. It was privatized through corporatization (Jomo, K.S., *Privatizing Malaysia*, pg207). The light rail transit system also was privatized. Government and Sistem Transit Aliran Ringan (STAR) signed a franchise agreement in December 1992 for Phase One of the project (Naidu 1995: 207). Government and Indah

⁵ Restructuring exercises resulted in changes of corporate structure where currently, various Khazanah’s owned companies in infrastructures, constructions, properties, technology and communications (included UEM) being grouped under “UEM Group”.

Water Konsortium signed a RM 6.2 billion concession agreement to privatize the development of the national sewerage system in December 1993. The upgrading and refurbishing of the existing sewerage system and also the construction of new multi-point sewerage system were involved (Naidu 1995: 207).

Malaysia Airline System Berhad (MAS) turned in a loss of RM35 million, because it was hit by high interest rates and high fuel costs. Therefore, it paid no dividend to the government during the five years to 1985. Because of the success of privatization of British Airway in the United Kingdom, the government also privatized MAS in a broader capital restructuring and listing of MAS share on the Kuala Lumpur Stock Exchange (KLSE, currently known as “Bursa Malaysia”). 30% of MAS shares worth RM350 million were sold to private sector in October, 1985 and further 10% was sold later. The reason of government has retained a major part of the ownership of MAS is to make sure that decisions affecting their operations were consistent with government policies and national needs (Ismail Muhd Salleh 1994: 173). It was privatized through sale of equity (Adam & Cavendish 1995: 105). For the purpose of running Toto (lottery) betting activities in terms of the Pool Betting Act, 1967, Sports Toto Malaysia was established by the government in 1969. The Minister of Finance sold 70% of the equity to a private company, B&B Enterprise Berhad which is controlled by Vincent Tan for RM35 million because of an offer by interested private-sector investors in August 1985. Then, Melewar Corporation Berhad was passed on 10% of the equity from B&B Enterprise Berhad. It was privatized through sale of equity (Adam & Cavendish 1995: 104).

Besides, licensing of a private television network such as TV3 alongside RTM’s two channel also a type of privatization. TV3 was established because at that time government had decided to reduce the size of official debt. The government licensed the privately-owned, profit oriented Sistem Television Berhad (STMB), and also is TV3. STMB was incorporated and is Malaysia’s first private commercial television station in 1983 (TV3 2004). In June 1984, shareholders of The New Straits Times Press (Malaysia) Berhad (NSTP) launched TV3, the nation’s first private TV network. In April 1988, TV3 went public and was placed together with NSTP under the holding of Malaysian Resources Corporation Berhad. In September 2003, these media assets were unbundled and established under a separate holding company which is Media Prima Berhad. It was privatized through Build-Operate. Besides TV3, there are other cases of privatization. In October 1990, government announced that Food Industries of Malaysia Bhd

(FIMA) and Peremba Bhd were being privatized through management buy-outs. In early 1994, the government privatized the Rm15 billion Bakun hydroelectric dam project in Sarawak to Ekran Berhad.

The Success Stories of Privatization

One of the main objective of privatization policy is to improve efficiency and productivity, hence seen as one of the four the criteria of successful privatization. Firstly, in business sense, the best yet simple proxy to measure efficiency and productivity is profit. Besides, increase in sales and market shares, or reduce in cost and customer's complaint may also serve as indicator for improve efficiency and productivity. Secondly, from the perspective of public welfare, any privatization that can bring benefit to the public is deem successful. For example, roads privatization (particularly highways) bring convenient to the public. Third, a successful privatization should also bring gain to the government in term of lessen financial burden of those entities that operate at a loss. Forth, privatization should help to achieve the NEP objective of enhancing Bumiputera equity ownership as a process to restructure Malaysian society. Nevertheless, this paper give emphasis to the first creteria, which focus on the efficiency and productivity of privatized companies as measurement of success.

Cases of success

For Klang Container Terminal, privatization had increased the efficiency at the port. In 1987, KCT handled 773,335 TEUs (Twenty-foot Equivalent Units) compared to in 1985, before the privatization, the terminal only can handle 244,120 TEUs. There was an increase of 216.8%. It was making profit during 1986 and 1987, and about RM 0.7 million and RM 2.1 million respectively. (Ismail Md.Salleh 1991: 624).

After the privatization, Telekom Malaysia began to improve various aspects of the production process. Errors were reduced in the billing system, improved the counter service and quicker response to applications for the telephone installations. For example, about 98% of calls made by subscriber trunk dialing (STD) were successful on the first dial. The other example is 96% of calls made to the operators were answered within 10 seconds. The Tenaga Nasional Berhad (TNB) executives found that privatization was good for the firm and would ensure better work facilities. They felt that the quality of service will become better due to greater employee

dedication. In other hand, after the privatization, incidences of breakdown were reduced from 311,190 to 42,850 in 2000 (8th Malaysia plan).

There was an immediate enhancement of Toto after the privatization. The expansion of the existing operations and the introduction of new products had made it more success. Before the privatization, government unlikely to expand business of Toto, it is because it involves gambling (Ismail Muhd Salleh 1994: 178). TV3 also performed well after the privatization. It set new standards for industry as a whole to the benefit of the viewing public and consumers. Through this privatization, it introduced some element of competition into an industry which was previously monopolized by the public sector. TV3 boasts 43 per cent share of advertising expenditure (ADEX) and 48 per cent share of television viewers.

The Unsuccessful Stories of Privatization

The government began implementing its privatization policy in 1983 by farming out infrastructure projects to private companies. However, some of the privatized projects have encountered spectacular failures and were subsequently re-nationalized. The following criteria for failure may serve as a proxy for evaluating the privatization policy:

1. There is no complete transfer of ownership or management power to private entities. Government still retain majority share holding or remain powerful through “golden share “system.
2. There are quite a number of privatized companies (still existing) suffering continues losses. Example for the case of Indah Water Konsortium (IWK). This indicates failure to improve efficiency and profitability.
3. Government took back already privatized companies. For the example case of UEM-Renong Group (De-listed from KLSE) that will show later. This proves that at least not all privatized companies can survive.

Freedom of Control in Privatization?

Generally, privatization has been defined as the transfer of enterprise ownership from the public to the private sector. More commonly, privatization or denationalization refers to changing of

status of a business, service or industry from state, government or public to private ownership or control. Privatization can be strictly defines to include only cases of 100% or at least a majority share of public enterprise, or its assets, to private shareholders. But, in Malaysia, such privatization are not the norm, the government implement some strategy such as golden share, holding majority share, and use government agencies and parties to control the privatized enterprise (Jomo 1995: 43).

Golden Share

The Special Right or “Golden Share” shows a unique way in sales of share when implementing privatization. This concept is feature of a number of UK privatizations, operates in principles as an entrenched provision allowing the holder powers of veto over fundamental decision of the company (usually involving any major change to the basis operation direction and scope of the enterprise) irrespective of the Special Shareholder’s ordinary shareholding. It is essentially a guarantee which becomes operable when the holder is a minority shareholder, and is usually prevalent in cases where the enterprise is deemed to be of strategic or social importance. In Malaysia, there are three assets sales of privatization have involved the use of Golden Share – Malaysia Airline System (MAS), Malaysian International Shipping Corporation (MISC) and Sports Toto. But privatization of MAS and MISC become not rationalize because the government just sells a very small part of its shares (MAS sold 30%), so there is no changes in the effective ownership structure of the enterprise and no change in the management, yet strengthens its control on an otherwise commercial company through the creation of a special share. On the other hand, government sold a majority of its equity holdings in Sports Toto (sold 70%, remain 30%), the rationale for the golden share is much clear compare to MAS and MISC.

MAS Case Study

The privatization of MAS occurred in October 1985. After MAS listing on the KLSE, it issued a RM 1 Special Rights Redeemable Preference Share to the government. This “Golden Share” gave the government the right of veto over the acquisition of the airline by a third party, the acquisition of other companies by MAS, and any major sale of assets. In addition, the golden shareholder (government) also had the right to appoint six of the eleven board members (Adam & Cavendish 1995: 107).

MISC Case Study

MISC privatize in 1987. A RM 1 Special Preference Share was issued to the Minister of Finance which allows the government to attend general meetings as a non-voting member (above and beyond its rights as an ordinary shareholder), and to grant or withhold prior consent on issues of merger, take-over, asset disposal, and amalgamation (Adam & Cavendish 1995: 108 & 110).

Sports Toto Case Study

Sports Toto privatized in August 1985. When listed in 1987, it issued a Special Right Shares to the government, allowing it to be represented with observer status at AGMs, to grant or withhold prior consent on issues merger, take over, assets disposal, or amalgamation, and to appoint three directors, including the chairman, in addition to its rights as an ordinary shareholder. Even if the government share decline to less than half with considerably diminished minority ownership, it can still retain control with golden share (Adam & Cavendish 1995: 104).

Indah Water Konsortium Case Study

The government has been taken to task for bailing out Indah Water Konsortium (IWK), the sewage treatment concessionaire, which already government had pumped in about RM1 billion since its privatization. Its failure was a reflection of what was deeply wrong with the government's privatization program started in 1984.

The purpose of privatization is to relieve the government of financial and administrative burden, but when the government ends up footing the bill for companies' failure, and then it defeats the whole purpose of privatization. During the initial stage for privatization, IWK had prepared costing for maintenance and infrastructure work for 1800 sewage treatment plant. But after IWK prepared the inventory, it found that there were in fact more than 6000 plants. The cost estimated before the privatization process was not realistic. IWK facing loses of RM103.65 million when the commercial charges were reduced to 30 per cent in July 1998 and by five per cent more in October 1999 ("IWK incurred" 2001). Furthermore, IWK also faced problems in collecting sewage charges. Many public did not want to pay the sewage bills because IWK, unlike TNB or Telekom Malaysia, can cut the public services if they did not paid any services charges. As at April 1999, the accumulated charges stood at RM144.3 million.

At the same year, IWK had taken over the maintenance of 245 pumps stations, 6081 sewage treatment plans and 8589 kilometers of sewage pipes. The company also has yet to implement a few large infrastructure projects such as construction of treatment plan in Bayan Baru, Penang and Padang Matsirat, Langkawi and the upgrading of sewage plants in Port Dickson. But, it has also not upgraded 81% of treatment plans nationwide. The auditor of IWK, General Datuk Dr.Hadenan Abdul Jalil said that this is due to constant changes in the board of directors. It could not implement the projects according to the plan. DAP then chairman Lim Kit Siang claimed that the concession, first given to business tycoon Vincent Tan Chee Yioun in 1994, had changed hands “four times” in the last seven years, and that in every changeover, the previous concessionaire’s interests were fully protected with each of them reaping a profit at taxpayers’ expense. When 2001, IWK was RM700 million in debts and bailed out by the government with RM200 million, pay to Indah Water Konsortium as Compensation. Indah Water Konsortium, now is a wholly-owned company of Minister of Finance Incorporated.

UEM-Renong Group Case Study: (De-listed from stock market listing)

United Engineers (Malaysia) Berhad (UEM) privatized in 1985, is then Malaysia’s biggest construction group while Renong group was Malaysia’s biggest industrial group that owned by UMNO. Renong Berhad owns UEM’s 37.1% shares. During its heyday, UEM-Renong was Malaysia’s pre-eminent corporate giant controlling 11 listed companies and was flushed with lucrative government projects and unlimited bank loans. However, its weak management and reckless expansion proved to be its downfall when the Asian financial crisis struck in 1997. Halim Saad as CEO of the Renong group & UEM director and executive vice chairman was eventually made to placate the investing public by personally granting a put option (with RM2.3 billion, was subsequently increased to RM3.2 billion to include the holding costs) to buy over 723 million shares representing 32.6% of Renong Bhd (Kim 2004).

Considering the facts that UEM shareholders’ fund was only RM2.9 billion and its net current assets were not more than RM0.1 billion, the market was stunned by this unbelievably senseless move. Halim’s distractor makes UEM-Renong Groups faced a misery disaster. First, he put the company in great financial difficulties in the midst of tight liquidity all round, in an environment of fast falling stock and currency markets. And UEM had to borrow heavily to complete this purchase. Second, he placed shareholders’ value in a precarious state, as the entire stock market was then in a highly-jittery state, having fallen almost 50 percent from its high (composite index

1,271) earlier that year in a major sustained downtrend without any sign of bottoming out. Market reaction was instantaneous. In the ensuing stampede to get out of the market, within the month of November 1997, UEM shed two thirds of its value, Renong 40 percent, and the KLSE composite index 30 percent (Kim 2004). By 2001, UEM-Renong buried under RM30 billion of debts, Renong group were Malaysia's biggest corporate borrower. It managed to survive only after a series of government bailouts involving more than RM10 billion of public funds.

It was apparent that the continuing insolvent state of the UEM-Renong groups proved to be a lingering drag on the entire stock market. With the dual purpose of making a final massive bailout of the group as well as to polish the badly damaged image of the stock market, the government bought over UEM completely (which then controlled the entire conglomerate through Renong) and removed Halim from the management. Following the buy-over of UEM, the government moved quickly to have it de-listed. The latter's move was easily seen as an attempt to obviate the group's monumental debt burden away public glare. Now, UEM is 100% under Khazanah Nasional Berhad, an investment agency owned by Malaysia Government.

Conclusion

Since the Privatization policy have introduce almost 20 years in our country, are there any changes / impact to our country economic growth, country development, and was it truly success or failure? From point of economic growth, privatization policy really benefits a lot. With privatization, more major and large project was distributed to the private sector especially construction and transportation. Besides that, many enterprise and company listed on KLSE after privatization to collect more capital such as MAS. It makes KLSE become Asia largest and premier stock exchange market once before. One of the benefits of privatization is release government burden both in financial and country development. With privatization, government can more focus on social development and lead to more effectively and efficiency. In the example of Damansara – Puchong Highway, the construction was completed in 28 months instead of 36 months. This is due to capital and resources are more concentrated with privatization compare to government has limited resources and capital to distribute.

Country development is much improved with privatization. Infrastructure and services, such as KTMB, LRT-STAR, and LRT-PUTRA provide fast, efficiency alternative transportation to the public in Klang Valley. It can reduce urban traffic jam that faced by citizen nowadays.

Furthermore, it can also reduce car usage and air pollutions. Besides that, highways are very important in our country, it provides the fastest ways to transport. Most of the highways in Malaysia are built by privatization with BOT (build, own and transfer), it makes the roads more wide and well-illuminated. Road users can reduce traveling time, lower vehicle operating cost, and most important is safety of the roads. Examples of highways are Federal Highway, North-South Highway, SILK Highway, KESAS, and Kajang-Cheras Highway that are familiar route of road users.

Privatization also provides more job vacancy to the public because with much privatized company, needs expertise from different areas to cope with the activities. TNB, Telekom, MAS, Proton, MISC, UDA, UEM provided more job vacancy and further reduce unemployment

But in other hands, some cases (either mentioned or not mentioned in this paper) faced high capital costs which relied on sufficient operating revenue (IWK, LRT, MAS) and/or subsidies. This was even more necessary given the lack of commercial viability of sewerage services (where the public is often unwilling to pay rates needed to cover costs) and urban rail systems (where low operating revenues rarely cover operating expenses let alone capital costs). Similarly, the airline and auto industries have been characterized by state subsidies and bail outs. As subsidies affect the incentive structure, the privatization of these sectors necessitated monitoring and regulation. These issues were inadequately addressed, leading to the inability of the concessionaire or private owner to continue operations (IWK, LRT) or finance capital investment (IWK, MAS, Proton). Furthermore, efficiency gains, where measurable (MAS, Proton) were mixed at best and generally poor.

Poor performance was partly due to privatization being inconsistent with the existing institutional framework. Privatization was undertaken despite information problems in the cases of the sewerage and LRT systems. Detailed information was needed to determine sewerage charges (necessary to structure incentives and ensure public willingness to pay) and LRT ridership (to ensure commercial viability). Attempts to keep domestic sewerage charges artificially low required cross subsidies, which substantially raised tariffs for non-domestic customers and led to collection problems. However, the refusal of domestic customers to pay tariffs underscores the political problem of commercial sewerage charges.

Industry difficulties related to high capital costs and low fare box ratios for the LRT were exacerbated by the decision to award contracts for both construction and operations to the concessionaire. This created a debt burden, which led to disincentives to improve efficiency given the unlikelihood of recovering costs, let alone making a profit. It also led to moral hazard problems where construction became more profitable, and hence attractive, than operations. Similarly, the privatization of MAS was structured entirely on loans, leading to an unmanageable debt burden, which undermined incentives, which may partly explain the owner's subsequent actions.

FAILURE CASES OF MALAYSIAN PRIVATIZATION: MAS, PROTON AND LRT PUTRA

Lim Saw Mooi
Hew Lee Khean

Introduction

The introduction of the Privatization policy in 1983 was an essential part of the overall strategy in the country's economic development. Privatization means the transfer of three components, namely government management responsibilities, assets (with or without liability) or rights to use the assets, and personnel to the private sectors. The objectives of privatization are as follow:- (1)To relieve the government's financial burden; (2)To improve work efficiency and productivity; (3)To facilitate economic growth ;(4)Reduce the size and presence of the public sector in the economy; (5)To meet the New Economic Policy (NEP). NEP has two major objectives which are to eradicate poverty irrespective of race and restructure society in order to remove the identification of economic functions with face. Under restructuring, the government aims to provide opportunity for greater Bumiputera participation in the manufacturing sector in terms of equity, employment, marketing and professional services. Privatization will create more business opportunities for Bumiputera participation.

To attain the restructuring objective, the government has since 1970 established a large number of public enterprises. Over the years, privatization exercises on public entities in Malaysia by the government has not lowered costs and increased efficiency as promised but instead has led to burdening consumers with increasing and exorbitant tariffs, basic needs such as public transport services, electricity, telephone, sewerage and more recently public health and education. In year 2006, Malaysia seems do embark on a reversal of privatization policy. Privatization of public entities in Malaysia has more often resulted in failure and has affected consumer's welfare. Evident cases such as the collapse of Indah Water Konsortium (IWK), Light Rail Transit-Projek Usahasama Transit Ringan Automatik Sdn Bhd (LRT-PUTRA) ,Malaysia Airline System (MAS) which resulted in government using public monies to bail or buyout these companies before the end of concession period clearly shows that the concept of privatizing public services is not in the interest of the citizens.

Since the government has to pay higher costs with public funds to bail out failed privatizations, the objective of reduced fiscal burden on the government has backfired. Private companies such as LRT-PUTRA, MAS and others clearly do not have the capital or the capabilities to sustain their operations, let alone provide quality services.

As Malaysia seems do embark on a reversal of privatization policy in year 2006, the objective of this paper is to study whether this indicate a failure of its privatization policy. Our paper focuses on major reasons that considered privatization in Malaysia as failure by providing examples of three privatized company that is MAS, PROTON and LRT-PUTRA.

The remainder of this paper is organized as follows. Section I lists out the modes of privatization. Section II discusses some major reasons that contribute to failure of privatization and provide some examples of privatized entities. Section III describes the policy implications . Section IV concludes the paper.

