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STATE INCOME DISPARITY IN RELATION TO NATIONAL DEVELOPMENT PLANS IN MALAYSIA

SIVABALASINGAM VEERASINGAM

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STATE INCOME DISPARITY IN RELATION TO NATIONAL DEVELOPMENT PLANS IN MALAYSIA

SIVABALASINGAM VEERASINGAM

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UNIVERSITI PUTRA MALAYSIA

2007

STATE INCOME DISPARITY IN RELATION TO NATIONAL DEVELOPMENT PLANS IN MALAYSIA

By

SIVABALASINGAM VEERASINGAM

Thesis Submitted to the School of Graduate Studies, Universiti Putra Malaysia, in Fulfilment of the Requirements for the Degree of Doctor of Philosophy

June 2007

UPM

DEDICATION

This work is dedicated,

To the memories of my late brother, Dr V. Kulasingam who passed away while I was reading for this degree. I remain indebted and continue to miss him,

To my late parents for their love, wisdom and sacrifices,

To my beloved wife Thakshajini Panchanathan and loving daughter Tvisha. May the pursuit of goodness be their ultimate objective in life.

Abstract of thesis presented to the Senate of Universiti Putra Malaysia in fulfilment of the requirement for the degree of Doctor of Philosophy

STATE INCOME DISPARITY IN RELATION TO NATIONAL DEVELOPMENT PLANS IN MALAYSIA

By

SIVABALASINGAM VEERASINGAM

June 2007

Chairman: **Professor Muzafar Shah Habibullah, PhD**

Faculty: **Economics and Management**

Malaysia envisaged of bringing the low-income states to the general income level by 1985 (First Malaysia Plan, 1965). However, after 49 years of independence and equivalent years of economic planning, the national agenda of bridging the income divide across states in Malaysia remains an unresolved issue. This study is designed to address the question why for the last four decades and with nine National Development Planning programmes should substantial state income disparities be of great concern to the public, politicians and the academic circle.

In tandem with the general objective, we examined whether poor states in Malaysia are growing faster than rich states (β-convergence). In consonance with our comparative and non-parametric results, we find no econometric evidence to support β-convergence in Malaysia. In addition, an examination on sigma convergence, namely the tendency for cross-sectional dispersion of real per capita income to decline over time suggests that the dispersion in income across states in Malaysia has in fact widened. Our results also indicate that the strategies in the Third Malaysia

Plan were the most effective while the rest did not meet their intended target of reducing the income divide across states in Malaysia. We also find evidence to suggest that the rising income inequality is not a common phenomenon but mainly due to greater variation in real per capita income between Kelantan, Kedah, Perlis, Pahang and Sabah and the rest of the states in the country. A growth model based on the System Generalized Method of Moments technique suggest that investment has a positive impact, while agriculture sector and population growth rate has a negative impact on income growth.

Given these findings, we conclude that despite 49 years of independence and equivalent years of economic planning, the national agenda of bridging the income divide between the low and high-income states, in particular between Kelantan, Kedah, Perlis, Pahang and Sabah and the more developed states in the country did not materialise. This failure is largely associated to the ineffectiveness of the national regional policy. To mitigate the income divide across states in the country, greater industrial and investment activities are humbly recommended.

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Last but not least, I am very grateful to my wife, Thakshajini Panchanathan for her patience, especially for tolerating the vacuum I created during the period of this study. I thank her for enabling me to accomplish my life long dream.

DECLARATION

I hereby declare that the thesis is based on my original work except for quotations and citations which have been duly acknowledged. I also declare that it has not been previously or concurrently submitted for any other degree at UPM or other institutions.

_____

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Date: 22 DECEMBER 2006

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TABLE OF CONTENTS

		Page
DEDICATION		ii
ABSTRACT		iii
ABSTRAK		v
ACKNOWLEDGEMENTS		vii
APPROVAL		viii
DECLARATION		x
LIST OF TABLES		xiv
LIST OF FIGURES		xvii
LIST OF ABBREVIATIONS		xix
CHAPTER		
1	**INTRODUCTION**	1
	1.1 Background	1
	1.2 Statement of the Problem	7
	1.3 Objectives of the Study	20
	1.4 Significance of the Study	21
	1.5 Organization of the Study	23
2	**POLICY ISSUES AND CURRENT ECONOMIC SCENARIO**	24
	2.1 Introduction	24
	2.2 Geographical Location and Political System	24
	2.3 Issues and Policy Measures	25
	2.3.1 Diversification	25
	2.3.2 Economic Growth	32
	2.3.3 Poverty	34
	2.3.4 Unemployment	37
	2.3.5 Inflation	39
	2.3.6 Ethnic Economic Imbalance	41
	2.3.7 Regional Development	44
	2.4 Current Economic Scenario	47
	2.5 Background of the States in the Federation	54
	2.5.1 Johor	55
	2.5.2 Perak	56
	2.5.3 Pulau Pinang	56
	2.5.4 Melaka	57
	2.5.5 Negeri Sembilan	57
	2.5.6 Selangor	58
	2.5.7 Kuala Lumpur	58
	2.5.8 Kedah	60
	2.5.9 Kelantan	60

	2.5.10	Pahang	61
	2.5.11	Perlis	61
	2.5.12	Terengganu	62
	2.5.13	Sabah	62
	2.5.14	Sarawak	63
2.6		Conclusion	64
3	**LITERATURE REVIEW**		65
3.1		Introduction	65
3.2		Alternative Theories	65
3.3		Empirical Evidence	68
	3.3.1	Non-Parametric Approach	68
	3.3.2	Cross Section Evidence	74
	3.3.3	Time Series Evidence	85
	3.3.4	Panel Data Evidence	100
3.4		Conclusion	113
4	**THEORETICAL FRAMEWORK**		122
4.1		Introduction	122
4.2		The Solow-Swan (Neoclassical) Growth Theory	123
	4.2.1	Allowing for Depreciation	130
	4.2.2	Implications of the Neoclassical Model	131
	4.2.3	Convergence Hypothesis	133
	4.2.4	Absolute Convergence	133
	4.2.5	Conditional Convergence	135
	4.2.6	Adding Technical Progress	136
4.3		Conclusion	141
5	**METHODOLOGY**		143
5.1		Introduction	143
5.2		The Test for Convergence	143
5.3		β-Convergence Test	150
5.4		σ- Convergence Test	154
5.5		Effectiveness of Malaysia's Five-Year Development Plans	155
5.6		States Contributing to the Growing Disparity in Per Capita Income	157
5.7		Factors Affecting Per Capita Income Growth Across States in Malaysia	158
5.8		Data	164
5.9		Conclusion	165
6	**RESULTS OF EMPIRICAL ANALYSIS**		166
6.1		Introduction	166
6.2		Results of Empirical Analysis on Beta and Sigma Convergence in Malaysia	166
	6.2.1	Comparative Analysis of β-Convergence	167
	6.2.2	Non-Parametric Analysis of β-Convergence	173

		6.2.3 Parametric Analysis of β-Convergence	175
		6.2.4 σ-Convergence	177
	6.3	Results of Empirical Analysis on the Effectiveness of Five Year Malaysia Plans	179
		6.3.1 Comparative Analysis	180
		6.3.2 Non-Parametric Analysis	182
		6.3.3 Parametric Analysis	191
		6.3.4 σ-Convergence	195
		6.3.5 Reasons for σ- and β-Convergence during the Third Malaysia Plan Period	195
	6.4	Results of Empirical Analysis on States Contributing to the Growing Disparity in Income	196
		6.4.1 Comparative Analysis	197
		6.4.2 Non-Parametric Analysis	198
	6.5	Factors Affecting Growth Across States in Malaysia	205
		6.5.1 A Review of the Estimation Technique	206
		6.5.2 Empirical Results	211
	6.6	Conclusion	216
7	**SUMMARY, POLICY IMPLICATIONS AND FURTHER RESEARCH**		221
	7.1	Introduction	221
	7.2	Summary of Research Findings	222
	7.3	Policy Implications	226
	7.4	Limitations	232
	7.5	Future Research	233
	7.6	Conclusion	235
REFERENCES			236
APPENDIX			246
BIODATA OF THE AUTHOR			253