Mode of Privatization

The Privatization Master Plan (PMP), issued by Economic Planning Unit (EPU) in 1991, stated several modes. In Malaysia, the first mode of privatization involves divesting part of the equity of a government-owned enterprise to institutions, both local and foreign, and to private individuals. This partial transfer of ownership and control to the private sector may be referred to as partial privatization in contrast to complete privatization where the entire ownership stake and therefore control is sold off to the private sector. Such partial divestment was resorted to because the government had no wished to give complete control over the enterprise to the private sector. It could also be due to the limited absorptive capacity of the country's capital market. Examples of partial divestment include the sale of part of the equity of the MAS, Perusahaan Otomobil Nasional (Proton), and MISC to the public. Another mode of privatization adopted in Malaysia is that allowing the private sector to provide a service hitherto monopolized by the government. This amounts to deregulation of the industry into which some competition is now introduced. A good example of this is the privatization of TV3 which is owned by Sistem Televisyen Malaysia (STMB) which has been given a license to operate the third television channel.

The third mode of privatization involves “contracting out”, under which private firms are invited to bid for the right to provide the service previously provided by the government as in car

parking, hospital laundry, cleaning services, and highway construction. A good example is the privatization of the North-South Highway. Closely akin to contracting out is the fourth mode of privatization where an agency responsible for certain services or interest, sells or leases a part of its services to the private sector, while still retaining the remaining services under public ownership, control and management. For example, the container terminal at Port Klang where the Port Klang Authority leased out the container terminal facilities to a private company, the Klang Container Terminal Sdn Bhd.

Finally, there is deregulation which means the removal of statutory restrictions on competition. This may take the form of encouraging, or requiring, private sector firms to compete with each other-as in the financial markets- or permitting new entrants to invade the territory of the established nationalized industries or regulated monopolies

Reasons to Consider Failure of Privatization

Government still retain majority share holding or remain powerful through “golden share” system. In other words, the government has retained special rights which basically guarantees control over the privatized enterprise, ostensibly to enable it to exercise veto powers over decisions deemed to be of strategic and public significance. (Jomo K.S., 2002) There is no complete transfer of ownership or management power to private entities. Privatization is supposed to lead to a reduction in the size and involvement of the government in the economy. But the experience of privatization in Malaysia thus far has shown that the involvement of the government in the economy has been reduced only marginally. For example, although part of the equity of the MAS and MISC has now been divested to the private sector, the government remains the majority owner. In fact, if shares owned by the trust agencies established by the government such as the National Equity Corporation (PNB) are included in the portion owned by the government, then the government’s share becomes even larger. Thus, privatization has not really led to a substantial reduction in the economic role of the government.

Besides that, there are quite a number of privatized companies such as MAS and Proton sufferings continue losses. This indicates failure to improve efficiency and profitability. To achieve both productive and allocative efficiency, a firm must not only be privatized but be exposed to grater competition as well. This promotes profit maximization as the objective of

managers in line with the goal of shareholders. It is thus through the interaction between private ownership and competition that leads to enhanced efficiency.

According to Toh Kin Woon (1989), it also argues that in order for privatization to succeed, there must be an adequate supply of efficient managers. But efficient management is not exactly in abundant supply in Malaysia. In fact, as the government pushes with determination towards privatizing the huge and complex sections of the public sector such as the utilities, the major concern appears to be whether Malaysia has the requisite managerial talent capable of taking over and turning around such mammoth concerns. Indeed, finding managers of high caliber and experience in the Malaysia context may be difficult. For example, Proton needs a reputable car maker as its strategic alliance to improve its financial position.

Another obvious reason to support the failure of privatization in Malaysia is the government took back already privatized companies. For example, in year 2002, the government effectively took over the assets and operations of the two LRT systems following their inability to meet their debt obligations after being served winding-up petitions.

In order to further understand privatization in Malaysia, below are some examples of privatized entities that provide some insights about the history and failure of privatization of the companies respectively.

Malaysian Airline System (MAS)

In the early 1980s, Malaysian Airline System suffered losses due to high fuel costs and high interest rate. Since the government faced financial difficulties, there were only limited funds available for MAS for expansion. Therefore, partial divestiture, a form of privatization appeared as a solution of this problem.

Privatization of MAS began in September 1985. A substantial minority (48 percent) of the company's shares was sold, of which the Brunei government held around 10 percent (Malaysian Business, 16 January 1994 in Jomo K.S., 2002), raising only RM 180 million from the sale of almost half the national airline. The central bank, Bank Negara Malaysia continued majority ownership and the government's share remained stable at 42% for nearly a decade. Then, in 1992, Bank Negara Malaysia sold a 32 % stake in MAS to Tajudin Ramli, effectively giving

him control of the airline. The government's stake in airline was reduced to 10 % by 1996. (Findlay, Christopher; Chia Lin Sien and Karmjit Singh ,1997)

During 1997 Asian economic crisis, the spiraling oil price and the cutthroat competition reveal its weaknesses. Unfortunately, MAS faced major financial problems – by 2002, MAS recorded five years of consecutive losses. The losses are RM696.7 million and RM255.7 million in year ended 1999 and 2000 respectively⁶. For the year ended 2001 and 2002 the losses are RM417.4 million and RM835.6 million (Malaysian Airline, n.d.). As an international airline, servicing major routes, it has potential. Its domestic service losses about RM 1 million a day and only international routes bring in profits.

Although publicly available information does not allow a full assessment, there is considerable evidence that management of MAS deteriorated in private hands. The government bought back a controlling stake in the MAS at almost three times the market price, the same price for which it sold the stock at (RM 8 each) from Tan Sri Tajuddin's company, Naluri to improve and revive MAS. It was believed that the government paid close to RM 1 billion more than the market value for the stake held by Tajudin Ramli, the former chairman who had no experience in the airline business before he took over the company and was widely blamed for running the airline into the ground. In mid 2002, the government established a new holding company, Penerbangan Malaysia Berhad (PMB) which took control of MAS' fleet and assuming its liability. Under the renationalisation programme, MAS becomes purely an international and cargo services operator, leasing planes from PMB.

Prior to 2002, MAS was virtually a monopoly operator in the domestic airline market. With the entry of a low-budget carrier, Air Asia , the domestic airline market became more competitive. In year 2006, the removal of the price floor for MAS will certainly, as claimed by the government, intensify competition between the two airlines. However, the government's recent decision sparked a strong protest from AirAsia, citing unfair competition due to RM 1 billion that MAS receives from the government for restructuring purposes. If there is no specific rules on how such funds are to be used by MAS, it is plausible that MAS may indeed use it to cross subsidize its operations in route that it is competing with Air Asia.

⁶ MAS financial year end March.

The objective of rationalization plan is to promote healthy competition in the domestic sector. Unfortunately, there is no further clarification on what is meant by healthy competition.

Perusahaan Otomobil Nasional (PROTON)

According to Cassey Lee (2004), the national car company, Proton, was established in the early 1980s as the government embarked on promotion of heavy industry programme. The government tilted playing field in the domestic car market in Proton's favour by exempting it from import duties on CKD kits. This enables Proton to sell its cars at prices 20 to 30 percent cheaper than comparable cars produced by other car assemblers in the country. Proton turned out as a dominant car producer in the Malaysian market by the 1990s.

The priority of the privatization was on giving preferential treatment to Bumiputera controlled companies, Proton. Privatization continues in name grant exclusive right to Proton such as reduction and exemption from import duties on parts and components, reduction and exemption from commodity taxes on sales of finished automobiles. As a result, the original aims of privatization (1) improving efficiency and productivity of services and (2) the fostering of competitively strong private sector businesses were overlooked.

During late 1990s, Proton Holdings Berhad failed to meet its key performance. According to Martin Jalleh (2005), after Proton reported a net loss of RM 19 million in the nine months to 31 December 1999, the government used Petronas funds to buy 27 percent of Proton for about RM 1 billion and making it the controlling shareholder. After disposed of its controlling stake, the stake was held by the DRB – Hicom Group Berhad, which was deeply in debt.

Currently, Khazanah Nasional is the controlling shareholder in Proton, with a 42.74 percent stake. State Pension Fund EPF and national oil firm Petronas own 12.07 percent and 8.84 percent respectively. The remaining 36.35 percent is held by a mix of local and foreign companies (extract from Malaysiakini, 21 June 2007, cited in WorldPress.com, 2007).

Proton last year lost its status as Malaysia's biggest selling automaker to homegrown rival Perodua, and recently reported a whopping net loss of RM 591.4 million for the year to March 2007 against a profit of RM 46.7 million previously. Loss per share stood at 107.7 sen compared with earnings per share of 8.5 sen in year 2006. ("Proton", 1 June 2007) The losses were due to

weak sales volume and higher production costs. Challenging environment such as intense competition like Perodua's Viva in the market and launching of Toyota's new models also affect Proton's lower sales volume.

The decline in operation and financial position of Proton already tells that a reputable car maker is needed to help turning Proton around. Malaysia government cannot afford to shoulder the huge burden anymore longer. The government is also under intense pressure to announce details of a partnership for Proton in a bid to provide it with expertise to stem a sharp decline in market share and cut financial losses. A strategic alliance is needed and the reported interested parties including Volkswagen AG and General Motors (GM) are still in the picture. Khazanah will sell some equity to share and work on a collaborative model in terms of management to ensure the national auto sector has its best chance of being put on a sustainable path. The government will decide who the potential buyer is and carry out the national auto policy interest.

LRT-PUTRA

The STAR system started as the first urban rail BOT project in Malaysia with 60 years lease in November 1991. The 1998 Commonwealth Games precipitated the government to request a southern extension of the line to serve the Games stadium. As a compensation for the low density extension, STAR was given a 3 km northern extension into a high density residential area. Operations began in Dec 1996 for phase 1 (12 km) with completion of the line in 1998 with a total route length of 27 km.

PUTRA was incorporated in 1994 with a 60 year concession to design, construct and operate a 29 km LRT. PUTRA was wholly owned by Renong Berhad – a major Malaysian conglomerate that was asked to start work before signing a concession to meet the Commonwealth Games deadline. The fully automated driverless system began operations in September 1998.

After a few years of operation at less than one third of forecast demand, and under difficult conditions brought on by the Asian economic crisis, both STAR and PUTRA faced serious financial difficulties in servicing their debts and were subsequently 'bailed out' in 2002 by the government. Phase I of the takeover involved the government converting overdue loans into bonds in the nation's biggest ever corporate restructuring through a government owned company Syarikat Prasarana Negara Berhad (SPNB) established to manage 'critical public infrastructure'

in the Klang Valley. In 2001, the SPNB purchased all the rights to the outstanding debts of STAR and PUTRA via the issue of RM 5.5 billion of fixed rate guaranteed bonds to the two companies' creditors. In 2002, the government effectively took over the assets and operations of the two LRT systems following their inability to meet their debt obligations after being served winding-up petitions.

The takeover of the LRT systems was considered by many to be a failure of the privatization programme and was justified by the government as necessary and unavoidable as public interest was involved, and affordable public transport services were considered ultimately to be the responsibility of the government. As PUTRA was also a subsidiary of Renong, the biggest conglomerate with the largest debt in the country (over RM25 billion), a government takeover also helped reduce its debt as well as the amount of non performing loans in the banking system. Critics however viewed sums involved to save STAR and PUTRA as excessive, with actual construction costs believed to be much less. Moreover, SPNB subsequently leased back the LRT operations to the management of PUTRA and STAR at discounts after nationalization and has described to saga as 'tantamount to socializing losses and liabilities while allowing profits and profitable assets to be privatized.'

Policy implication

Recognizing the problems that have been faced in implementing the policy, and the need for clear direction in steering the programme, the government decides to embark on a Privatization Masterplan study in 1988. Six central requirements for an expanded, accelerated and effective programme have been identified in the privatization Masterplan study.

Firstly, the argument for privatization is premised on the belief that entrepreneurs reacting to market signals will make better decision than public servants responding to administrative directives. To allow this change to be realized, privatization must be accompanied by the granting to privatized entities of commercial freedom to respond to market signals and opportunities. Hence, existing regulation of private sector activity such as regulation of pricing of input to production, regulation of terms of employment and regulation of investment decision will need to be reviewed.

Secondly, changes in management style are required to adapt to a fully commercial environment. Within the business, management structures should be reorganized to reflect new priorities. Relations between the government and privatized entities should be at arms length even though the former may have participation in the latter. The new service conditions should provide performance incentives. While in the short term, the managers needed for privatized concerns can be drawn from the existing pool of entrepreneurial talent within the public and private sectors, in the long term a sharper focus on training and development of middle level managers will be needed, despite the fact that the new opportunities created by privatization should directly encourage more rapid development of managerial talent.

Thirdly, supplementary policies are needed to ensure that market behavior fulfils national objectives. This means government influences private sector behavior indirectly and in a predictable manner. These policies may relate to the system of taxation or subsidy, or provision of indirect assistance through infrastructure, training or research. In general, these policies will influence private sector activity rather than direct it.

Fourthly, privatization will require a substantial increase in the supply of capital available to the private sector. Although the size of potential demand for equities is estimated to be large, it is highly dependent on the overall funds available to potential investors as well as overall market confidence. A package of policy measures to underpin this demand has been considered which includes promoting wider share ownership, encouraging the issue of partly paid shares, promoting unit trusts, relaxing restrictions on employee participation in equities, reviewing present investment guide lines of institutions and selective permission to foreign investors to participate in large initial issues.

Fifthly, to ensure that privatization strategies tailored to the national objectives, the government need to recognizing the need for consistent principles governing the choice of privatization candidates and the strategies to be followed, an action plan has been recommended to help channel efforts to priority areas in a more organized manner, so that the programme as a whole acquires momentum and credibility. Although privatization may involve transfer to the private sector three elements of an entity, the authority to manage, present assets and existing employees. However, it is not always possible to transfer the ownership of assets at the same time as the other two elements. Hence, a process of phased privatization may be called for. As a

general rule, however, to achieve the best results and the objectives of privatization, a total transfer that includes all the elements to the private sector is preferred.

Conclusion

In the case of Malaysia, desired improvements in efficiency and distribution may not be achieved through privatization, since there has been little evidence of increased competition associated with privatization. Privatization of public entities in Malaysia has more often resulted in failure. The major reasons contribute to failure of privatization include are as below. First, there is no complete transfer of ownership or management power to private entities. Secondly, There are quite a number of privatized companies suffering continues losses that indicates failure to improve efficiency and profitability. Thirdly, there is inadequate supply of efficient managers to handle the privatized projects. Finally, the government took back privatized companies that embark on a reversal of privatization policy.

Seen from a rent-seeking perspective, it is not surprising that many of those who had previously advocated and benefited from privatization urged the government to nationalize their debt and liabilities in the aftermath of the 1997-98 financial crisis. It might be argued that privatization has been an important means to enhance Bumiputera stock ownership, but there has been little increase of the overall Bumiputera share of corporate wealth since the mid-eighties, instead, there is now considerable evidence that privatization was an important means for enhancing the private wealth of the politically influential and well connected, and not just among the Bumiputera elite. This situation can be seen in the case of MAS.

There is also little evidence that privatization has significantly enhanced growth. In fact, a case can be made that financial resources were diverted to buy over assets from the government at discounted prices, i.e. at the expense of the state and the public. This does not mean that it could not have been worse. However, there is little evidence that the government's retention of golden shares, limited privatization of minority portions to nationals and other checks on private power have been crucial to limiting possible abuse.

MALAYSIAN PUBLIC SERVICES: IMPROVED EFFICIENCY TOWARDS PAPERLESS GOVERNMENT

Liew Ji-Leng
Wong Sing Wah

Privatization was the theme of then Prime Minister Dr. Mahathir Mohamad. His legacy of privatization and Malaysia Incorporated policy leaved both successful and unsuccessful stories, thus prompting his successor to look for complementary solution that can further enhance the success factors and overcome the causes of failure in Malaysia privatization. Besides, another utmost concern for our privatization policy is the national security issues. We cannot privatize all government departments and agencies but yet cannot afford a poor public delivery system to slow down our economy progress. As a result, Prime Minister, Abdullah Badawi, in year 2007, has instructed public services and government-link companies to increase their efficiency as both substitution and complementary to the privatization policy.

In line with the Prime Minister's instruction, many positive changes have been noticeable. One of the efforts that have been made is the Home Affairs Ministry complex located in Ayer Keroh. This complex provides both locals and tourists the express service from all of the seven departments housed under one roof. The Home Affairs Ministry complex houses the Immigration Department, National Registration Department (NRD), Registry of Societies, Office of the People's Volunteer Corps (RELA), Division of Film Control, Department of Civil Defense and National Anti-Drug Agency. Many of the visitors to the complex were impressed with the quality and friendly service of the NRD officers. The officers-on-duty serve with smile and patiently explained any procedures that are unclear asked by the visitors. The seven departments in complex had made the service delivery more efficient and convenient. It is also open during weekends for those who are busy to go during week days. The operating hours on the weekends is from 8am to 12.45pm. It is to facilitate the tourism industry in the state (Tan, 2007). Visitors also claimed that the complex is sophisticated, efficient and add up to international standards. At the NRD, it would take only 20 minutes to apply for a replacement MyKad⁷ while at the Immigration department, applications to renew or for a new passport would be processes by the end of two hours. At present, those who want to renew and apply for a MyKad will have to wait for one day if they go to the NRD Headquarters in Putrajaya. The Home Affairs complex also

⁷ MyKad is the name for Malaysian identity card.

provides services for foreign workers, maids, expatriates and international student to renew their I-Kad; an immigration identity card with 17 safety features to make it duplicate proof. Information is vital to how we run our daily lives. The Government Portal holds information reserves that are concerned with matters like taxation, health, and education, legal and of course family topics such as pregnancy, adoption, and even marriage issues. All these are within one click of the mouse. Others information available from the portal pertain to Agriculture, Consumer Affairs, Culture and Arts, Defense and Security, Health, Housing, Information, Communication Technology and Media, Manpower and Employment (Kou, 2007b).

Another effort being done is the government website (www.gov.my). The website provides information ranging from payment to complaints applications, search and services. The website has recorded about 2.5 million hits. The website list down 395 online services of ministries, departments and agencies and 3,300 Government forms can be downloaded free (Sujata, 2007b). The service provided through the website is the Government proactive way to help enhance the public delivery system. Among the online services provided under the website include zakat, loan and quit rent payments, application to update mailing address with the Employee Provident Fund, application to the Museum Department to extend the archeological search license and to apply for foreign workers with the Immigration Department. There are also “Quick Links” direct to the Government machinery, directory, tenders, job vacancies, public complaints and even to get information on the weather. Malaysia Administration Modernization and Management Planning unit upcoming services are application of birth certificate with the National Registration Department and online registration of business with the Companies Commission of Malaysia. There are efforts underway to provide the ability to send application forms downloaded from the website “directly” to the relevant authorities instead of having it printed and submitted via post. It can be filled electronically and submitted the same way as well.

The Employee Provident Fund department has increase and improves their services by putting in more services online. This is in line with the department’s objective to provide convenient, more efficient and faster service to the member. Some of the online services include i-Akaun, Smart Kiosks and many more (Tee, 2007b). Contemporary, in their website (refer to www.gov.my), the Malaysian government proudly claimed “2,909 Government forms can be downloaded for free and 688 online services are available on the Portal”, in addition to encourage the public go online to transact with the government. Out of the online services hosted by the officials

Government's portal, the most popular among Malaysians are sites on job opportunities and applications (Sim, 2007d).

E-Services is one of the pilot applications the Government has embarked upon to demonstrate how information and communication technology can be exploited for the benefit of the public deliveries via the fastest and most convenient ways, the Internet, kiosks and mobile hand phones. It is in sync with the Government's wish to enhance efficiency, effectiveness, productivity and the overall quality of public services. The Road Transport Department (Jabatan Pengangkutan Jalan, JPJ) is the prime agency allotted the task of transforming this project into reality, along with Tenaga Nasional Berhad (TNB) and Telekom Malaysia (TM). In 2002, the scope of E-Services was broadened to include the services of four of Government agencies, namely the Royal Malaysian Police (Polis Diraja Malaysia, PDRM), Dewan Bandaraya Kuala Lumpur (DBKL), Insolvency Department of Malaysia (Jabatan Insolvency Malaysia) and National Registration Department (Jabatan Pendaftaran Negara, JPN). Based on the "Built Operate and Own" model, the four consortia appointed by the Government to execute these projects consist of a Gateway Provider and three Service Providers. Among the eight services provided under the E-Services umbrella, four includes checking and payment of JPJ summons, checking and payment of PDRM summons, scheduling and sitting for Highway Code Test Computerized Theoretical Test, issuance of Learner's Driver License (LDL) checking and payment of electric and telephone bills, checking and payment of DBKL compounds and checking bankruptcy status of an individual. Internet wise, E-Services is currently available via three portals at "www.eservices.com.my", "www.rilek.com.my" or "www.mycy.com.my". There are also 38 kiosks located throughout the Peninsular at JPJ premises. Other sources will also follow such as renewal of one's Probationary Driver's License, renewal of advertisement and premise license, transferring of driver's license and post information into MyKad and applicator for replacement of MyKad will also come under the synergy of E-Services (Pang, 2007b). Currently, services are charged using credit cards and direct debit, but paying method shall proliferate the use of debit cards, MyKad, MEPS Cash and other forms of convenient payments to make E-Services as easily accessible as possible (Pang, 2007b).

Other than that, Chief Secretary to the Government Tan Sri Mohd Sidek Hassan suggested that bosses should make unannounced visit to improve counter service and public delivery system (Rajah and Sujata, 2007). There are complaints mailing up to the government door steps. They

should be taken as a feedback that not to indicate that public servants is not doing a good job, instead treating it as an improving point to start with (Sim, 2007c).

The public service agencies are forging ahead to become a virtual integrated and paperless administrative vehicle, in line with the global trend of efficiency, reliability and convenience. Started in 1989, with the launch of the “Excellent Work Culture” campaign, the country’s public administrative vehicle has undergone numerous reform measures ranging from Total Quality Movement (TQM) at the broadest level right down to how materials to how menial tasks like answering calls are handled. From then on, the Clients Charter was rolled out from 1991, as well as the execution of the MS ISO 9001:2000 certificate. At that time the quality culture was increasingly entrenched in the public sector. Other restores implemented expost-fact include measures to improve counter services; creation of new system and work procedures; quality control circles; as well as the inculcation of positive work values, of all which focus on citizen as customers. Malaysian Administrative Modernization and Management Planning Unit (MAMPU) is the agency entrusted for effective implementation of all enhancement initiatives in the public service. Further in 1996, the Government launched Electronic Government (e-Government), one of seven flagships under the wings of the visionary Multimedia Super Corridor initiative. The e-Government’s main intent is to “electronise” its transaction to enhance accessibility and the quality of interactions with citizens and to increase efficiency as well as to improve policy development coordination and enforcement (Pang, 2007d). And all at this can be seen in the inculmination of the myGovernemnt portal. Some of the celebrated applications provided in the national portal include online renewal of driving licenses issued by the Road Transport Department (JPJ). Tax e-Filling system by the Inland Revenue board (IRB); cross-checking of voters’ details from the Ellection commission (SPR) and National registration department (JPN); as well as Government employment opportunities and tenders (Pang, 2007d).

The Road Transport Department (JPJ) had also response to Prime Minister’s instruction. The country’s 10.35 million registered drivers will not have to queue at JPJ or Pos Malaysia to renew their competent driving license. They may do so via 27 of the 110 testing centre available throughout the country. As prove of renewal, a receipt and renewed license will be sent by post. The kiosks in training centre are currently able to process the application (and renewal) of new learner’s driving license and to check for JPJ and police summonses. JPJ is also finding other ways to remind drivers by short messaging service (SMS) and ATM machines – among many

other futuristic paperless initiatives from the department. JPJ are “electronising” and tightening the work procedures and policies under the Electronic Government initiative to enhance and augment the speed of processing. The department also conducts regular training to keep the staff informed, and commenced smart partnership with other agencies like Pos Malaysia, the Custom Departments, Ministry of International Trade and Industry, local authorities and Pusat Pemeriksaan Kenderaan Berkomputer Sdn Bhd (PUSPAKOM) to fine tune service delivery. Recent inclusion scope of e-Applications include NIK (Nombor Identifikasi Kenderaan), designed to curb car registration fraud automatically generating into of newly – mode cars strictly from car-makers; NIKI (Nombor Identifikasi Kenderaan Import) to curtail illegal importation of foreign cars by registering imported cars at the port; e-Daftar to be implemented in conjunction with NIK and NIKI when car buyers details are verified by car distributors before the vehicle is registered; e-Insurans, to do away with producing one’s vehicle insurance before renewing their road tax; e-Hakmilik for absolute accuracy in vehicle ownership claims; e-Kastam, for direct link with the customs departments for verification of exercise duty declarations before a car is registered; e-Driving for input of vehicle records; e-Puspakom for vehicle inspections updates; Automatic Vehicle Screening System for regulation of foreign vehicles in the country. The JPJ is also spending huge amount on boosting its existing electronic procedures inclusive of the transference of its existing data centre in Kuala Lumpur to new facility in Cyberjaya (Pang, 2007c).

The Kiosk that have been set up for the public to interact with the Road Transport Development (JPJ) for various transactions have received good response, hence resulted in more kiosks are being set up in around the Peninsular. The current kiosks available are 27 but the number will be increase to fifty by the end of June 2007. The kiosks can be used to check and pay for summons, renew driving licenses, printing learner driving licenses and checking the Kejara demerit points (Sujata and Sim, 2007). The next plan of JPJ is to extend the services to Sabah and Sarawak by setting up similar kiosks. The idea of having kiosk was part of JPJ’s e-services an electronic Government initiative towards creating a multi service delivery channel through the use of information and communication technology. The move is customer driven. JPJ wants people to feel at ease when interacting with Government agencies at their own pace as well as having their own space using their personal infrastructure like telephones and computers. This kiosk also helps JPJ to reduce bureaucracy. Now, driving licenses can also be renewed via the kiosk or via

the Internet. The e-Services has also been used for the Highway Code Test for learner drivers before they are issued with the Learner Driver License and drive on the road.

Inland Revenue Board (Lembaga Hasil Dalam Negeri, LHDN) has also try to increase their efficiency in collecting taxes without imposing excessive burdens on the public while incurring minimal cost to the government; to instill public trust in the tardiness and excellence of the present tax system; and to encourage the public to pay their taxes voluntarily. Supervisors in LHDN are encouraged to personally step in to handle arising problems. Processing time for one cheque takes only four minute. Hence, processing up to 40 cheques would definitely take more than 2 hours. Due to different amount of cheques each person brings in daily, dispatches and customers would need to key in the number of cheques they wish to process into a machine located at the branch. The machine would then segregate the amount of customers and lead them to respective counters. Counter services also include the provision of one-stop service counter to facilitate access to a variety of service as well as ensuring or adequate number of counters and manpower to provide efficient services. Multi-service counters, emergency counters, special counters for disabled, elderly and expectant mothers, extended service hours, electronic queue management system and indication of expected serving time were also implemented while customer satisfaction feedback forms were utilized to further improve customer service based on customer commentary. Other offers to upgrade customer services were strengthen through programmes that trained staff on courteous customer service. Many assessment officers are stationed at the LHDN quarters so as to personally advise customers with their tax payment issues. With LHDN e-Filing, the Inland Revenue Board of Malaysia's e-Filing services allow the submission of Tax Return Forms electronically via the internet. The service is totally free. All Tax Return Forms submitted through the e-Filing applications are protected by Public Key Infrastructure Technology. Tax Return Forms can be filed at anytime, anywhere online. This application will assist in billing up forms, compute then submit it electronically. Easy, accurate and extremely safe, first time users need to get a Personal Identification Number (PIN) to register the Digital Certificate. E-Payment works hand in hand with the e-Filing system, Internet banking process is made easier with e-Payment via Public Bank, CIMB and Hong Leong Bank. E-Stamping services are currently being actively looked into for tax payers to utilize (Kou and Leow, 2007).

While the entire department is working in their effort, the National Registration Department (JPN) has also done something. The new Director-General (DG) of the JPN imposes an unquestionable authority among his over 2000 staff. Tardiness and incompetence are never tolerated. The Public Relation Officer stated that “Training courses are a big part of my department, besides the welfare and social activities we get ourselves involved in. the logic is simple. Your office is your second home. You need to build loyalty among your employees. You need to change their mindset to love the department. Only when they proud of their workplace will they contribute better. The new DG ensures his staffs are preoccupied at all times. Every month, departmental activities are aplenty. They consist of Best Counter Service, Best Office Chief, Cleanest Toilet, JPN idol and even “*Teh-Tarik* outings” to motivate the staff (Tee, 2007c).

House buyers will have a sign of relief now that the Building and Common Property (Maintenance and Management) Act 2007 has been gazetted. It means the Act can be entered and the public state government empowered to appoint a Commissioner of Building (COB) to settle disputes and to ensure smooth management of the building even offer strata titles are issued (“Ensuring,” 2007). The COB will help to resolve problems related to the maintenance and management of subdivided buildings, vacant possession and the formation of the management corporation. This Act is aimed at more systematic approach to eliminate problems related to the maintenance and management to common property. The creation of the COB ensures that all parties involved, be it the developer or purchaser plays a role. The developer, Joint Management or Management Corporation has to make sure that charges collected for maintenance will be managed more effectively and property owners are required to pay charges or face legal actions.

The Insolvency Department of Malaysia is committed towards achieving excellence in improving service efficiency and keeping up with the move towards online services. E-Insolvency was established for the convenience of the public where time spent traveling and queuing up can be a thing of the past. This online service is hassle free as individuals can check their bankruptcy status in the comfort of their own home. The purpose of the e-Insolvency project is to facilitate individuals in checking their bankruptcy status and the company’s liquidation via internet through e-solvency portals (Leow, 2007a). E-Insolvency provides the corporate government and public sectors on online search service for individual bankruptcy and

company liquidation status. A search is done through the service providers appointed by the government. Not that the Insolvency department is responsible to print all original certificates requested via e-Insolvency portals. Nonetheless, if the users wish to acquire the certificate, there are several ways where you can obtain it. That is through certificates to be delivered straight to your home/office address; collect from Insolvency department of Malaysia Headquarters in Putrajaya and collect from the branches of Insolvency Department of Malaysia. Ever since the project was implemented in 2005, the amount of searches has been increasing, 89.2% searches conducted where individual bankruptcy status whereas 10.8% were searches of company's liquidation status. The department have future plans to curb the spelling error entries problem by making searcher simpler where individuals are only required to key in their IC number. Consequently, there will be less room for mistakes it is also in consideration to expand the service more than just printing a receipt copy so that the individuals can print the original certificate through the web portals. E-Insolvency is indeed beneficial to the public as they can track the status of people that they have been guarantor for. Moreover, it is also useful for employees, especially in the process of employing senior management as they can run a background check as part of the recruitment process. E-Solvency helps users save cost, time and money as they don't need to travel all the way to Putrajaya headquarters (Leow, 2007c). Mistake is also tend to occur lesser because themselves are more familiar with their own particulars

The Electronic Labour Exchange (ELX) developed by the Ministry of Human Resources has been operational as a free online job portal since 2004. The ELX registers both employees and employers who are then matched online respectively. Suitable employees will be aptly matched with the potential employer according to their employability status. The moment the match is done, the candidate will be contracted for an interview. The ELX is in line with the e-Government initiatives and aimed at improving the mobilization of the nation's human resource. The Job Clearing System (JCS), a primary application in the ELX will ensure manpower utilization is optimized through its systematic matching job seekers to job vacancies (Kou, 2007a). To date, an estimate 17,000 placements have been made available on the ELX. Available jobs are updated "live" every second in the ELX website so the statistic is stay up to date. Individuals can register online anywhere, at any time, at convenience. The system assists employers to find the right candidates for their jobs. JCS is also able to provide current labor market information and analysis. The Government sees the ELX as a social contribution to the people. Ministry of Human Resources Malaysia (MOHR) has planned 18 jobs fairs at the state

level. In addition, a total of 72 mini carnivals are planned and arranged at the district level. Aside from the job fairs, there are the ELX stations, also known as “mobile ELX kiosks” that exist purely for users’ further assistance in their ELX registrations and job searches (Kou, 2007c). The ELX stations are meant to gauge the response from the public; another seven stations are already scheduled to be places around the nations by the end of this year. An additional advantage of using the ELX stations is that these rear audio speakers for narration making them user friendly for everybody. This year, every job fair held throughout the nations holds a special “Sistem Penempatan Orang Kurang Upaya” (SPOKU) to cater for the disabled. This is to push higher employment rates for the disabled (Sujata 2007a).

E-Procurement is the Government to Business Electronic Government System. Traditionally, upon receiving request from the government departments, interested suppliers would write in and submit their quotations. Procedures were tedious and plenty of legwork was involved. Suppliers would make several trips to the office, checking on their status and filling out countless forms. No changes could be made to their offer price should a change at heart occur. Moving on, in the year 1999, an agreement between the Government and Commerce Dot Com Sdn Bhd (CDCSB) was signed. The IT company was commissioned to set up a sophisticated online procurement system that would enable supplier registration, central contract (consistent suppliers are selected and listed), direct purchase (for goods, services below RM50,000), quotation (RM50,000-200,000), tender (RM201,000 and above) and e-Bidding (allow suppliers to auction their prices live). E-Procurement (eP), launched in synergy with the country’s aim of becoming an Electronic Government is multi-pronged. It allows Government Ministries to make an electronic approval process, create, submit and receive purchase orders, delivery orders and remit payments to suppliers. The full-fledged system covers Certification Authority (a small card issued to registered suppliers), local suppliers, relevant agencies, banks, the Accountant General’s Department, the internet, and EG Net (network used by all the government office that links to eP). The E-Procurement now procures two types of resources; suppliers and services. The aim of eP is to ensure that procurement is carried out easily, speedily and its transactions made transparent (Tee, 2007a).

Recently, the Companies Commission of Malaysia (also known as SuruhanJaya Syarikat Malaysia, SSM) liberalizes the information pertaining to businesses and companies in Malaysia over the Internet. The creation of e-info, part of SSM’s effort to “electronise” its high demand

services and to support the Government's call for greater service efficiency and higher accessibility, has helped thousands of those who wish to seek info about companies and business in Malaysia. E-info also helped reduce the severe congestion at SSM's walk-in counters during peak periods like when companies announce their performance at the end of the financial year, usually in January or July. SSM also try to improve the payment method besides than credit card. The public now may purchase from e-info via an e-Account at SSM where prepaid amount is deposited for future buys (no expiry date is fixed) or an e-Card a privilege card usually provided by SSM during road shows and promotions. One may also purchase information from e-Info via TMnet or post-paid methods. A company is liable to lodge the yearly annual returns to SSM under Section 165 at the Companies Act 1965 (Pang, 2007a). SSM now introduce e-Lodgement which save time and has the pace to lodge the information on time. E-Lodgement enables company and businesses owners or its authorized personnel to lodge selected statutory documents over the Internet by May 2007 through the myGovernment Portal (www.gov.my). SSM has its own enforcement division, which ensures that all legislations under its jurisdiction are properly administered and effectively enforced. The enforcement division actively conducts pro-active surveillance with wide investigation powers, which includes the power of entry into premises, inspectors, search and seizure and to call for information. More importantly, SSM's staff member is regularly trained to raise their competency level towards greater expertise and specialization.

As more of the Government's functions and public delivery system shift into high technology mode, a key concern will be if the computer infrastructure powering these online services is safe from cyber attacks. In 2003, the Government Information and Communications Technology (ICT) Security Command Centre (GISCC) was set up to provide close monitoring, detection and response to online security breaches as well as to reduce the risk for it. GISCC consists of the Government Computer Emergency Response Team (GCERT) and the Public Sector Network Monitoring System (PRISMA). While PRISMA's main role is to detect any attempt of intrusion through alerts from sensors installed in the agencies, GCERT receives reports on incidents and is responsible for tracing the source of attack and providing technical advice on safeguards and counters measures to prevent future attempt. All this effort is to build trust in the public so that they would use the online services (Sim, 2007b).

Syariah Court's award-winning portal e-Syariah will receive a makeover this year, allowing its clients to sort out their claims with the help of mediators without even having to step foot into the hallowed halls. There is also plan for e-Syariah to allow teleconferencing and mediation via the Internet as one way for the department in upgrading the level of the services. In the year 2009, resolution of the cases through mediation had helped reduce by 67% the number of backlog Syariah court cases in Selangor alone. Other plans in the pipeline will be the departments' endeavour to record all of its court proceedings and upload the video clips on the portal. Lawyers, plaintiffs and members of the public view the proceedings online. The payment is allowed through debt and credit cards (Sim, 2007a). E-Syariah not only makes things easier for the public, it mean less work for the court as well. Less time spent at the counter and standardized documentation bodes well for better reference. Before e-Syariah was introduced, there were total of 185 different documents, but after e-Syariah, a total of 38 forms are being cut down ("E-Syariah," 2007). This shows the efficiency of this system.

In line with Prime Minister, Datuk Seri Abdullah Ahmad Badawi's determination to improve the efficiency of the country's public delivery system, bold changes have been made to revamp the local property sector. These changes streamline all processes prior to construction concerning land, planning and building plan approval. The changes involve implementing measures that will reformat and simplify application procedures, resolve problem related to building and common property and improve the public delivery service. The changes also include fast track approvals; will result in greater efficiency and transparency in the housing industry. One-Stop-Centre has been set up to speed up the process in handling and approving housing projects, replacing the Certificate of Fitness for Occupation (CFO) with the Certificate of Completion and Compliance (CCC) and incentives for developers to adopt the Built Then Sell (BTS) concept ("Bold local," 2007). The new One Stop Centre (OSC) has been set up to ensure the development projects are given fast-lane approval within 4 months ("OSC," 2007). The establishment of the centre is in line with the call for improvements in Government's delivery system ("New system," 2007). The Government will also extend the fast lane approval to high impact projects, projects attracting foreign investment and government projects (Leow, 2007). To increase the efficiency and effectiveness of the OSC, the ministry will provide training courses to government officials and stakeholders ("Bold changes," 2007). The Certificate of Completion and Compliance (CCC) has replaced the Certificate of Fitness (CFC) for Occupation to smoothen the delivery process of building under this new Act, the architect or

engineer of a project who submits building plan is defined as the “principal submitting person” who will have to issue the CCC before occupants can take ownership of their homes (“CCC, not,” 2007).