LIST OF TABLES

Table		Page
1.1	GDP Growth of ASEAN-5 (Annual Average Percentage Growth)	6
1.2	Summary of World Output (Annual Average Percentage Growth)	6
1.3	Unemployment Rate in ASEAN-5 (Annual Average)	6
1.4	Summary of Inflation in ASEAN-5 (Annual Average Percentage Change)	7
1.5	Summary of World Inflation Rate (Annual Average Percentage Change)	7
1.6	State GDP as a Percentage of National GDP	12
1.7	State Per Capita GDP as a Percentage of National Per Capita GDP	16
2.1	GDP by Kind of Activity at Constant Prices (Percentage Share of GDP)	48
2.2	External Trade – Exports by Commodity Section	49
2.3	Summary of Economic Information	52
2.4	GDP Growth and Per Capita GDP of More Developed States	55
2.5	GDP Growth and Per Capita GDP of Less Developed States	59
3.1	Summary of Convergence Studies	116
6.1	Cross-State Real Per Capita GDP for Malaysia (1987 Prices)	168
6.2	Cross-State Real Per Capita GDP Growth Rate	168
6.3	Per Capita GDP Growth Performance between Poor and Rich States	171
6.4	Number of Points for Log of Initial Level of Real Per Capita GDP (1970) and Annualized Growth Rate of Real Per Capita GDP (1971-2005)	174

6.5	Correlation Coefficient Matrix	175
6.6	Cross-State Real Per Capita GDP Regressions for Malaysia	177
6.7	Standard Deviation of the Log of Per Capita Income	178
6.8	Real Per Capita GDP Growth Rates during Malaysia Plan Periods	181
6.9	A Summary of Income Growth Performance between Relatively Poor and Rich States	182
6.10	Number of Points for Log of Initial Level of Real Per Capita GDP (1970) and Annualized Growth Rate of Real Per Capita GDP (1971-1975)	184
6.11	Number of Points for Log of Initial Level of Real Per Capita GDP (1975) and Annualized Growth Rate of Real Per Capita GDP (1976-1980)	185
6.12	Number of Points for Log of Initial Level of Real Per Capita GDP (1980) and Annualized Growth Rate of Real Per Capita GDP (1981-1985)	186
6.13	Number of Points for Log of Initial Level of Real Per Capita GDP (1985) and Annualized Growth Rate of Real Per Capita GDP (1986-1990)	187
6.14	Number of Points for Log of Initial Level of Real Per Capita GDP (1990) and Annualized Growth Rate of Real Per Capita GDP (1991-1995)	188
6.15	Number of Points for Log of Initial Level of Real Per Capita GDP (1995) and Annualized Growth Rate of Real Per Capita GDP (1996-2000)	189
6.16	Number of Points for Log of Initial Level of Real Per Capita GDP (2000) and Annualized Growth Rate of Real Per Capita GDP (2001-2005)	190
6.17	Coefficient of Correlation between Log of Initial Level of Real Per Capita GDP and Annualized Growth Rate of Real Per Capita GDP	191
6.18	Cross State Real Per Capita GDP Regressions for States in Malaysia during Different Five-Year Malaysia Plan Period	193
6.19	A Summary of Income Growth Performance between Relatively Poor and Rich states (1970-2005)	198

6.20	Coefficient of Variation for Log of Real Per Capita GDP	199
6.21	Theil Entropy Indices for 14 and 9 States (1970-2005)	202
6.22	Gini Coefficient for 14 and 9 States (1970-2005)	205
6.23	Cross-State Regressions for Malaysia's Real Per Capita GDP (1970-2005)	213
7.1	Proportion of Agriculture Output to Total GDP (1970-2005)	229
7.2	Proportion of Investment to Total Investment by States (1975-2000)	231