Immigration department has made the status of one’s applicant and payments through online, where last time the applicants need to queue in a long line. The department has also future plan to introduce more kiosks for passports renewals of immigration offices in other states as the pilot project was a tremendous success (Anis, 2007). The department plans to set up 11 more kiosks throughout the country and in the Klang Valley. Other than the kiosk services, the department also in the process of issuing I-Kad to 66,000 add foreign students studying in Malaysia as part of the effort to issue foreigners who are legally working or studying here with high-tech, chip embedded card. This is to make it easier for the authorities to identify, the student cards would come in a light green color. The new I-Kad, which will replace the current student card issue to all international students, will have 17 security features such as embossing and engraving to prevent forgery. I-Kad allows international students access to a range of services without having to endure excessive bureaucratic process (“High-tech,” 2007).

In conclusions, the Malaysian public services are performing well and very efficient, especially since the stern directive to increase efficiency from the Prime Minister, Abdullah Badawi. All of the changes so far have shown the improvement of public services towards achieving the country ambition to be an effective paperless government in near future.

LEVERAGE EFFECT AND MARKET EFFICIENCY OF KUALA LUMPUR COMPOSITE INDEX*

Har Wai Mun
Lenan a/l Sundaram
Ong Sze Yin

Introduction

Time series models have been widely employed in the literature to explain the dynamics of financial time series and thus the applications of the ARCH model introduced by Engle (1982) or its extension Generalized Autoregressive Conditional Heteroscedasticity (GARCH) by Bollerslev (1986) in finance have become commonplace. Generally, this type of non-linear time series model is able to capture a special type of non-linearity in the data generating process, known as multiplicative non-linearity, or non-linear-in-variance, in which non-linearity affects the process through its variance (Hsieh 1989). For most financial data, one of the stylized features is that they do experience volatility clustering and thus GARCH models have been popular used for examined financial data because they are able to capture this clustering feature. Despite their popularity, the ARCH parameterization of the conditional variance does not have any solid grounding in economic theory, but represents 'a convenient and parsimonious representation of the data' (Hall et al. 1989).

Many studies have tries to estimates the leverage effect in the stock market. Many empirical studies use different kind of model to estimate the leverage effect. In which this paper will focus on the Exponential GARCH model to estimate whether there is leverage effect on the stock market. In earlier period many authors uses GARCH model to capture the leverage effect. But if GARCH shows the negativity in volatility, it's meaningless. So, non-negativity constraints have to be imposed on these parameters. Nelson (1991) stated that the non-negativity constraints in the GARCH model are too restrictive. He introduced the Exponential GARCH (EGARCH) model to overcome this problem.

EGARCH models the logarithm of the conditional variance where, the coefficient γ measures the asymmetric effect, which if negative, indicates that negative shocks have a greater impact upon conditional volatility than positive shocks of equal magnitude. EGARCH has certain

* The improved version of this article has been published in an international journal.

advantages over GARCH. Firstly, by using the exponential formulation, the restrictions of positive constraints on the estimated coefficients in GARCH are no longer necessary. Secondly, GARCH fails to capture the negative asymmetry apparent in many financial time series. The EGARCH model solves this problem by allowing for the standardized residual as a moving average regressor in the variance equation, while preserving the estimation of the magnitude effect. Due to the argument about, this paper will apply EGARCH model to capture the Malaysia stock markets data.

Further studies will hold to examine the weak form market hypothesis. A vast number of the empirical studies on efficient market hypothesis in the stock markets have been examined, which asserts that stock market price should reflect the intrinsic value of underlying assets. According to Fama (1970), a market is efficient if prices fully reflect all available information on a particular stock market. This means that there are no opportunities for investors to make abnormal returns by exploiting information contained in the history of fundamental data (includes price movement as well as indicators of changing economic fundamentals). When asset and commodity markets are efficient, economic agents who make decisions on the basis of observed prices will insure an efficient allocation of resources. Furthermore, the issue of efficiency is particularly important for emerging markets because efficiency signals an increase in liquidity, a removal of institutional restrictions and an increase in the quality of information revealed in these markets.

Fama (1970) categorized three forms of market efficiency which is weak form, semi-strong form and strong form. These three forms differ in terms term of the types of information which are used in developing investment strategies. This paper is concerned with the weak form test of the efficient market hypothesis only because if the evidence fails to pass the weak form test, there is no reason to examine strong forms before declaring the market inefficient on such evidence (Wong and Kwong, 1984). Efficient market hypothesis (EMH) states that weak-form efficiency exists if security prices fully reflect all the information contained in the history of past prices and movement. As McNish and Puglisi (1982) pointed out, a sufficient condition for weak-form efficiency is that stock price fluctuates randomly. Thus, a market is efficiency in weak-form if stock prices follow a random walk process. If capital markets are weak-form efficient, then investors cannot earn excess profits from trading rules based on past prices or returns. Therefore,

stock returns are not predictable, and so-called technical analysis (analyzing patterns in past price movements) is useless.

Following the seminal paper of Fama (1970) on market efficiency, a large number of empirical studies have been conducted which find evidence in support of efficient market hypotheses. But Fama's seminal paper set the theoretical basis for the concept of efficiency in capital markets, and the methodology for testing certain aspects of the hypothesis of efficient markets. Therefore, tests for Fama's efficient market hypothesis (EMH) in the context of stock market usually meant testing the null hypothesis that autocorrelation coefficient of different lags are statistically insignificant.

The main purpose of this paper will focus on the EGARCH to estimate the leverage effect of Malaysia stock market. Further studies will investigate the weak form efficiency for Malaysia stock market with using Augmented Dickey-Fuller. The remainder of this paper is organized as follows. The second chapter will provide an extensive review of literature on the efficient market hypothesis with emphasis on time series studies. Chapter three will introduce the methodology with an emphasis on recent econometric developments in time series analysis. Chapter four will concentrate on the empirical results obtained from the research and the final chapter will provide conclusions of the research.

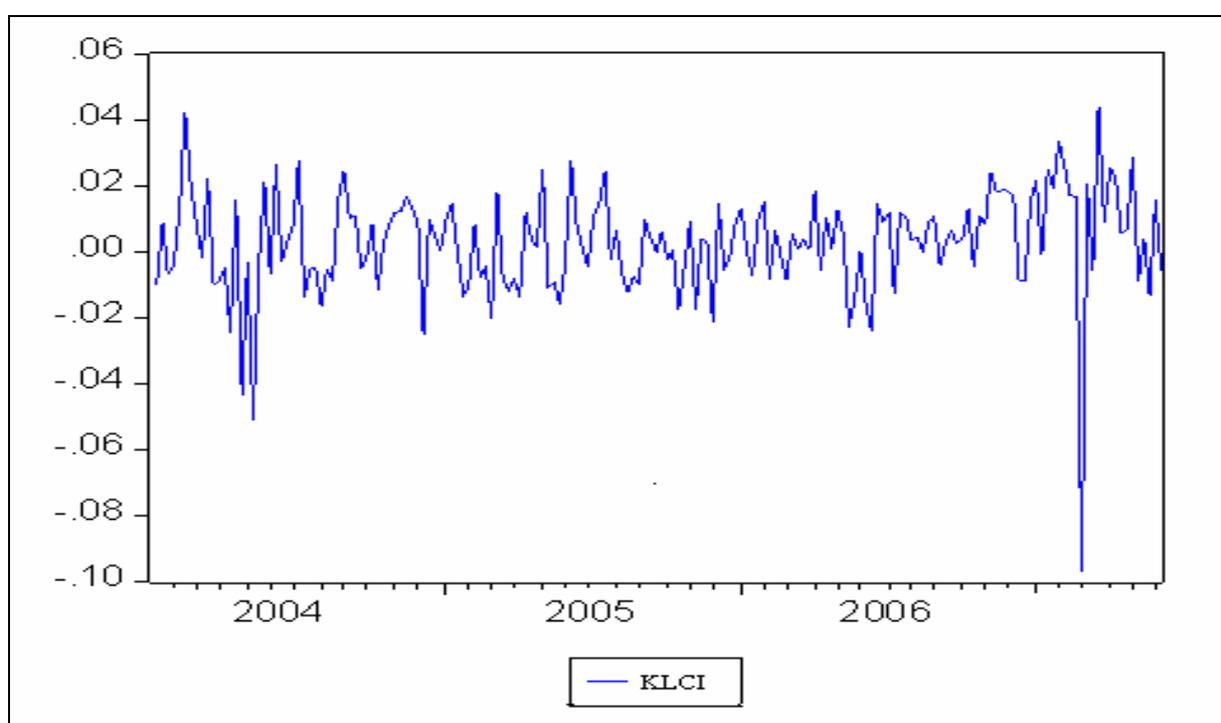
Literature Review

In the literature, the family of GARCH models has grown at a wonderful rate. Engle (1995), Hentschel (1995) and Pagan (1996), among others, provided an excellent account of the variations and extensions of GARCH models over the years. In the GARCH models, the variance is time varying and this provides an alternative and useful measurement of volatility. Volatility refers to a statistical measure of the dispersion of a return distribution, and it is specified as the square root of the conditional variance estimated on the basis of the information available in t , and projected τ periods ahead (Schwert, 1990). In the literature, consensus has been reached that volatility in asset returns has some basic characteristics such as volatility clustering, leptokurtosis or fat tails, leverage effect and mean reversion.

Normally, the plot of financial time series data such as stocks, exchange rate is often observed that large and small changes tend to occur in clusters. That is, large returns are followed by more

large returns, and small returns are followed by more small returns. This behavior was first evidenced by Mandelbrot (1963) and Fama (1965), and further reported by Baillie et al., (1996), Chou (1988) and Schwert (1989). The implication of volatility clustering is that volatility shocks today will influence the expected volatility many periods ahead. In this paper, the stock market data will be plotted to check the volatility clustering. Figure 1 shows that stock market (KLCI) produces volatility clustering which larger return follows by larger return and smaller return follow by smaller return for the period from year 2004 to 2007.

Figure 1: Volatility Clustering of the KLCI



Financial time series often show fat tails in their distributions. This phenomenon is usually referred to as leptokurtosis. Simply stated, this means that we observe more extreme values (outliers) than we expect to. Statistically, fat tails suggest that the kurtosis of the return series exceeds the kurtosis of a standard Gaussian distribution (Mandelbrot, 1963). Besides that, it is often observed in many stock returns that volatility is higher after negative shocks (bad news) rather than after positive shocks (good news) of the same magnitude. So volatility seems to be affected asymmetrically by positive and negative returns. This fact is called the leverage effect and was first noted in Black (1976). The leverage effect suggests that changes in stock prices tend to be negatively correlated with changes in volatility. Christie (1982) and Nelson (1991)

both documented this negative relationship of volatility with equity returns. Engle and Ng (1993) described a News Impact Curve with asymmetric response to good and bad news. Therefore, this paper will concern the leverage effect of Malaysia stock markets data.

Most financial practitioners believe volatility is mean reverting. For example, Engle and Patton (2001) interpreted mean reversion of volatility as meaning that there exist a normal level of volatility, to which volatility will eventually return. Extremely long run forecasts of volatility should all converge to this normal level of volatility, and current information has no effect on the long run volatility forecast. The properties addressed above have important implications for the understanding of various volatility models, as the development of volatility forecasting models is largely motivated to capture and reflect these stylized facts in volatility.

The GARCH models have been known for more than two decades, most of their applications are on the widely traded financial markets of developed industrialized countries. However, there is a growing trend of their applications in the Asian stock markets, for instance forecasting volatility of stock returns (Choo et al. 1999), modeling the volatility of stock index futures market (Tan 2001) and determining volatility spillover effects among major Asia-Pacific stock markets (Hooy and Tan 2002). While these Asian studies involved different applications of GARCH models, none of them conducted a thorough investigation to determine the adequacy of the GARCH models.

This issue is of great importance to the field of finance in view of the wide application of GARCH models in understanding the relationship between risk and expected returns, particularly in the areas of asset pricing, portfolio selection and risk management. Motivated by the above consideration, this study contributes to the current literature by addressing the fundamental issue of GARCH adequacy in characterizing the behavior of Malaysia KLCI stock returns series.

GARCH models are capable of capturing the first two properties of the return series, but their distribution is symmetric. Therefore, fails to model the leverage effect (good and bad news). To solve this problem, many nonlinear extensions of the GARCH model have been proposed in the last twenty years. Among the most widely spread are EGARCH of Nelson (1991), Threshold ARCH (TARCH) and Threshold GARCH (TGARCH), which were introduced independently by

Zakoian (1994) and Glosten, Jagannathan and Runkle (1993). This paper will apply the EGRACH model that introduced by Nelson (1991) to test out the leverage effect.

Financial economists have studied the relationship between risk and expected returns and the conditional volatility of stock markets. For example, Baillie and DeGennaro (1990) studied the dynamics of expected stock returns and volatility in the U.S. stock markets. Poon and Taylor (1992) investigated the same relationship in the U.K. stock market. Both studies found volatility clustering, predictability, and persistence is presented in these markets. For practical forecasting purposes, however, the predictability of various conditional volatility models is of most concern, whereas the results on this issue are inconsistent in the literature. Pagan and Schwert (1990) compared GARCH, EGARCH, the Markov switching regime and three nonparametric models for forecasting monthly U.S. stock return volatilities. The EGARCH, followed by the GARCH models, were found to perform moderately, while the remaining models produce very poor predictions.

Besides testing the volatility and the clustering effect of stock markets, there have been many studies on the random walk hypothesis (RWH) for stock markets efficiency for different countries. The rejection of the RWH implies that stock returns are predictable on the basis of its own lagged values, which can say that the markets are not weak-form efficiency. However, the empirical evidence of random walk on the weak form efficiency indicates mixed results. Conrad and Juttner (1973) applied parametric and non-parametric tests to daily stock price changes in the German Stock Market. They found that the random walk hypothesis is inappropriate to explain the price changes. Furthermore, Frennberg and Hansson (1993) examined the random walk hypothesis using Swedish data from 1919 to 1990. They found that Swedish stock prices have not followed a random walk in that period.

Cooper (1982) studied world stock markets using monthly, weekly and daily data for 36 countries. He examined the validity of the random walk hypothesis by employing correlation analysis, run tests and spectral analysis. With respect to the USA and the UK, the evidence supports the random walk hypothesis. For all other markets, the random walk hypothesis can be rejected. Whereby, Panas (1990) could not reject the hypothesis of random walk and thus demonstrated that the Athens stock Market is efficient. This paper will studies the RWH for Malaysia stock market efficiency as well.

Methodology

EGARCH

The EGARCH model is an alternative choice to accommodate the asymmetric relationship between stock returns and volatility changes. EGARCH (1, 1, and 1) is chosen as the appropriate model for the return series.

$$\ln h_t^2 = w + \beta \ln \sigma_t^2 + \delta \left| \frac{\varepsilon_{t-1}}{\sigma_{t-1}} \right| + \gamma \frac{\varepsilon_{t-1}}{\sigma_{t-1}} \quad (1)$$

where h_t is the risk of the market. If γ hypothesis do not reject, then the model does not have leverage effect. If the γ is negative then it shows that the good news is better than bad news and vice versa. For the δ is to capture the negative value which to avoid the negativity constraint.

Weak form hypothesis

The weak EMH model can be return as

$$R_t = \alpha + \mu_t \quad (2)$$

Expressing R_t as the differences between two successive logarithmic price indexes

$$\ln P_t = \alpha + \ln P_{t-1} + \xi_t \quad (3)$$

Applying the augmented Dickey-Fuller test (ADF) test that addresses the problem of autocorrelation in ξ_t , equation 3 may be tested by

$$\Delta P_t = \beta_1 + \beta_2 T + \lambda P_{t-1} + \tau_i \sum \Delta P_{t-1} + \mu_t \quad (4)$$

with T being time trend. In performing the ADF test the lag length m is selected such that the new error term μ_t is free of auto correlation. This paper uses Akaike Information Criterion to check the significant lag length to test.

Results

Data

In this study, the data consist of weekly closing prices for Malaysia stock market indices Kuala Lumpur Composite index (KLCI), these indices collected from Bursa Saham Malaysia. The prices covering the sample period from 9 January 2004 to 8 Jun 2007 are transformed into a

series of continuously compounded percentage returns, using the relationship: $r_t = \log(P_t / P_{t-1})$ where P_t is the closing price of the stock on week t , and P_{t-1} the price on the previous trading week.

Test for stationary

To provide a better description of the time dependant pattern that is important in modelling the series under study, it is necessary to test the stationarity of the return series, which is an approximation of the volatility process. This paper tests for stationarity can be performed by the Augmented Dickey-Fuller (ADF) unit root test. As reported in Table 1, show the result with no constant and no lagged term, the ADF t-statistic for the return series is -7.374291 , which is less than the critical value of -2.567926 at the 1% significance level. Therefore, we can reject the unit root hypothesis of the return process with a confidence level of more than 99%. Furthermore, in Table 1, the paper concludes that the KLCI return series are stationary.

Table 1: Augmented Dickey-Fuller Tests for Unit Root on the Returns of Malaysia for the period 9 January 2004 to 8 Jun 2007

variable	t-statistic
KLCI	-7.374291^*

Notes: The null hypothesis is that the series is non-stationary, or contains a unit root for the ADF.

The rejection of null hypothesis for ADF tests based on the Mackinnin critical values

* indicates the rejection of the null hypothesis of non-stationary at 5% significance level.

Test for ARCH effect

The results of the ARCH LM test for the return series on the KLCI index in Table 2. It is interesting to see that lag 1 and lag 2 AR terms are not significant in the ARCH LM test, whilst lag 3 and lag 4 terms are significant in the test. This indicates that volatility displays a long memory, or long-term dependence. The ARCH LM test, in Table 2, F-statistic is significant, with a p-value of 0.088673 with a confidence level of 10%. This paper concludes that ARCH effects exist and the variance of the return series is non-constant. This result can be further confirmed by examining the correlogram of the squared standardized residuals from the mean equation the Q-statistics from lag 3 are highly significant, indicating the existence of an ARCH

effect. It shows that the data have ARCH effect. The paper will proceed to test the EGARCH to determine the leverage effect.

Table 2: ARCH LM Test

F-statistic	2.056827	Probability	0.088673***
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Note: * ** *** denotes significance at the 1% ,5% and 10% level respectively

Testing for EGARCH

$$h_t = - 8.909048 + 0.514998 \sigma_t + 0.346928 \delta_t - 0.016686 \gamma$$

(1.9422941) (0.228860) (0.168054) (0.236854)

The EGARCH model did not confirm the existence of the leverage effect, because the measure of the leverage effect γ , which equals to -0.016686 is larger than the critical value, which indicates that any news in the market would not reflect in the stock market. The ARCH LM test in Table 3 indicates the F-stat cannot be rejected at any significant level; there is no ARCH effect left in the model. The paper uses LM autocorrelation test to find out the autocorrelation problem and find out that the result support the null hypothesis. Also, normality test been conducted to test whether the model is normal; the test supports also the null hypothesis. The paper shows that there is no misspecification error in the model.

Table 3: EGRACH LM Test

F-statistic	0.944166	Probability	0.439946
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Note: * ** *** denotes significance at the 1% ,5% and 10% level respectively

Testing for weak form hypothesis

Table 4 illustrates that, the KLCI possess a unit root with no trend but with drift or known as random walk drift. It suggests that KLCI is weak form hypothesis. The paper shows that the F-stat is more than the critical value which this show that the null hypothesis cannot be rejected. The KLCI cannot be predicted or no technical analysis can be used to determine the price movement.

Table 4: Augmented Dickey-Fuller Tests for Unit Root on the Natural Logarithms of KLCI of Malaysia for the Period from 9th January 2004 to 8th Jun 2007

variable	without trend	trend
KLCI	0.684266	-0.92001

Notes: The null hypothesis is that the series is non-stationary, or contains a unit root for the ADF.

The rejection of null hypothesis for ADF tests based on the Mackinnin critical values

* indicates the rejection of the null hypothesis of non-stationary at 5% significance level.

Conclusion

In this paper, the EGARCH has been tested for KLCI. The result show that the market would not captured the bad or good news. The results may support the behavioural finance theory which indicates that people will think irrationally or the market is random walk. For example, a person purchase a stock with their prediction that the stock price expected to increase in the future, any bad news about the stock would effect his decision because the person believe his stock or may not want to admit that he made the wrong decision. So, this kind of person would hold the stock until it rises.

For the weak form EMH result show that KLCI move randomly which no one can predict the stock price movement. This result may be supportive with the EGARCH in the sense that the stock price has already fully reflected all available information into the market. Which any news cannot shift the stock price movements. Moreover, it can be said that any technical and fundamental analysis cannot be performed to predict the stock price.

STOCK MARKET AND ECONOMY GROWTH IN MALAYSIA: CAUSALITY TEST*

Har Wai Mun
Ee Chun Siong
Tan Chai Thing

Introduction

One of the most debatable issues in economics was whether the stock market can be served an important indicator for the prediction of future economic growth or vice versa. Many believe that large decrease in stock prices were reflective of future recession, whereas large increase in stock prices may reflect the expectation towards future economic growth. However, there were controversy issues to doubt the stock market's predictive ability such as the 1987 stock market crashed followed by world recession and 1997 Asian financial crisis.

In addition, we find that related researches done in the past three decades mostly focused on the role of financial development in stimulating economic growth, without taking account to the stock market development. In emerging economies, the evolution of stock market has great impact on the operation of banking institutions (Levine and Zervos, 1998). Beside that, Paudel (2005) stated that stock market, due to their liquidity, enable firms to acquire much needed capital quickly, hence facilitating capital allocation, investment and growth. Thus, domestic stock market is expected to have significant relationship with the economic growth.

There were several possible arguments have been discussed as equity market may led economic growth such as (i) There was evidence that a more developed equity market may provide liquidity that lowers the cost of the foreign capital essential for development, thus, nation with greater development of equity market tends to generate more domestic savings for economic growth (Benchivenga et al., 1996; Neusser and Kugler, 1998). (ii) The role of equity market provided incentive for managers to make investment decisions that may affect firm value in the long run (Dow and Gorton, 1997). (iii) The ability of equity markets to generate information about the innovative activity of entrepreneurs (King and Levine, 1993) or the aggregate state of technology (Greenwood and Jovanovic, 1990). (iv) The importance of stock market in providing portfolio diversification and enabling individual firms to engage in specialized production with efficiency gain (Acemoglu and Zilibotti, 1997). Therefore, given those debatable issues whether

* The improved version of this article has been published in an international journal.

stock market can be served as a vital determinant for economic growth, it seems relevant to further research this topic.

There were theoretical reasons for stock prices may predict economic growths which were the traditional valuation model of stock prices and the “wealth effect” (Comincioli and Wesleyan, 1996). The traditional valuation model of stock price explained that stock prices reflected the expectation of public towards the future economy activities. Beside that, concept of “wealth effect” suggested that changes in stock prices cause the variation in the real economy. Additionally, less developed countries’ capital markets were able to mobilize domestic savings and allocated funds more efficiently (Pardy, 1992). Thus, stock market can play a role to promote economic growth in less-developed countries as assume Malaysia in this case. Therefore, the objectives of this paper were to evaluate does the stock market led to economic growth in Malaysia case or vice versa by testing with Granger causality test. This paper will explore (a) does the stock market “Granger-cause” the real economy, in which past values of stock prices able to improve the prediction of future economic growths? (b) Does the real economy “Granger-cause” the stock market, in the sense that the lagged values of economic activities advance the prediction of the stock market?

Literature Review

The link between stock markets and economic growth provided ambiguous result on a major strand of finance-growth hypothesis (Schumpeter, 1932; McKinnon, 1973) with an insight into how financial intermediation facilitates economic growth. Spears (1991) reported that in the early stages of development, financial intermediation stimulated economic growth in Sub-Saharan Africa. On the other hand, Atje and Jovanic (1993) using cross-sectional regressions conclude that stock markets have long-run impacts on economic growth and it was also found that stock markets influence growth through a number of channels which were liquidity, risk diversifications, acquisition of information about firms, corporate governance and savings mobilization (Levine and Zervos, 1996). Demetriades and Hussain (1996) found very little evidence that financial market is a leading sector in the process of economic growth in a sample of 10 countries. While Luintel and Khan (1999) studied 10 developing economies and find bi-directional causality between financial development and economic growth in all sample countries. Instead of this, Levine and Zervos (1998) have measured stock market development along various dimensions; first, aggregate stock market capitalization to GDP and the number of

listed firms (size). Second, domestic turnover and value traded (liquidity). Third, integration with world capital markets, and lastly, the standard deviation of monthly stock returns (volatility). The results suggested a strong and statistically significant relationship between initial stock market development and subsequent economic growth. In addition, Mauro (2000) exhibited that stock market was a stable predetermining factor of economic growth in emerging economies. Empirical works continue to show largely some degree of positive relationship between stock markets and growth.

We address issues of causality in the framework introduced by Granger (1969). Granger causality tests have been widely used in studies of financial markets as well as several studies of the determinants of economic growth including savings (Carroll and Weil, 1994); exports (Rahman and Mustafa, 1997; Jin and Yu, 1995); government expenditures (Conte and Darrat, 1988); money supply (Hess and Porter, 1993); and price stability (Darrat and Lopez, 1989). A limited number of previous studies have used Granger causality to examine the link between financial markets and growth. Thornton (1995) analyzed 22 developing economies with mixed results although for some countries there was evidence that financial deepening promoted growth. Subsequently, Ahmed and Ansari (1998) reported similar results for three major South-Asian economies. On other hand, Neusser and Kugler (1998) reported that financial sector GDP Granger-caused manufacturing sector GDP in a sample of thirteen OECD countries. Nevertheless, a study using Granger causality techniques to examine the link between financial markets and growth, Rousseau and Wachtel (2000) analyzed 47 economies and report that greater financial sector development leads to increased economic activity. Adajaski and Biekpe (2005) found that positive influence of stock market development on economic growth is significant for countries classified as upper middle income economies from the study of 14 African countries. Similarly, Siliverstovs and Duong (2006) revealed that even when accounting for expectations, represented by the economic sentiment indicator, the stock market has certain predictive content for the real economic activity. All past literature reviews have been contributed an idea to this paper that the present development of stock market development and economic growth. In summary, previous empirical research has suggested a possible connection between stock market and economic growth, but is far from ambiguous. Although the relationship claimed is a causal one, most empirical studies have addressed causality indirectly, if at all. Moreover, most studies have not adequately deal with the fact that efficient markets

should incorporate expected future growth into current period prices. Hence, the subsequent of this paper will further discussed the methodology, as well as results and interpretations.

Methodology

Stationarity

The VAR is modeled in stationary variables so that the test statistics have standard distributions. Since a causality test holds only for stationary variables, unit roots tests have to be performed on all the variables involves. In order to avoid spurious regression, determine the stationarity of the series enable to ensure the validity of the usual test statistics (t-statistics and F-statistics, and R^2). Stationarity could be achieved by appropriate differencing and this appropriate number of differencing is called order of integration. The Augmented Dickey Fuller (ADF) [Dickey and Fuller 1979] tests of stationarity are used in the study.

Augmented Dickey Fuller (ADF) Test

The ADF test is based on the estimate of the following regression:

$$\Delta Y_t = \beta_1 + \beta_2 t + \delta Y_{t-1} + \alpha_i \sum_{i=1}^m \Delta Y_{t-1} + \varepsilon_t$$

where Y_t is our variable of interest = {RGDP_t, KLCL_t}, Δ is the differencing operator, t is the time trend and ε is the white noise residual of zero mean and constant variance. $\{ \beta_1, \beta_2, \delta, \alpha_1, \dots, \alpha_m \}$ is a set of parameters to be estimated. Both of the null and alternative hypotheses in unit root tests are:

$$H_0 : \delta = 0 \text{ (} Y_t \text{ is unit root)}$$

$$H_1 : \delta \neq 0 \text{ (} Y_t \text{ is stationary)}$$

The unit root hypothesis of the Dickey-Fuller can be rejected if the t-test statistic from these tests is negatively less than the critical value tabulated. In other words, by the Augmented Dickey Fuller (ADF) test, a unit root exists in the series Y_t (implies nonstationary); the null hypothesis of δ equals zero is not rejected (Gujarati 1995, p. 719-720).

Lag Length Selection

A critical element in the specification of VAR models is the determination of the lag length of the VAR. There are several alternative criteria for finding the most appropriate model, which

take into account certain tradeoffs between better fit, smaller residuals, and loss of degrees of freedom due to number of estimated parameters. The appropriate lag length is established by Akaike Information Criterion (AIC). The best fitting model is the one that minimizes the information criterion function in essence, the overall sum of squared residuals. To help to ensure the appropriateness of the estimated VAR, the use of various diagnostic tests is common in studies that is Breusch-Godfrey serial correlation LM test and in the Jarque-Bera (JB) test for normality.

Granger causality test

According to the Granger (1969) causality approach, a variable y , say economic growth, is caused by x , say stock market growth, if y can predicted better from past values of y and x than from past values of y alone. For a simple bivariate model, we can test the causality between stock market growth and economic growth. The hypotheses are tested in the context of VAR of the following form:

$$RGDP_t = \sum_{i=1}^n \alpha_i KLCI_{t-i} + \sum_{j=1}^n \beta_j RGDP_{t-j} + u_{1t} \quad (1)$$

$$KLCI_t = \sum_{i=1}^n \lambda_i KLCI_{t-i} + \sum_{j=1}^n \delta_j RGDP_{t-j} + u_{2t} \quad (2)$$

where, RGDP is economic growth denotes the changes of real GDP and KLCI is stock market growth is the changes of KLCI. Both variables denotes into logarithm form. It is assumed that the distributes u_{1t} and u_{2t} are uncorrelated. Equation (1) postulates that current RGDP is related to past values of itself as well as that of KLCI, and equation (2) postulates a similar behaviour for KLCI. Based on the estimates OLS coefficients for the equations (1) and (2) four different hypotheses about the relationship between RGDP and KLCI can be formulated:

1. Unidirectional Granger-causality from KLCI to RGDP. In this case stock market growth increases the prediction of the economy but not vice versa. Thus $\sum_{i=1}^n \alpha_i \neq 0$ and $\sum_{j=1}^n \delta_j = 0$.

2. Unidirectional Granger-causality from RGDP to KLCI. In this case the growth rate of the economy increases the prediction of the stock market growth but not vice versa. Thus $\sum_{i=1}^n \alpha_i = 0$

and $\sum_{j=1}^n \delta_j \neq 0$.

3. Bidirectional (or feedback) causality. In this case $\sum_{i=1}^n \alpha_i \neq 0$ and $\sum_{j=1}^n \delta_j \neq 0$, so in this case the growth rate of the economy increases the prediction of the stock market growth and vice versa.

4. Independence between RGDP and KLCI. In this case there is no Granger causality in any direction, thus $\sum_{i=1}^n \alpha_i = 0$ and $\sum_{j=1}^n \delta_j = 0$.

Hence by obtaining one of these results it seems possible to detect the causality relationship between stock market growth and the economic growth of a country.

To test the hypotheses, the restricted F-test is applied, which is given by:

$$F = \frac{[(RSS_R - RSS_{UR}) / m]}{[RSS_{UR} / (n - k)]} \quad (3)$$

where, m is number of lagged terms and k is the number of parameters. RSS_R and RSS_{UR} are residual sum of squares of restricted and unrestricted models respectively. If the F value exceeds the critical F value at the chosen level of significance, we reject the null hypothesis, in which case the lagged RGDP terms belong in the regression. This is another way of saying that RGDP cause KLCI.

Data

The data analyzed in this paper consists of economic and financial time series of Malaysia there are real gross domestic product (RGDP) and Kuala Lumpur Composite index (KLCI). The data for Kuala Lumpur Composite index was obtained from Bursa Malaysia and GDP data was collected from International Financial Statistics, published by International Financial Statistics (IMF). The data set of the study consists of 30 annual observations covering the period from 1977 to 2006.

Results and interpretations

Testing for Stationarity

Augmented Dickey-Fuller (ADF) unit root tests are employed to test for the stationarity of the macroeconomic series at level and then first difference of each series. The results of the ADF at level are reported in Table 1, by taking into consideration of trend variable and without trend variable in the regression. Based on Table 1 (Panel A), the t-statistics for all series from ADF tests are statistically insignificant to reject the null hypothesis of non-stationary at 0.05 significance level. This indicates that these series are non-stationary at their level form. Therefore, these variables contain a unit root process. When the ADF test is conducted at first difference of each variable, the null hypothesis of non-stationary is easily rejected at 0.05 significance level as shown in Table 1 (Panel B). This is consistent with some previous studies that have been demonstrated the most of the macroeconomics and financial series expected to contain unit root and thus are integrated of order one, I (1). The number of lag included is to solve the problem of autocorrelation; to ensure the error terms are uncorrelated and enhance the robustness of the results.

Table 1: Results for the Augmented Dickey-Fuller unit root tests for RGDP and KLCI

Panel A: Level		
Variable	Constant with trend	Constant without trend
RGDP	-2.6979(1)	-0.4813(0)
KLCI	-2.8151(0)	-2.2411(0)

Panel B : First difference		
Variable	Constant with trend	Constant without trend
RGDP	-4.8474(1)*	-4.3405(0)*
KLCI	-5.5444(0)*	-5.5884(0)*

Notes:

The null hypothesis is that the series is non-stationary, or contains a unit root for the ADF. The rejection of null hypothesis for ADF tests based on the Mackinnin critical values.

* indicates the rejection of the null hypothesis of non-stationary at 5% significance level.

Since the variables are stationary, then we can proceed to check the number of lags input into the model. The study uses the AIC to determine the number of lags in the model. To ensure the appropriateness of the estimated VAR, the use of various diagnostic tests is common in studies. The results show that the optimal lag lengths are equal to two, based on the AIC criterion.

Testing for Granger causality test

The procedure used in the study for testing statistical causality between the stock market and the economy is the “Granger-causality” test (Granger, 1969). The Granger causality tests determine the predictive content of one variable beyond that inherent in the explanatory variable itself. The variables to be used in the Granger Causality test are assumed to be stationary. In the case of the study’s data set, test statistics for unit root have already been reported in Table 1, with the conclusion that the time series are I(1) or stationary. The Wald test is then used to test the above Granger causality hypothesis.

Based on the results of the lag length and the integration order determination, we proceed with testing for Granger causality. The results of Granger causality for equations (1) and (2) are represented in Table 2. As represented in Table 2, the Wald F-statistic is 4.1184 and the p-value is 0.0303. This implies that the null hypothesis that KLCI does not Granger cause RGDP is decisively rejected. However, the hypothesis that RGDP does not Granger cause KLCI can not be rejected at the usual significant levels. Thus, there exists the uni-directional Granger causality from the KLCI to the RGDP. However, there is no reverse causation from RGDP to KLCI.

Table 2: Results of Granger-causality Tests

<u>Dependent variable</u>	<u>Independent variable</u>	
	RGDP	KLCI
RGDP	-	4.1184* (0.0303)
KLCI	0.5488 (0.5354)	-

* indicates statistical significant at 0.05 level.

One possible explanation for why stock prices predict the economy is that stock prices actually cause what happens to the economy. This would be consistent with the wealth effect. According to this argument, fluctuations in stock prices raise and lower wealth, which in turn, raises and lowers aggregate consumption. As a result, economic activity is affected or "caused" by fluctuations in the stock market.

Another possible explanation for why stock prices "Granger cause" economic activity is that the stock market is forward-looking. If investors are truly forward-looking, then stock prices reflect

expectations about future economic activity. If a recession is anticipated, for example, then stock prices reflect this by decreasing in value. Since the results indicate that the stock market improves the prediction of economic activity, and if we assume that the stock market is forward-looking, then investors' expectations about the future economy are fairly accurate. Furthermore, since the economy does not predict stock prices, expectations about the future economy are not being formed by simple looking at past values of GDP, which is suggested by the adaptive expectations model. For the adaptive expectations model to hold true, past values of GDP would have to 'granger cause' stock prices.

Conclusion

The purpose of this paper was to evaluate the stock market as a leading economic indicator and explore causal relationships between stock market and the economy. This empirical study used formal tests of causality developed by C. J. Granger and yearly Malaysia data for the period 1977-2006. Our results indicated a "causal" relationship between the stock market and the economy. We found that while stock market Granger-caused economic activity, no reverse causality was observed. Furthermore, we found that statistically significant lag lengths between fluctuations in the stock market and changes in the real economy are relatively short. The longest significant lag length observed from the results was two year.

One issue that needs further exploration is the actual reason for the causality relationship between the stock market and economic activity. Is the causality relationship more consistent with the wealth effect or with the forward-looking nature of the stock market? The results from this paper are consistent with both the wealth effect and the forward-looking nature of the stock market, but do not prove either. Our results reveal that expectations for future economic activity are not simply formed by looking at the past trend in the economy as the adaptive expectations model would suggest. However, it showed that the stock market growth Granger cause the economic growth. Hence, for policy implication purposes, we can be suggested that Malaysia government should promote the stock market in order to promote economic growth of nation as the stock market can be served as a leading indicator for economic growth.

In order to promote the stock market, there was several suggestions to be discuss as following: (1) Government could be liberalized stock market regulation towards the foreign direct investment (FDI) involve in the domestic equity market. By doing so, it was help to attract

greater volume of FDI flow into Malaysia and providing portfolio diversification and enabling individual firms to engage in specialized production with efficiency gain. (2) Malaysia government has to develop the domestic equity market as there were evidences showed that a more developed equity market may provide liquidity that lowers the cost of the foreign capital essential for development, thus, nation with greater development of equity market tends to generate more domestic savings for economic growth. For example, in order to boost the confidence of foreigner to invest in Malaysia, we have to make sure that all public information which provided by all those public listed companies must be accurate and transparent. For recently cases of Transmile Group Bhd and Megan Media Bhd as its provided faulty company statement to the public, securities commission of Malaysia has been tighten the regulation such as Capital Markets and Services Act 2007 (CMSA) to avoid this scenario exist again. Hence, this was best to protect the interest of public by creating a fair and transparent condition for domestic equity market to rebuild the confident of foreigner as well as domestic investors. Beside that, more developed stock market does provide incentive for managers to make investment decisions that may affect firm value in the long run. (3) Lastly, government has to improve the liquidity of stock market by providing more capital market services such as derivative markets, thus, it enable firms to acquire much needed capital quickly to facilitate capital allocation for greater investment and lastly lead to economic growth. Those markets provided a platform for foreign portfolio investors as well as domestic portfolio investors to diversify their portfolio in domestic equity market.