LIST OF FIGURES

Figure		Page
1.1	Total Real GDP of More Developed and Less Developed States	13
1.2	Difference in Real GDP Between Selangor and Other More Developed States	14
1.3	Difference in Real GDP Between Sarawak and Other Less Developed States	15
1.4	Real Per Capita GDP of More and Less Developed States	17
1.5	Difference in Real Per Capita GDP Between Kuala Lumpur and Other More Developed States	18
1.6	Difference in Real Per Capita GDP Between Terengganu and Other Less Developed States	19
4.1	Intensive Production Function	126
4.2	Steady-State Growth	128
4.3	The Solow-Swan Phase Diagram	129
4.4	Steady-State Growth with Depreciation	130
4.5	A Rise in Population Growth Rate	132
4.6	Changing the Savings Rate	133
4.7	Absolute Convergence	134
4.8	Conditional Convergence	135
4.9	Technical Progress	137
4.10	Growth with Harrod-Neutral Technical Progress	141
6.1	Per Capita Growth Rate Versus Initial Per Capita GDP Relative to Malaysia	172
6.2	Cross Plot of Annualized Growth Rate of Real Per Capita GDP (1971-2005) on Log of Initial Level of Real Per Capita GDP (1970)	173
6.3	Sigma Convergence in Malaysia	179

6.4	Cross Plot of Annualized Growth Rate of Real Per Capita GDP (1971-1975) on Log of Initial Level of Real Per Capita GDP (1970)	183
6.5	Cross Plot of Annualized Growth Rate of Real Per Capita GDP (1976-1980) on Log of Initial Level of Real Per Capita GDP (1975)	184
6.6	Cross Plot of Annualized Growth Rate of Real Per Capita GDP (1981-1985) on Log of Initial Level of Real Per Capita GDP (1980)	185
6.7	Cross Plot of Annualized Growth Rate of Real Per Capita GDP (1986-1990) on Log of Initial Level of Real Per Capita GDP (1985)	186
6.8	Cross Plot of Annualized Growth Rate of Real Per Capita GDP (1991-1995) on Log of Initial Level of Real Per Capita GDP (1990)	187
6.9	Cross Plot of Annualized Growth Rate of Real Per Capita GDP (1996-2000) on Log of Initial Level of Real Per Capita GDP (1995)	188
6.10	Cross Plot of Annualized Growth Rate of Real Per Capita GDP (2001-2005) on Log of Initial Level of Real Per Capita GDP (2000)	189
6.11	Sigma Convergence for 14 and 9 States	200
6.12	Trends in Theil Entropy Index for 14 and 9 States (1970-2005)	202
6.13	Trends in Theil Second Measure for 14 and 9 States (1970-2005)	203
6.14	Trends in Gini Coefficient for 14 and 9 States (1970-2005)	204

LIST OF ABBREVIATIONS

APEC	Asia Pacific Economic Cooperation
ARMA	Auto Regressive and Moving Average
ASEAN	Association of Southeast Asian Nations
BIMP-EAGA	Brunei Darussalam-Indonesia-Malaysia-Philippines East ASEAN Growth Area
BPMB	Bank Pembangunan Malaysia Berhad
COMECON	Council for Mutual Economic Assistance
CPI	Consumer Price Index
CSTCI	Country Specific Technical Change Index
EU	European Union
GDP	Gross Domestic Product
GLCs	Government Linked Companies
GMM	Generalized Method of Moments
GNI	Gross National Income
GNP	Gross National Product
GPP	Gross Provincial Product
HICOM	Heavy Industries Corporation of Malaysia Berhad
IMD	The Institute for Management Development
IMT-GT	Indonesia-Malaysia-Thailand Growth Triangle
JDS	Joint Development Strategy for Border Areas
KKMB	Kompleks Kewangan Malaysia Berhad
LAFTA	Latin American Free Trade Area
MARA	Majlis Amanah Rakyat
MEXPO	Malaysian Export Trade Centre