In conclusion, the results of this paper revealed that the stock market does help predict the future economy. Although it may not be surprising to find that fluctuations in economic activity may be preceded by changes in stock prices, our finding that changes in GDP are "Granger-caused" by changes in stock prices is important in that it provides additional support for the leading economic role of the stock market. Our findings suggest that the evolution of financial sector in particular the stock market tends to be more likely to stimulate and promote economic growth when monetary authorities adopt liberalised investment and openness policies, and improve the size and the regulations of the stock market and macroeconomic stability.

DEVELOPMENT OF CRUDE PALM OIL (CPO) FUTURES MARKET: A HISTORICAL PERSPECTIVE

Lim Fang Ching
Ong Siong Weng

Introduction: Bursa Malaysia Derivatives Berhad

Exchange-traded derivatives were introduced in the Malaysian capital market in 1980, with the establishment of the Kuala Lumpur Commodity Exchange Bhd (KLCE) and the launch of its flagship product, the crude palm oil (CPO) futures, that year. The country's first financial derivatives exchange, KLOFFE was established in 1995 with KLCI futures launched the same year, while the three-month KLIBOR future contract was launched in 1996.

Exchange of financial and commodities futures in Malaysia are concluded through the Bursa Malaysia Derivatives Berhad (formerly known as Malaysia Derivatives Exchange Berhad, MDEX). The Malaysia Derivatives Exchange (MDEX) is a limited share company formed during June 2001 in Malaysia through the merger of the Kuala Lumpur Options and Financial Futures Exchange (KLOFFE) and the Commodity and Monetary Exchange of Malaysia (COMMEX Malaysia). The Bursa Malaysia Derivatives is a subsidiary of Bursa Malaysia, the local stock exchange. Important changes are now taking place in the structure of the exchange's business, with important implications for the way that the exchange will position itself internationally going forward (Bursa Malaysia 2007a).

Bursa Malaysia Derivatives Berhad operates under the supervision of the Securities Commission Malaysia (SC) and is governed by the Futures Industry Act (FIA), 1993. The exchange also falls under the jurisdiction of the Ministry of Finance Malaysia. Bursa Malaysia Derivatives currently offers ten derivative products for trade; they are (Bursa Malaysia 2007b):

- I. Kuala Lumpur Composite Index (FKLI) Futures
- II. Kuala Lumpur Composite Index (OKLI) Options
- III. 3-Months Kuala Lumpur Inter-bank Offered Rate Interest Rate (FKB3) Futures
- IV. Crude Palm Oil (FCPO) Futures
- V. Crude Palm Kernel Oil (FPKO) Futures
- VI. Three-Year Malaysian Government Securities (FMG3) Futures

- VII. Five-Year Malaysian Government Securities (FMG5) Futures
- VIII. Ten-Year Malaysian Government Securities (FMGA) Futures
- IX. Single Stock Futures (SSFs)
- X. Ethylene OTC Futures Contract

Futures Contracts

In finance, a futures contract is a standardized contract, traded on a futures or derivative exchange, to buy or sell a certain underlying instrument at a certain date in the future, at a specified price. The future date is called the delivery date or final settlement date. The pre-set price is called the futures price. The price of the underlying asset on the delivery date is called the settlement price. The futures price, normally, converges towards the settlement price on the delivery date. Both parties of a "futures contract" must fulfill the contract on the settlement date. The seller delivers the commodity to the buyer, or, if it is a cash-settled future, then cash is transferred from the futures trader who sustained a loss to the one who made a profit. To exit the commitment prior to the settlement date, the holder of a futures position has to offset his position by either selling a long position or buying back a short position, effectively closing out the futures position and its contract obligations. It is a financial instrument used to manage one's exposure to today's volatile markets.

Crude Palm Oil Futures (FCPO)

Malaysia was the first country in South East Asia to initiate futures trading following the introduction of the Crude Palm Oil (CPO) futures contract in October 1980. The CPO futures traded on MDEX is the leading benchmark for the pricing of crude palm oil internationally and has continued to be an important mechanism to meet pricing and hedging requirements for the industry. The designation of this future contract is aim to ensure its continued relevance to the wider economy and ultimately its long-term competitiveness, there should be concerted effort to the:

- Facilitate effective hedging by investors with exposures in the underlying market
- Allow efficiency pricing of risk to both parties.
- Hedge against price risk which face by producer and user of the crude palm oil.
- Allow to some extent of speculation, which might lead to overall market efficiency, such as pricing behavior.
- Broader investment vehicle.

For a standardize FCPO contract, each contract carrying 25 metric tons. The minimum price fluctuation is RM1 per metric tons. With the exception of trades in the spot month, trades for future delivery of Crude Palm Oil in any month shall not be made, during any one Business Day, at prices varying more than 10% above or below the settlement prices of the preceding Business Day (“the 10% Limit”) except as provided below. When at least three non-spot month contracts are trading at the 10% Limit, the Exchange shall announce a 10-minute cooling off period (“the Cooling Off Period”) for all contract months (except the spot month) during which trading shall only take place within the 10% Limit. Following the Cooling Off Period, all contract months shall be specified as interrupted for a period of five minutes, after which the prices traded for all contract months (except the spot month) shall not vary more than 15% above or below the settlement prices of the preceding Business Day (“the 15% Limit”). If the 10% Limit is triggered less than 30 minutes before the end of the first trading session, the following shall apply: the contract months shall not be specified as interrupted; the 10% limit shall be applied to all contract months (except for the spot month); the rest of the first trading session; and the 15% limit shall be applied for all contract months (except the spot month) during the second trading session. If the 10% Limit is triggered less than 30 minutes before the end of the second trading session, the 10% Limit shall be applied to all contract months (except the spot month) for the rest of the Business Day.

Under the FCPO, there are many various contract months traded in the market. The main and active traded volume contract month is the Spot month contract. Other traded contracts month are the next succeeding months, and thereafter, alternate months up to 60 month. Trading hours for the FCPO has separate into 2 sessions, which is first trading session, from 10.30am to 12.30pm, and second trading session, 3pm to 6pm. For the speculative position, there has limit of 500 contract of net long or net short position for the Spot Month Contract. 5000 contracts for any single delivery month except for the Spot month contract are allowed, or, 8000 contracts for all months combined.

The contract will expire at the noon of the 15th day of the delivery month, or if the 15th is a non-market day, it will locate at the preceding Business or Trading day. Tender period is the first Business Day to the 20th Business Day of the delivery month, or if the 20th is a non market day, the preceding day will be the last tender day for the contract. This agreement is standardized

according to quality, quantity, delivery time and location. For the delivery, Crude Palm Oil must be in a good merchantable quality, in bulk, unbleached, in Port Tank Installations approved by the Exchange located at the option of the seller at Port Kelang, Penang (Butterworth) and Pasir Gudang (Johor). Free Fatty Acids (FFA) of palm oil delivered into Port Tank Installations shall not exceed 4% and from Port Tank Installations shall not exceed 5%. Moisture and impurities shall not exceed 0.25%. Deterioration of Bleach-ability Index (DOBI) value of palm oil delivered into Port Tank Installations shall be at a minimum of 2.5 and of palm oil delivered from Port Tank Installations shall be at a minimum of 2.31.

The deliverable units are 25 metric tons, plus or minus 2% of the 25 metric tons. Settlement of weight differences shall be based on the simple average of the daily Settlement Prices of the delivery month from:

- a) the 1st Business Day of the delivery month to the day of tender, if the tender is made before the last trading day of the delivery month; or
- b) the 1st Business Day of the delivery month to the Business Day immediately preceding the last day of trading, if the tender is made on the last trading day or thereafter.

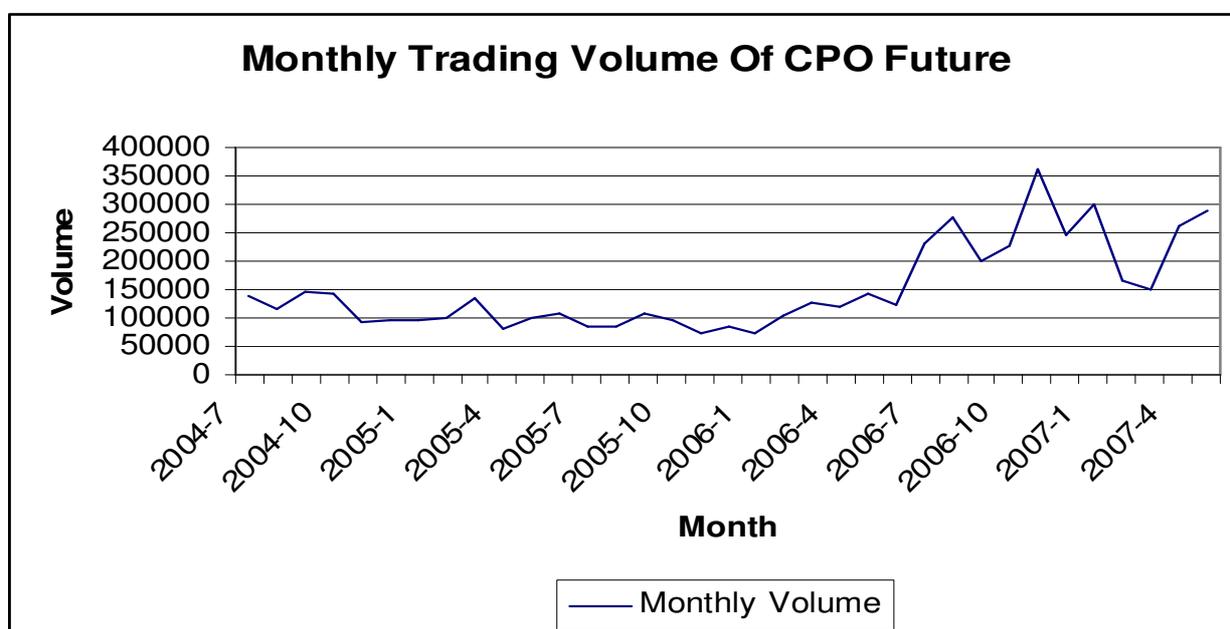
Unlike the KLCI Futures which is cash settled, physical delivery takes place in the CPO futures market if one were to hold a CPO futures contract to expiry. It is important to take note of this if you have no use for taking delivery of tons of palm oil! A speculator usually trades the third month (and farther months) as opposed to the spot month, as there is more time to expiry thereby reducing the probability of having to take delivery. Under the amended trading fee on 28 March 2007, the general trading fee on the contract is RM2 per contract. Trading fee for market maker is non-applicable to the market maker. However, trading fee for local participant is applicable, which is costing RM2 per contract (Bursa Malaysia 2007c).

Historical Trading Record

From the Graph 1, we can see the trend of the FCPO trading volume. From July 2004 until April 2006, the trading volume is quite flat, and there have no any big fluctuation on that time, this is mainly because at that time, the palm oil prices is not so high and the supply of the Oil Palm is stable, so there is less incentive to trade in FCPO either for hedging or speculation purposes. But from July 2006 onwards, the trading volume start to increase in a huge amount, and the

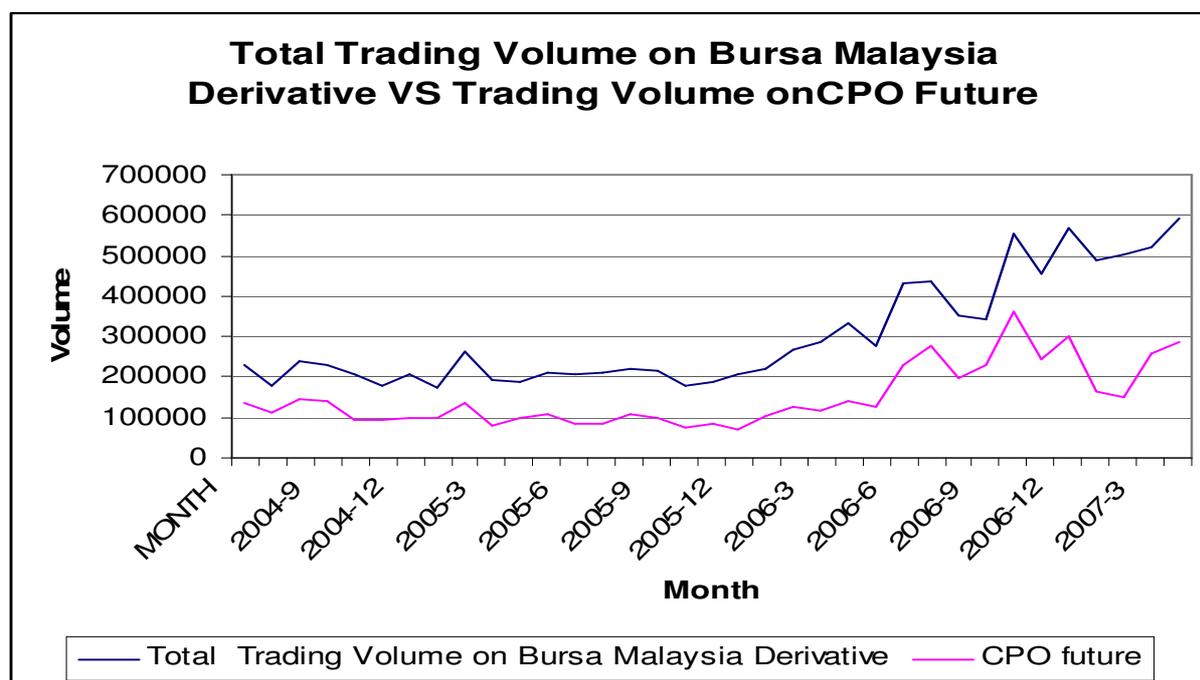
fluctuation of the trading volume also very large. This is mainly caused by the boost of the price of the Oil Palm in the market, and the short of supply in the market. Besides, the large demand from China may also contribute to the price increase of the Oil Palm. And due to the worry of the increase of the oil palm price in the future, so people start to buy FCPO in order to hedge against the increasing price of the oil palm. Other than hedger, speculator also start to go into the market in order to earn profit from this market, and all this factor contribute to the increase in the FCPO trading volume, and it is expected that the trading volume will keep going up in the future, since there are more and more people attracted to FCPO (Bursa Malaysia 2007d).

Graph 1: Monthly Trading Volume of CPO Future in Last 35 Months



The Graph 2, shows the total trading volume on Bursa Malaysia Derivatives with trading volume on FCPO. And from this graph, we can see a clear pattern between the two different trading volumes. The trading volume for Bursa Malaysia Derivative and FCPO share the same trend of movement. And from this graph, we can conclude that the total trading volume on Bursa Malaysia Derivative and FCPO have a very strong correlation. But without a proper test, we cannot conclude which one is the leading factor for the movement of the trading volume.

Graph 2: Total Trading Volume on Bursa Malaysia Derivative Against Total Trading Volume on CPO Future



Future Prospects and Challenges

As Bursa Malaysia Derivative Berhad has reduced in transaction fee for derivatives trade (included FCPO) and improve its crude palm oil (CPO) futures contracts as it seeks to boost trading volume on Bursa Derivatives Exchange by 40% this year, and thus, this may accelerate the growth in the industry. In FCPO, the trading volume will expected to rise. This might imply that, there is more and more market participant to the trading of FCPO. Thus, this might lead to greater market efficiency. Investors are able to use it to speculate and hedge against the risks.

Bursa Malaysia Derivative Berhad had also introduced new contract months to enable the CPO futures contracts to be traded up to 24 months forward. By the enrichment of the product, this may attract speculators to take place in the market. They might entry to the FCPO contract which has longer term to maturity. If there has shorter maturity for the contract, speculator must to accept the deliveries of the Crude palm oil when the contract is expire. As longer term to maturity, speculators have more time to make a covering position - that is, buying a contract to cancel out an earlier sale (covering a short), or selling a contract to liquidate an earlier purchase (covering a long).

Beside that, the launched of contract with longer maturity, producer might able to lock in their future revenue by supplying longer term to maturity FCPO contract if their expectation to the product price may decrease over the time. This is crucial to the producer who might just able to get the output at later stage. For example, a newly plant of palm oil crop may just able to get the palm fruit at later stage (according to MPOB, it require 5 year to get the fruits). Product price might decline over the time, thus, their revenue will decline as well when they get their output. If the producers fear of declining product price over the time, they might lock in their future revenue by supplying longer maturity FCPO contracts. At the maturity, they can sell the product at their favorable price. On the other hand, demander may also able to lock in the future cost of purchasing the crude palm oil. As they fear of future price of the crude palm oil will increase, their purchasing cost will increase as well. As so, they might lock in their future purchasing cost by going long position in the market (buy FCPO). With the launched of longer maturity FCPO contract, this may enable investors to increase the efficiency of controlling the participants revenues and costs.

The exchange have also increase trading limit of the contracts to allow for greater volatility and liquidity. Total Speculative Limit Position has increase from 5000 to 8000 contracts for all contract month combined. The increased flexibility would help attract more "speculators and hedgers" to the world's biggest CPO derivative futures market.

To attract foreign investors to participate our domestic derivative market, Bursa Malaysia Derivative Berhad has planning to launch a brand new FCPO contract, which is the price, is denominated in US Dollar and it is expected to launched by early next year. The designation of these contracts is aim to attract foreign investor. As the price denominated in US Dollar, this may help the foreign investor to eliminate the foreign exchange risk. With no exchange risk involve, they are more willing to participate in our domestic crude palm oil Future, irrespectively they are speculators or hedgers.

All of the above have shown that there are good prospectuses to the development of FCPO, and aim to develop a broader and wider investment scope to the market participants. Degree of activeness of the FCPO might increase. However, there is some other issues have ready stand for challenging the domestic crude palm oil future contract (Bursa Malaysia 2007e).

The main consideration is the Singapore Exchange Derivatives Trading Limited (SGX-DT) has developing a similar crude palm oil futures contract. This may result increase competition between the two Exchanges on a similar futures product. Therefore, launching of the crude palm oil futures may reduce the trading activeness on our domestic crude palm oil futures contract as some investor might choose to participate in crude palm oil Futures contract which listed in Singapore Exchange Derivatives Trading Limited. This may impede the development of domestic crude palm oil Future contract (Singapore Exchange Limited 2007).

Another consideration may arise due to increasing initial margin on FCPO. As at 25 June 2007, the updated Gross Margin Rate is RM5750 per contract and the margin interval is RM220. This figure might too high as investor have to deposit RM5750 per contract they had entry. Compare to 4 May 2007, the Gross Margin Rate is just RM4900 per contract. In other word, the gross margin rate has increase RM850, and representing investor have to deposit greater amount to the contract. Investors (speculators and hedgers) will reluctant to make transaction on our derivative exchange, and shift the participation of the FCPO trading to alternate choice such as crude palm oil Future contract which listed in Singapore Exchange Derivatives Trading Limited. Without great amounts of participants, or inactive trading scheme, development of FCPO will be slow.

Under the Capital Market Master plan, one of the objectives is to become a main regional capital market. To achieve the mission, a depth and width capital market is required. Thus, Bursa Malaysia and its subsidiary (including Bursa Malaysia Derivative Berhad) have always ensured the growth of the industry by revising the rule and regulation imposed on the products, facing competition by developing more new products and supervising to the products, in order to outline the competitors. As FCPO is the main product of Bursa Malaysia Derivative Berhad, a development of FCPO is carrying a significant role as well.

MICROFINANCE IN MALAYSIA

Pang Jo Li
How Rouyih

Introduction: What is “Microfinance”?

Microfinance is the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to poor and low-income households and their micro-enterprises (Asian Development Bank 2000: 1). The meaning of microfinance with broader version has developed and changed with revolutionary approach to development finance with the provision of financial services such as credit, savings, insurance, money transfer to poor and low income households and their micro-enterprises. The narrower version of microfinance refers to giving tiny loans to the hard core poor at subsidized interest rate (Mukhtar Ramli, 2001).

Whereas, microcredit is the extension of very small loans (microloans) to the unemployed, to poor entrepreneurs and others living in poverty who are not considered bankable. These individuals lack collateral, steady employment and the verifiable credit history and therefore cannot meet even the most minimal qualifications to gain access to traditional credit. Microcredit is a part of microfinance, which is the provision of financial services to the very poor. Apart from loans, microcredit also includes savings, microinsurance and other financial innovations. Microfinance was initially offered by different kind of institutions, informal and traditional systems, local and international non-government organizations (NGO) funded by donors, cooperatives and credit unions, local government institutions, specialized financial institutions and ultimately by regulated, formal commercial financial institutions.

Grameen Bank and Microfinance

The Grameen Bank is a microfinance organization and community development bank started in Bangladesh that makes small loans (known as microcredit) to the impoverished without requiring collateral. The system is based on the idea that the poor have skills that are under-utilized. The bank also accepts deposits, provides other services, and runs several development-oriented businesses including fabric, telephone and energy companies. Muhammad Yunus, founder of Grameen Bank, earned a doctorate in economics from Vanderbilt University in the United States. He discovered that very small loans could make a difference in a poor person's

ability to survive, but that traditional banks were not interested in making tiny loans to poor people, who were considered poor repayment risks.

In 1976, Yunus founded the Grameen Bank to make loans to poor Bangladeshis. Since then the Grameen bank has issued more than \$5 billion in loans to several million borrowers. At the close of 2005 the number of outstanding loans is more than 4 million. Under Yunus, Grameen Bank operates differently compared with traditional banks. Whatever banks did, Yunus did the opposite. The traditional banks made large loans, Grameen Bank made small loans; traditional bank required paperwork, Grameen's loans were for the illiterate. The Grameen Bank is a leading advocate for the world's poor that has lent more than \$5.1 billion to \$5.3 million people. The bank is built on Yunus' conviction that poor people can be both reliable borrowers and avid entrepreneurs. Under Yunus, Grameen Bank has spread the idea of microcredit throughout Bangladesh, Southern Asia, and the rest of the developing world. In 2006, Yunus and the Grameen Bank were awarded the Nobel Peace Prize.

To ensure repayment, the bank uses a system of "solidarity groups". Solidarity groups is a small informal groups, nearly all of them exclusively female, that meet weekly in their villages to conduct business with representatives of the bank, and who support each other's efforts at economic self-advancement. The system incorporates a set of values into the banking system, embodies in Bangladesh by the *Sixteen Decisions* (refer to Appendices, Figure 1). The system is the basis for the microcredit and the self-help group system now at work in over 43 countries. Each group of five individuals are loaned money, but the whole group is denied further credit if one person defaults. This creates economic incentives for the group to act responsibly such as other members then being able to receive additional loans, increasing Grameen's economic viability. There is no legal instrument between the lender and the borrower. Grameen Bank considers its relationship to be people, not with papers. They build up human relationship based on trust. Grameen succeeds or fails depending on how strong their personal relationship is with the borrowers.

Grameen has discovered microcredit is a very effective instrument to empower the poor, particularly the poor women in all cultures and economies of the world. It is cost-effective, sustainable and works in a business way. It gives a poor person an opportunity to take their own destiny into their own hands and get out of poverty with their own efforts. The program was

originally started with men and women, but later focused on women when data showed a dramatically lower risk in women. Women have become the focus of many microcredit institutions and agencies worldwide. This is due to the observation that loans to women tend to more often benefit the whole family than loans to men do. It also been observed that giving women the control and responsibility of small loans raises their socio-economic status, which is seen as a positive change to many of the current relationships of gender and class. Today, 96% of Grameen's borrowers are women (Wikipedia 2007c).

Microfinance Industry in Malaysia

Nowadays, microfinance is nothing new in Malaysia. It has been operated by credit unions, co-operative banks and specialized credit windows of banks. Microfinance services of financial credit range from few hundreds to about RM10, 000 (USD2, 631) and mostly to finance small businesses, agricultural loans and loans for poverty reduction.

Majlis Amanah Rakyat (MARA), council of trust to the Bumiputera and Credit Guarantee Corporation (CGC) are some of the pioneers to introduce microfinance loans to its borrowers. Rural credit institutions comprising of Agriculture Bank of Malaysia (BPM), Farmers Organization Authority (LPP), Federal Land Development Authority (FELDA), and agro-based Co-operative Societies provide microcredit for the agriculture sectors. Besides, there are a number of non-government organizations (NGOs) that engaged in microfinance. These include Yayasan Usaha Maju operating in Sabah, Koperasi Kredit Rakyat in Selangor and the best and significantly known microfinance institution (MFI) is Amanah Ikhtiar Malaysia (AIM).

Malaysia is classified as an upper middle income country by the World Bank. This is an important factor in the approach taken to poverty alleviation through microfinance in Malaysia, an approach deriving from the New Economic Policy (NEP) which operated from 1971 to 1990. The NEP was directed to reducing poverty and income disparities between ethnic groups, and particularly to improving the position of the Bumiputera. These are the indigenous of Malaysia, Malay community, who were seen as economically disadvantaged by comparison with other ethnic groups, particularly the Chinese (Conroy, J.D., 2002). Malaysia has experienced one of the fastest economic growth rates in Asia. GDP growth rate increased from 5.8% in 1999, to 8.5% in 2000, but Malay still not exempt from the poverty problem. In 1997, 10.9% of households were in rural areas and 56,000 households were under the poverty line. Although the

poverty rate has decreased over the years, the percentage of people in poverty increased recently as a result of the economic slowdown and declining commodity prices. Amanah Ikhtiar Malaysia (AIM), which began to replicating Grameen Bank, plays an important role in reducing poverty in Malaysia today. It is also the oldest and one of the largest Grameen Bank replications in Asia until now.

AIM was established in September 1987 as an NGO, registered under Trustee Act 1965, private trust. Trusted and recognized by the Malaysian government, it aims directly to eradicate poverty in the rural areas of peninsular Malaysia. With some modification from the Grameen Bank model, the Ikhtiar project was adopted as a program to eradicate poverty of the rural poor in Malaysia (Mukhtar Ramli, 2001). The objective of AIM is to give out benevolent loans to finance income generating activities to the poor households and eventually help them to move out from the poverty group. It is complementary to the Malaysia government objective in eradicating poverty among the poor households in Malaysia. AIM has received government support from the very beginning. It has received financing from sources such as Government of Malaysia, Islamic Economic Development Foundation (YPEIM), Credit Guarantee Corporation (CGC), financial institutions, state government and other organizations. Next, AIM operational costs are bear through its administrative charges to its borrowers, state government, federal government, banks and financial institution and the private sectors. The concept of AIM is to create out of the hardcore poor households, highly motivated individuals who are committed to earn an honest living and eventually move out of the poverty level. The strategies are by giving out to borrowers interest free loans to undertake income generating projects. The loans are to be repaid on a weekly basis. Once fully paid, bigger loans are being offered. This process goes on as the needs arise. The first loan is normally restricted to RM1,000 (USD1,315) or even up to RM10,000 (USD2,2631).

By following the Grameen Bank's model, poor borrowers in Malaysia also formed themselves into group of five who in turn guaranteed each others loans. These households will undergo a one week compulsory training of one hour per day to understand their rights and obligations in order to ensure good repayment. Loans products that AIM currently offers to its members are as following (*Refer to Figure 2 in Appendix*):

I. Ikhtiar Loan Scheme 1 (Skim Pembiayaan Ikhtiar 1-SPI 1)

- II. Ikhtiar Loan Scheme 2 (Skim Pembiayaan Ikhtiar 2-SPI 2)
- III. Ikhtiar Loan Scheme 3 (Skim Pembiayaan Ikhtiar 3-SPI 3)
- IV. Single Mother Loan Scheme (Skim Ibu Tunggal - SKIT)

In addition, special Education loan Scheme up to RM1, 000 (USD263) with maximum loan period up to 50 weeks, and special housing Loan Scheme up to RM5, 000 (USD1, 315) with maximum repayment period up to 100 weeks are available to borrowers with good repayment record. As at August 2003, AIM has an outstanding loans balance of about RM130 million (USD34.2 million). From its inception in 1987, the loans programs have benefited more than 120, 000 members. The existing members now stand at about 89, 000. Based on the figures of 150, 000 (two-third) of poor households targeted by AIM, it has successfully made an outreach of about 80 percent in term of the number of poor households it has targeted in Malaysia. AIM uses special means test to identify eligibility of its potential clients. It is based on conditions of the house and monthly households income of not more than USD66 (1986-1994), USD75 (1995-2000) and USD90 (2001). Priority of AIM loans will be given to the poorest among the poor. AIM has set up requirements to ensure that the poor has access to the credit programs. These requirements are:

- a) Suitable loan condition (no collateral, no guarantor and no legal action)
- b) Credit is taken to the very poor, to their village
- c) Simple procedures, compulsory group training and oral test on understanding of rules and regulations.
- d) Formation of groups by potential members (five members in a group, equal socio-economic status, create right peer pressure and peer support)
- e) Collective responsibility, group and centre accept collective responsibility
- f) Small loan and weekly repayment
- g) Loan for income generation
- h) Close supervision by field staff in centre meeting and loan monitoring
- i) Availability of subsequent loan
- j) Open conduct of all business at centre meeting

Efficient and effective operational staffs are required to deliver a well done job. Rigorous and practical training are conducted with a basic training for six months and probation period of 12

months. The training period is divided into three phases and trainees must pass each phase before being offered as AIM probation staff. All staff must have good understanding of AIM rules and procedures. AIM has the support from both the federal government and also from the state government. Grants and soft loans are given to support its operational and administrative costs. AIM also has close linkages with government agencies and they have been supporting its branches and regional offices by organizing together programs and workshops for its members and their families.

Table 1: Numbers and Amount Finance (1998-2002)

	1998	1999	2000	2001	2002
Number	42, 668	39, 600	46, 451	55, 067	57, 290
Amount (RM)	102, 685, 700	82, 980, 990	107, 247, 260	128, 126, 650	140, 712, 480
Sahabat Members	56, 557	60, 815	69, 017	79, 492	87, 438

Note: "Sahabat Members" refer to the member who borrow micro loan from AIM.

Source: Ahmad, I. (n.d.). *Current Situation of Microfinance in Malaysia and Its Issues*. Agricultural Bank of Malaysia.

Refer to Table 1, total amount of loans being disbursed were RM102.6 million in 1998, decreasing to RM82.9 million in 1999 and with an upward trend up to 2002 amounted to RM140.7 million. Sahabat members increased nearly double from 1998 to 2002. From its inception, AIM has a cumulative disbursement of more than RM800 million (USD210.5 million) loans to its members. AIM still has good collection rate of about 96% (2001: 96.5%, 2002: 95.5%, August 2003: 95.3%) from its loan programs. The set-back was due to the Single Mother Loan Scheme (SKIT) which contributes to its poor performance of collection of about 36% and also from fisherman Loan Scheme.

BPM has launched its Micro Credit Scheme (Pembiayaan Kredit Mikro) on the 3rd June 2003 after the announcement of the economic package by the Prime Minister on the 21 May 2003. The scheme starts with an initial capital injection of RM200 million from the government and will be increased to RM500 million when the fund for the scheme has been finally raised. The scheme is offered to small entrepreneurs in agriculture related projects in production, processing and marketing. Loan size is up to a maximum of RM20, 000 (USD5, 263) with an interest rate per annum and loan period of not more than 4 years. The applications from the public are very

encouraging. Up to October 2003, RM188.6 million (USD49.6 million) has been disbursed to the borrowers with a loan balance of RM174.1 million (USD45.8 million). It is still early to measure the performance of the scheme, although the collection rate that has been achieved to date is about 92%.

AIM still depends on the support from the government and related agencies for funding. With a fixed administrative charge of 4%, it does not cover its operating costs and could not be sustainable and self-dependent. John D. Conroy (2002) commented on his articles that AIM should re-looked back from its fundamental principles because of the loss of direction, not focusing on the not so poor or non poor and giving larger loans and better-off borrowers. With the recent management shakeout it is hopeful AIM will be succeeded by a period of stability and recovery. Further, as the number of poor households decreases, due to various governments' effort to reduce the poverty level to 0.5 percent in 2005, the outreach to new members will be limited. AIM could consider Sabah and Sarawak which shown a higher poverty level as its potential expansion of growth. In addition, there is another issue related to the effectiveness of microfinance in Malaysia. Microfinance really can reduce poverty level of all nations in Malaysia? In Malaysia, bumiputera always got the priority in every aspect, whereas other non-bumiputera will need to try hard in order to quit poverty situation and compete in the competitive market. Although AIM had modified Grameen Bank's microfinance concept in order to suit Malaysia market, however, AIM also can try to offer more variety of loans to the nations in order to fully cover and truly decrease the poverty level in Malaysia.

Whereas for BPM, the extension of loans with low interest rate (4%) will become an issue if the fund is not supported by grant or soft loan from the government. If BPM has to outsource its funding from the market, the government should be willing to come out with the differential margin for BPM to extend loans with low interest rate. Besides, the implementation of microcredit will put more burdens to BPM in term of operational costs. The scheme will increase credit risks due to it's relax condition of no collateral and guarantors. Besides, agriculture sector is differ from other sectors because it required higher start up capital in order to purchase needed equipments and machines to operate and run its business. In this case, the lowest loans that BPM can offer will be higher compared to other microfinance institutions. Thus, it will indirectly increase burdens to BPM and it also risky from financial perspective.

Conclusion

In conclusion, the official policy of subsidizing of microfinance was appropriate in circumstances of Malaysia. It would still be appropriate given the relatively small number of hardcore poor and the poor outside the financial sector getting access to credit and financial services. AIM has made a great success in reaching the poorest of the poor complementary to the government effort to eradicate poverty. For BPM it's too early to make any judgment from the microcredit scheme that has been launched. The future of microfinance institutions in Malaysia to survive will depend on whether they could be sustainable and dependent. It would be possible for microfinance institutions in Malaysia becoming financially sustainable if they could improve their administrative and operational capacity, increase the availability of capital on-lending and extending loans with competitive market rate.

Appendix

Figure 1: The "Sixteen Decisions"

1. We shall follow and advance the four principles of Grameen Bank: Discipline, Unity, Courage and Hard work- in all walks of our life.
2. Prosperity we shall bring to our families.
3. We shall not live in dilapidated houses. We shall repair our houses and work towards constructing new houses at the earliest.
4. We shall grow vegetables all the year round. We shall eat plenty of them and sell the surplus
5. During the plantation seasons, we shall plants as many seedlings as possible.
6. We shall plan to keep our families small. We shall minimize our expenditures. We shall look after our health.
7. We shall educate our children and ensure that they can earn to pay for their education.
8. We shall always keep our children and the environment clean.
9. We shall built and use pit-latrines.
10. We shall drink water from tubewells. If it is not available, we shall boil water or use alum.

11. We shall not take any dowry at our son's weddings; neither shall we give any dowry at our daughter's wedding. We shall keep our centre free from the curse of dowry. We shall not practice child marriage.
12. We shall not inflict any injustice on anyone; neither shall we allow anyone to do so.
13. We shall collectively undertake bigger investments for higher incomes.
14. We shall always be ready to help each other. If anyone is in difficulty, we shall all help him or her.
15. If we come to know of any breach of discipline in any centre, we shall all go there and help restore discipline.
16. We shall take part in all social activities collectively.

Source: Grameen Communications (1998)

Figure 2: Loans products of AIM

I. Ikhtiar Loan Scheme 1 (Skim Pembiayaan Ikhtiar 1-SPI 1)

SPI 1 provided loans to poor households with average monthly income of not more than RM340 (USD89) or two third of poverty line income. Initial loans are up for a maximum of RM1, 000 (USD263), increasing to RM2, 000 (USD526), RM3, 000 (USD789), RM4, 000 (USD1, 052) and RM4,900 (USD 1, 289). The loan repayment period is between 50 weeks to 100 weeks.

II. Ikhtiar Loan Scheme 2 (Skim Pembiayaan Ikhtiar 2-SPI 2)

SPI 2 loan scheme provides loans between RM5, 000 (USD1, 315) to RM9, 900 (USD2, 605) to borrowers who have made good repayment from the previous two loans and having a monthly income exceeding RM600 (USD158). The repayment period of the loan is between 50 to 150 weeks.

III. Ikhtiar Loan Scheme 3 (Skim Pembiayaan Ikhtiar 3-SPI 3)

SPI 3 provides loans up to RM10, 000 (USD2, 631) to borrowers with good track record with perfect repayment for at least 2 times (SPI 1) or SPI 2 and having a monthly income exceeding RM1, 000 (USD263). The loan could be repaid up to a maximum of 150 weeks.

IV. Single Mother Loan Scheme (Skim Ibu Tunggal - SKIT)

SKIT provides loans to single mothers living in town areas. The aims of the scheme are to increase the living standard of single mothers and motivate them to undertake stable economic activities to support the family. Eligibility for the loans depends on the household earnings and varies within states. Household earnings for those living in Kuala Lumpur and Johore must not exceed RM1, 200 (USD315); Selangor, Malacca and Negeri Sembilan RM800 (USD210) per month; Kelantan, Terengganu and Kedah RM425 (USD111) per month; and Perak RM600 (USD157) per month.

[Source: Ahmad, I. (n.d.)]

DEVELOPMENT OF MICROFINANCE IN MALAYSIA AND ITS DILEMMA

Chew Cheng En
Khor Chueng Yen

Introduction

Microfinance has been originated often as late as the as the 1950s. It has been on it's route to progress only did any programmes came out to meet to the two main criteria which is people can be relied to repay their loans and it is possible to provide financial services to poor people through market-based enterprises without subsidy. The two criteria stated above have ultimately gave the pioneers a good reason to continue and proceed with their thoughts. Concept of micro finance is in need of meeting special goal to empower low-classes of society, women, and poor. The principles of micro finance are founded on the philosophy of cooperation and its central values of equality, equity and mutual self-help. At the heart of these principles are the concept of human development and the brotherhood of man expressed through people working together to achieve a better life for themselves and their children (Sapovadia, 2005).