MIDA	Malaysian Industrial Development Authority
MIDFL	Malaysian Industrial Development Finance Limited
MITI	Ministry of International Trade and Industry
NEP	New Economic Policy
NGOs	Non-Governmental Organizations
OECD	Organization for Economic Cooperation and Development
OLS	Ordinary Least Squares
PERNAS	Perbadanan Nasional
PNB	Pelaburan Nasional Berhad
PPRT	Development Programs for the Poorest
R&D	Research and Development
SMEs	Small and Medium Size Industries
SPKR	Skim Pembangunan Kesejahteraan Rakyat
System GMM	System Generalized Method of Moments
TFP	Total Factor Productivity
UDA	Urban Development Authority
USA	United States of America

CHAPTER 1

INTRODUCTION

1.1 Background

Economic growth and equity remains an important issue in the economic agenda of many countries. Although different countries have different perception of what equitable is and how best to achieve it, by and large, there is a consensus that extreme inequality of income, wealth or opportunity is unfair and that efforts should be made to raise the income of the poorest members of society. Accordingly, in their quest to achieve both development and equity at the same time, policies and strategies are continuously being formulated and implemented across the globe. Malaysia, a Federation of thirteen states and three Federal Territories is no exception. The thirteen states in the Federation are Perlis, Kedah, Kelantan, Terengganu, Pulau Pinang, Perak, Pahang, Selangor, Negeri Sembilan, Melaka, Johor, Sabah and Sarawak while the Federal Territories are Kuala Lumpur and Putrajaya in West Malaysia and Labuan in East Malaysia. These states can be categorized into two, namely the more developed states[1] and the less developed states.

Recognizing the importance of achieving regional equality in Malaysia, the government instituted several policies and strategies since independence to close the gap between the states in Malaysia. These policies and strategies which are reported in nine volumes of the Five-Year Malaysia Plan, reflects the sincerity of the Malaysian government in eradicating if not alleviating the problem of regional imbalances.

[1]The more developed states are Johor, Melaka, Negeri Sembilan, Perak, Pulau Pinang and Selangor. The less developed states are Kedah, Kelantan, Pahang, Perlis, Sabah, Sarawak and Terengganu. The Federal Territory of Kuala Lumpur and Putrajaya are categorized as more developed states, while the Federal Territory of Labuan is classified as a less developed state.

Malaysia as it is known today and as Malaya before independence is a nation with explicit social-economic goals. Well into the First Malaya Plan (1956-1960), on 31st August 1957, Malaya secured independence from Britain. While the Second Malaya Plan (1961-1965) was very much in progress, a new nation Malaysia was formed (September 1963) with the inclusion of the self-governing island of Singapore, and the British colonies of Sabah and Sarawak. While at the end of the Second Malaya Plan (August 1965), Singapore chose to separate itself from the Federation to form an independent state. Thereafter, Malaysia continued with the tradition of planning for the future. This led to the formulation and implementation of a series of five-year plans for the development of the Malaysian economy. These plans were guided by the development of the New Economic Policy (1970), the National Development Policy (1991), and the National Vision Policy (2001). More recent plans have been guided by a working paper presented by Tun Dr Mahathir Mohamad (former Prime Minister) in February 1991 entitled "Malaysia: The Way Forward", also known as Vision 2020.

During the period between 1956 and 1960, output in Malaya grew at an average rate of 4%. The economic accomplishment of the Federation during the period was impressive as attested by a relatively high standard of living, financial stability and worldwide recognition of the strength of the economy (Federation of Malaya, Second Malaya Plan, 1961). Nevertheless, it was not an economy without problems. One of the major economic problems identified in the Second Malaya Plan was over-specialization and excessive dependence on rubber. At that time rubber accounted for over 25% of national income, nearly 30% of employment and about 60% of exports. The plan therefore saw a need for economic diversification. The other problems

identified were the high rate of population growth and the depressed condition of the rural areas.

Between 1961 and 1965, the Federation experienced rapid economic growth with real Gross Domestic Product (GDP) averaging 6.4% and per capita income growth averaging 2.7%. During this period of rapid economic growth, the economy still depended heavily on agriculture and in particular, on the production of natural rubber (First Malaysia Plan, 1965). Between 1965 and 1970, GDP in real prices rose at an average rate of 5.5% (Second Malaysia Plan, 1971). Diversification not only in agriculture but also in other sectors, particularly in the manufacturing sector was also actively pursued. Consequently, the share of manufacturing to GDP rose from 8.5% in 1960 to 10.4% in 1965 and about 13% in 1970. Unemployment in West Malaysia in 1970 was estimated at 8% compared to 6.5% in 1965. For the period 1965 to 1970, per capita real income growth averaged 2.2%. Despite the significant progress made in improving the economic well-being of the poor, the problem of economic imbalance remained as large part of the population were engaged in low-income activities in the rural areas, particularly with the concentration of Malays and other indigenous people in the low-income activities. Thus the Second Malaysia Plan (1971-1975) adopted strategies to deal with the problems of poverty, unemployment and economic imbalance.

There on, seven other five-year plans were introduced and implemented and currently the Ninth Malaysia Plan for the period 2006 to 2010 is under way. Today as compared to the years in the foregoing paragraphs, Malaysia produces and exports a wide range of manufactured goods and primary commodities, including electronic

components and equipment, electrical machinery and appliances, chemicals, textiles, wood products, metal products, petroleum, liquefied natural gas, sawn timber, saw logs and tin. Malaysia is one of the world's largest exporters of semiconductors, air conditioners, rubber gloves, palm oil and rubber. This signifies the success of the diversification plan identified and pursued upon independence.

During the period between 1970 and 2005, Malaysia's GDP grew at an annual compounded rate of 6.9% from RM25,427 million to RM262,029 million in 2005. In the same reference period, Malaysia's per capita Gross National Income (GNI) in nominal prices recorded a compounded annual increase of 6.7% from RM788 to RM18,106. Other noticeable achievements include an increase in merchandise exports from RM2,182 million to RM533,790 million equivalent to an annual compounded increment of 12.1% and a surge in net official reserves from RM1,543 million to RM266,387 million during the 1957 to 2005 period which is equivalent to an annual compounded increment of 11.3%. The current account of Malaysia's balance of payments in 2005 totaled RM75,681 million compared to RM103 million in 1957. During post independence, rubber and tin dominated the export sector representing 62.3% and 53.8% in 1965 and 1970, respectively. Today manufacturing sector contributes 80.5% of Malaysian exports.

The foregoing paragraph illustrates that Malaysia was able to diversify quickly and grow very fast over the last few decades. Indeed, Malaysia has emerged as one of the most dynamic countries in the world. Between 1971-2005, Malaysia was among the fastest growing countries in the ASEAN-5 economies (Table 1.1). Malaysia's growth rate during this period was more than that of the world economy, even surpassing

that of the industrial economies (Table 1.2). Notably, the growth was accompanied by low unemployment and inflation rate. Despite population increasing at an annual compounded rate of 3.2% (between 1957 and 1992), Malaysia attained full employment in 1992 and continues to operate under such environment (Economic Report, 2004). On a regional comparison, Malaysia's unemployment rate remains low after 1990 (Table 1.3).

Likewise, inflation in Malaysia remains subdued and is among the lowest in the ASEAN-5 economies (Table 1.4). On an international benchmark, inflation rate in Malaysia is very much lower than that of the world (Table 1.5). More importantly, despite its richness in natural resources, the country continued to face the problems of poverty in the 60s (Second Malaysia Plan, 1971). Today poverty is more of an exception than a norm. The success of the Government in eradicating poverty is evident from the sharp decline in the incidence of total poverty from 52.4% in 1970 to 5.1% in 2002 (Economic Report, 2004) and declined further to 4.4% in 2004 (Ninth Malaysia Plan, 2006). Thus, it is not surprising that we hear calls for the USA and other western countries, which have also seen solid growth over the last 20 years but with little reduction in poverty rates to learn from the experience of the East Asian economies[2].

[2] Restoring the Asian Miracle", Wall Street Journal, Europe (3 February, 1998).