Microfinance typically means the practice of providing financial services such as credits, savings, and insurance to the poor. The practice of microfinance is by all means trying to accumulate useably sums of money which may then expands the choices for the poor as well as serving as a risk reduction option to the poor. In microfinance, most transaction involves amounts of money which is lower than US\$ 100 suggested by the name. Microfinance around the world shows that poor people with little education are reliable borrowers. They will invest wisely and are willing to save if given the chance. Experience has shown that women are the best borrowers and are better at repaying their loans. In the public eye, and according to many analysts, microfinance is a successful policy. The microfinance industry now has global outreach, with more than 92 million clients reported in developing countries. It is very difficult to find a Poverty Reduction Strategy that does not include microfinance as an element of national development stated by David Hulme and Karen Moore (2006).

Microfinance in Malaysia

Microfinance has not been anything new in Malaysia after all. It has been actively operated by credit unions, co-operative banks and specialised credit windows of banks. Microfinance in Malaysia provides service of financial credit that may range up to about RM10,000 (USD2,631)

and mostly being aimed to finance small businesses, agricultural loans and loans for poverty reduction. In Malaysia, the credit range is 26 times higher due to our very own economic aspect e.g: larger sum of money needed to start a small business and funds available to be borrowed is plenty while the poor applying for access of microfinance is at a relative low call. In Malaysia, *Majlis Amanah Rakyat* (MARA), council of trust to the Bumiputera and Credit Guarantee Corporation (CGC) are some of the pioneers to introduce microfinance loans to its borrowers. The rural credit institutions comprise of Agriculture Bank of Malaysia (BPM), Farmers Organisation Authority (LPP), Federal Land Development Authority (FELDA), and agro-based Co-operative Societies provide micro credit for the agriculture sectors. There are also a number of non-government organisations (NGOs) that engaged in microfinance which comprise of Yayasan Usaha Maju operating in Sabah, Koperasi Kredit Rakyat in Selangor, Tabung Ekonomi Kumpulan Usaha Niaga (TEKUN) and the best and significantly known microfinance institution (MFI) is Amanah Ikhtiar Malaysia (AIM).

On May 21, 2003 under the economic package announced by the Government, the government has aimed to generate economic activities by mobilising domestic sources of growth while reducing the country dependence on the external sector. Agriculture Bank of Malaysia (BPM) is given the allocation of RM500 million (USD 132 million) and National Savings Bank (BSN), the allocation of RM300 million (USD79 million) to carry out their respective micro credit programmes. The loan programmes was meant to give loans to individuals and small enterprises who do not qualify for existing bank products due to the lack of good collateral/guarantors or in short lack of good profile. The loans are given based on the projects cash flow and any criteria that may arise.

Legal Environment of Malaysia on Microfinance

According to the World Bank, in Malaysia, it takes 31 procedures and 300 days from the time a plaintiff files a lawsuit to when he or she is actually compensated. The cost of funding contracts in terms of legal and court fees reaches 20% of debt value. Filing bankruptcy takes about 2.3 years with a cost of 18% of estate value. The recovery rate for creditors in Malaysia is 35%.

According to the Director of Development Finance of Bank Negara Malaysia, Che Zakiah Che Din (2004), legislation for microfinance regulation includes: *Moneylender Act*, *Banking and Financial Institutions Act*, *Development Financial Institutions Act 2002*, and *Cooperatives*

Societies Act 1993. A financial entity must obtain licenses from the government in order to conduct money lending business and to carry out banking business. Furthermore, according to the book, "Getting the Framework Right: Policy and Regulation for Microfinance in Asia," written by Paul B. McGuire, John D. Conroy and Ganesh B. Thapa, NGOs are generally not allowed to make loans or take deposits. However, they can provide microfinance services by obtaining an exemption from the Minister of Housing and Local Government based on the provisions of the *Moneylenders Act*. The exemption is on a one-off basis which generally lasts for a period of 3 to 4 years. Bank Negara has determined that NGOs can accept compulsory savings as long as these compulsory savings are put into a trust account and not used as funds to be loaned. McGuire, Conroy, and Thapa (1998) stated in their book that establishing a commercial bank requires minimum capital of US\$8 million and a capital adequacy ratio of 8% of risk-weighted assets in line with the Basle Accord. Also, commercial banks are required to keep a reserve of 13.5% of their net eligible liabilities in Bank Negara as an interest-free deposit. Interest rates are also regulated by Bank Negara. Microfinance institutions are not regulated on how much they can charge borrowers for interest.

According to Che Zakiah Che Din (2004), Bank Negara Malaysia initiated the Microfinance Project to strengthen the microfinance network by building necessary infrastructure for the development of microfinance in Malaysia. The project focuses on developing product specifications, policies and procedures for microfinance management, an organizational structure for microfinance institutions as well as a supervisory and regulatory framework for microfinance. Bank Negara aims to establish a guide and reference of standard best practices for development financial institutions and other MFIs. According to Arumugam Rajenthiran (2002), a fellow at the Institute of Southeast Asian Studies, *The Industrial Coordination Act 1975* and *The Promotion of Investment Act 1986* are designed to regulate foreign investment activities in Malaysia. There are restrictions on enterprise ownership by foreign citizens.

Microfinance Institutions (MFIs) and Commercial Banks' Involvement in Malaysia

According to the Foundation for Development Cooperation, the financial system in Malaysia is comprised of both private and public financial institutions. Public financial institutions include 7 development banks and the Credit Guarantee Corporation (CGC) which provides guarantees on lending by other financial institutions to the poor which is unreachable by the retail banking.

According to McGuire, Conroy & Thapa (1998) Bank Negara has three lending guidelines that require banks to lend to particular priority sectors of the economy which is as follows:

1. Commercial banks are required to provide loans totaling US\$400 million to small business that lack an established track record under the New Principal Guarantee Scheme of the CGC. Such loans are allocated to commercial banks based on their assets, capital bases, and other criteria.
2. At least 50% of the total loans allocation of each bank must be provided to Bumiputera.
3. Individual loans under the scheme must be less than US\$200,000 and are partially guaranteed by the CGC.

In addition to providing small business loans, commercial banks are involved in microfinance through extending credit lines to Amanah Ikhtiar Malaysia (AIM) and as a conduit for schemes such as the loan fund for hawkers and petty traders operated by the Credit Guarantee Corporation (CGC). Some banks have small programs for individual lending to poor borrowers. The poorest of the poor are given priority for AIM loans. As a result, AIM has established an eligibility test for its potential clients based on factors such as the condition of their homes and monthly household income. In order to qualify for AIM loans, the potential borrower has to meet up to the requirement as stated below:

- (a) Suitable loan condition (no collateral, no guarantor and no legal action)
- (b) Credit is taken to the very poor, to their village
- (c) Simple procedures, compulsory group training and oral test on understanding of rules and regulations
- (d) Formation of groups by potential members (five members in a group, equal socio economic status, create right peer pressure and peer support)
- (e) Collective responsibility, group and centre accept collective responsibility
- (f) Small loan and weekly repayment
- (g) Loan for income generation
- (h) Close supervision by field staff in centre meeting and loan monitoring

- (i) Availability of subsequent loan
- (j) Open conduct of all business at centre meeting.
- (k) Individual's monthly household income must not be more than

USD66 - RM 250 (1986-1994)

USD75 - RM 280 (1995-2000)

USD90 - RM 340 (2001)

* subject to conversion of (reminded to revise according to particular year EX)

Tabung Ekonomi Kumpulan Usaha Niaga (TEKUN) is another NGO that is actively involved in microfinance in Malaysia. TEKUN is specialized in providing small loans to micro-enterprises of Bumiputera. Like AIM, TEKUN's operation is also mainly financed by the government. It provides simple loan processing without collateral. It also closely monitors accounts, imposes frequent repayment (every fortnight), and requires compulsory savings (0.5% of loan amount per week). Total loans disbursed by TEKUN amounted to US\$96 million as of December 2003. Che Zakiah Che Din (2004) reports that a micro credit scheme was launched in May 2003 by the Malaysian government to enhance micro-enterprises' access to financial supports. Two development financial institutions, Bank Pertanian Malaysia (the Malaysian Agriculture Bank) and Bank Simpanan Nasional (the National Savings Bank), are mandated to implement this micro-credit scheme. The scheme is collateral-free and borrowers are eligible for loans of up to US\$5,263 with interest rates at 4% per annum for a period of no more than 4 years. At the end of 2003, total loans disbursed amounted to US \$164 million.

One important feature of the banking system in Malaysia is Islamic banks. According to the Bank Negara Malaysia, charging interest is not allowed in Islamic banks based on the rules of Syariah, known as Fiqh al-Muamalat (Islamic rules on transactions). Instead of charging interest to borrowers, Islamic banks use a profit sharing mechanism. Other common Islamic banking concepts include safekeeping (Wadiah), joint venture (Musyarakah), cost plus (Murabahah), and leasing (Ljarah). Two Islamic banks, thirteen commercial banks, and seven financial companies provide Islamic banking products and services. According to the Global Development Research Center, CASHPOR Inc., based in Malaysia, is a network of 22 Grameen Bank replications that work to reduce poverty in the Asia-Pacific region by providing financial services to poor women. This network was established in 1991 and it provides management training, quarterly monitoring, technical assistance, and information exchange services to its members.

Amanah Ikhtiar Malaysia: The Dominant Microfinance Institution

Malaysia's dominant MFI, Amanah Ikhtiar Malaysia (AIM), was established in 1987. Up to 1998 it made some 103,000 loans and disbursed a total of RM 328 million (\$86 million at the current exchange rate, considerably more if contemporary exchange rates are applied). Some 80 per cent or more of all funds loaned were for economic purposes, the remainder for 'social' purposes (Kasim, 2000). AIM's activities have been directed almost entirely to the alleviation of poverty among poor Malays.¹ It was set up with a charter 'to disburse small loans on reasonable terms exclusively to the very poor households to finance additional income generating activities but for all practical purposes has confined its attention to the Bumiputera, the indigenous (principally Malay) people.

Believing that while the national economics policy had successfully reduced the number of households in poverty, the persistence of hardcore poverty required a new approach, Amanah Ikhtiar Malaysia (AIM) adopted the Grameen Bank model whereby poor borrowers formed themselves into groups of five who in turn guaranteed each others loans. These households will undergo a one week compulsory training of one hour per day to understand their rights and obligations in order to ensure good repayment. However, the whole context was subject to some modifications to suit the Malaysian context. An official survey in 1989 indicated that some 94,600 households, or 2.2 percent of the total population, were classified as 'hard core poor', with incomes below half the level of the official poverty line. The indigenous Malay community was disproportionately represented among these poor households. AIM, intent on targeting the poorest among the poor, used the official periodic Household Income Survey as a guide and developed its own means test to identify the hardcore category.

By August 1994, AIM had some 6,100 Grameen groups in operation with a total membership approaching 30,000 borrowers. Assuming that its procedures to identify the poor were both effective and consistently applied, this is quite impressive coverage of the target population, achieved in seven years. As discussed below, outreach might have been higher, but for political interference. Total loans disbursed to that time amounted to RM37.9 million (\$14.8 million) and, reflecting the relative priorities accorded savings and credit, total savings were \$1.8 million. Some 28 per cent of lending was for agriculture, 46 per cent for trade, 15 per cent for animal husbandry and 10 per cent for other activities (Conroy, Taylor & Thapa, 1995).

In Malaysia, because of the sensitivities of its Muslim clients and sponsors, AIM levied 'service charges' on loans rather than interest expressed in percentage terms. If calculated as interest on the principal involved, however, these charges were well below rates in the Malaysian commercial banking sector. For example, the average loan size for borrowers taking a third loan in 1994 was RM1,044 (\$427) for which the service charge equated to around 4.7 percent flat over the usual one year loan term. Service charges on larger loans were somewhat higher in percentage terms, but these were only a small proportion of total advances; for all classes of loans service charges covered only a portion of AIM's lending costs (Conroy, Taylor & Thapa, 1995). Some 60 per cent of AIM's operational costs between 1989 and 1995 were covered by Malaysian Government grant, while the state governments granted additional support of up to 40 per cent annually. In consequence of AIM had limited stimulus to strive for self-sufficiency in its early years (McGuire, Conroy & Thapa, 1998). Loan capital was provided by central government grants, supplemented by soft loans from CGC and some commercial banks, especially those with majority government shareholding.

However, from 1992 a constraint on expansion of outreach is being operated due to a government decision to channel a grant of \$7.3 million intended for loan capital over the period 1991 to 1995 through Yayasan Pembangunan Ekonomi Islam Malaysia (YPEIM), an Islamic foundation. YPEIM, however, decided to program the disbursement over a much longer period, a decision which according to a recent evaluation of AIM's program caused a serious cash flow problem and undermined AIM's plans for expansion and the achievement of viability (Kasim, 2000).

A Loss of Direction in Microfinance

Soft loan financing has tided AIM over cash flow difficulties since 1992, and indeed permitted or more or less forced for an increase in loan ceilings from 1994, after the departure of David Gibbons and Sukor Kasim from AIM in 1993 and resignation from its Board in 1994. According to the evaluation, the average loan size jumped by 400 percent between 1994 and 1998, and this was accompanied by an increase in portfolio at risk (Kasim, 2000). AIM's expansion from 1994, at which time it had reached some 50 per cent of its target group in Peninsular Malaysia (Kasim, 2000) appears to have been more in terms of value of loans outstanding than increased outreach to the hardcore poor. The evaluation notes that the restoration by central government of loan

capital funding in 1997 sparked a further upward revision of loan ceilings, accompanied with a blowout in operational costs. An increase in numbers of 'drop outs' from the program, especially among poorer members, was noted from 1994 as loan sizes increased, a trend which accelerated from 1997. Over some reasonable evaluation of the condition, Sukor drew attention to leakage of loans to the 'not so poor' and the 'non poor'. It is vital for Amanah Ikhtiar Malaysia (AIM) to relay the message that their outreach is women who are at the bottom two-third of the poverty household level as the author uncovered that due to relaxation on means testing, the less poor and the non-poor are motivated to become AIM's members (Kasim, 2000). He is particularly critical of two loan programs introduced after 1997. The first was given the name 'SPIN'. The SPIN was directed to men in the fishing industry. The second was titled SP-IT, directed at 'Single Mothers' (female heads of households). Participants were offered an unprecedented high first loan of RM10,000 (\$2,650). With the diversion of AIM's attention to larger loans and better-off borrowers, the evaluator was also concerned about the implications of this development for credit discipline and portfolio quality.

Whether or not the inclusion of larger amount of borrowers is a problem, it is entirely a matter of perception that counts. Other microfinance institutions (MFIs) might do so to diversify risk and improve overall sustainability, but the evaluator takes the view that, in terms of AIM's charter, larger loans amount to 'mission drift'. And there may be particular political circumstances affecting the choices made for AIM. In the event, the admission of people to the program who are out of sympathy with its objectives has had a corrosive effect on sustainability. By the end of 1998, portfolio at risk (PAR) had risen to 3 per cent (Kasim, 2000), not too serious as an end-point but certainly a warning as a trend indicator. But by the end of 2000, the PAR of the whole AIM program with RM100 million outstanding had increased to 10 per cent, with SPIN at 60 per cent PAR and SP-IT at 36 per cent (Kasim, 2000). These are levels which indicate grave problems for the AIM program.

In 1997, AIM decided to break with its early practice by raising the interest rate on loans to a uniform 19 per cent. Not only was this a substantial increase, it also expressed borrowing cost as a percentage of principle for the first time. The evaluation suggests this accelerated the loss of poorer clients from the program, not just because an increase in costs would depress demand but because many of the poorest would find the interest charge unacceptable. While management's decision to increase charges is understandable, as being consistent with movement away from

subsidies and progress towards financial sustainability for AIM, it does raise an important issue in the particular circumstances of Malaysia. An earlier discussion of funding policy set in a comparative context (McGuire, Conroy & Thapa, 1998) made the judgment that the then official policy of subsidizing microfinance was appropriate in the circumstances of Malaysia. It would still be appropriate to do so now, given the relatively small numbers of the hardcore poor and the relative prosperity of Malaysia, provided that AIM settles on an objective set of targeting principles without hint of political considerations and concentrates on running a lean and cost effective operation. At the end of 1998 AIM had 40 branches and 6 Area offices serving some 39,000 borrowers and almost 56,000 members. The evaluation refers to the need for 'a major and expensive rehabilitation exercise'. The more recent trends in portfolio at risk appear to underline the correctness of this judgment.

Inefficiency of Microfinance in Malaysia

In East Malaysia's Sabah state, for example, the Yayasan Usaha Maju microfinance program grew too fast. Last year, the program lent out some \$10.7 million in loans to 12,732 borrowers. But interest income on those loans was only \$115,000 and operating costs were over \$1.2 million. The program is now faced with cutting the number of branch offices by half. As mentioned above, AIM has increasingly focused on providing larger-sized and higher-interest loans and serving non-'hard core poor'. Two loan programs introduced after 1997 illustrated this point. The first was given the name 'SPIN'. The SPIN program targeted men in the fishing industry. The second was titled SP-IT, for 'Single Mothers' (female heads of households). Participants were offered an unprecedentedly high first loan of RM10,000 (US\$ 2,650). With the diversion of AIM's attention to larger loans and better-off borrowers, the evaluator was also concerned about the implications of this development for credit discipline and portfolio quality with SPIN at 60 per cent PAR and SP-IT at 36 per cent. These are levels which indicate grave problems for the AIM program.

Very clear that the problem face by Malaysia microfinance is the microfinance objective is to borrow out money to the poor or to develop the undevelopment industry but because of the fear of bad debt so microfinance bank will increase the requirement of borrowing so at the end this is will lead the bank to away from their objective. So microfinance have to headache of how to have a balance between their objective and profit.

Conclusion

Microfinance has been in Malaysia for decades. Throughout the few decades, Malaysia has seen to show progress in the development of microfinance to reduce poverty. More and more microfinance institutions has seem to appear accordingly due to the needs for it as well as substantial supports towards microfinance institution no matter at the economic, social or even politics viewpoint. Microfinance has been also once shown profitable therefore stimulating growth in microfinance. Microfinance institutions have also believed to made great success in reaching the poorest of the poor in order to complement to the government's effort to eradicate poverty. However, microfinance has shown that its effectiveness to reduce poverty as well as its ability to sustain itself has been a problem in the late 1990s. Microfinance institutions in Malaysia have been obtaining grants repeatedly and yet still fails to be independent after decades of operation. It reflects that the microfinance institutions itself is either inefficient or give out loans without proper consideration or even worse, both.

Microfinance faced downturn mainly due to certain parties seem to misuse the funds allocated for the poor. In another word, the microfinance institutions have failed to direct the funds towards their targeted clients. The failure is mainly due to the reason that internal officers are affected by political issues in approving loans leading to various problems such as increase in ineffective loans and default in loans. Political influences in microfinance institutions also drift the aim of targeting poorer clients to those who are not poor enough to obtain services under microfinance institutions.

The future of microfinance institutions in Malaysia to sustain will ultimately depend on whether they could be independent from government's grants and subsidies. It could be possible if these institutions improve their operational capacity and administrative cost as well as increasing the availability of capital on-lending and extending loans with competitive market rate.

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