Redefining Malaysia's Industrial Policy

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Malaysia is now at yet another crossroads. There is an ongoing debate as to whether its economic policies can enable the country to keep up with the rapid pace of globalization and escape the middle-income trap. In the past, Malaysia's industrial policy seemed suited to the needs of the private sector and supported by the global economic climate. This paper argues for the effectiveness of its industrial policy in the light of major economic developments in recent decades.

Let's recap. Pre-independence Malaya was once the source of raw materials such as tin and rubber for the British and small-scale steel for the Japanese. Despite being one of the world's major sources of raw materials, the development of Malaya's domestic industry was limited because almost all of its outputs were exported in raw and unfinished form. There was very little room for local industry to grow. Malaya's immediate priority after independence in 1957 was to restructure its economy towards import-substitution industrialization so that industries could be more outward looking. However, this strategy reached its limits of industrial enlargement when the government realized that the domestic market was too small to grow. Consequently, the government introduced export-orientation policies to reinvigorate manufacturing growth via the Investment Incentives Act 1968 and Free Trade Zones Act 1971. Multinational companies were quick to capitalize on Malaysia's low-cost production centers as a springboard to the global market. Malaysia's manufacturing industry thrived during the global oil-cum-financial crisis in the 1970s and the commodity crisis in the 1980s. This latter was the decade that marked the start of Malaysia's industrial master plans, stretching from 1986 to 2020.

Industrial Policy — a Form of Government Intervention

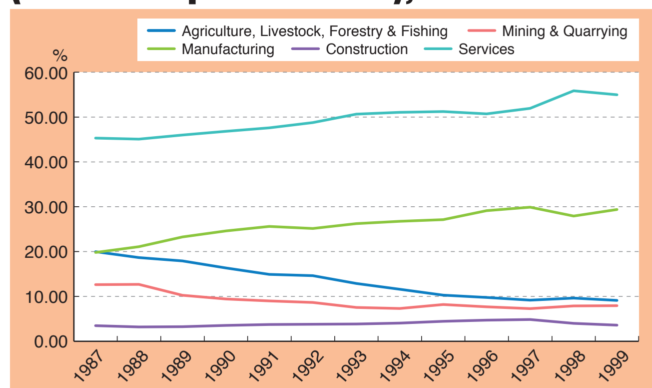
Government intervention in the manufacturing industry yielded commendable results in its early life. Following the success of the early export-orientation strategy, the government saw a need to boost its development further by following the growth models of successful Northeast Asian economies such as Japan and South Korea. As a result, the government undertook yet another round of import-substitution policies through a direct venture into heavy industries. The shift towards heavy industries reinforced the growing manufacturing industry by broadening the industrial base and creating wider linkages for growth. This was also the decade when industries utilized Malaysia's natural resources to manufacture rubber, palm oil, tin and wood-based downstream products.

The shift from an agricultural to manufacturing-based economy was a success. From 1987 to 1999, the manufacturing industry's contribution to GDP progressed well and moved almost opposite to that of agriculture, as shown in *Chart 1*. In fact, the share of Malaysia's manufacturing exports in total exports was almost equal that of newly industrial economies. This success was largely achieved by a series of investment-friendly policies such as tax relief, pioneer status, investment tax credits, and export and locational incentives by both federal and state governments.

As such, Malaysia's industrial policy can be said to have been effective in increasing production volume, thus creating wealth. However, its value-added component, the key to profitability, did not appear to keep pace with production. As illustrated in *Chart 2*, official data show that gross output initially grew in parallel to the value-added component before they started to move away from each other in the late 1980s. The gap between gross manufacturing output and the value-added component widened each year. As a result, the percentage of the value-added component of GDP has also been showing a downward trend since 2000. These events have eventually

CHART 1

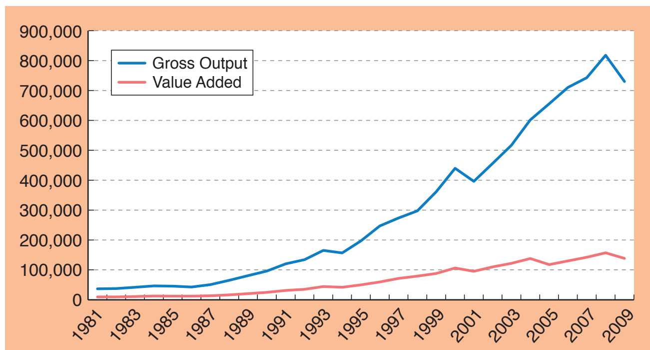
Percentage of GDP by sector (constant prices 1987), 1987-1999



Source: Department of Statistics, Malaysia

CHART 2

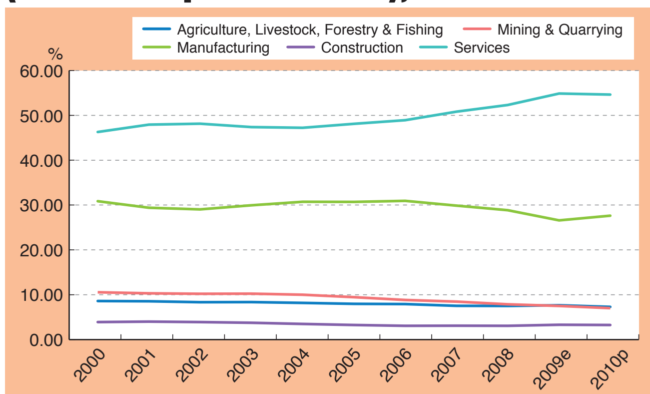
Value of gross output versus value-added components (in RM million), 1981-2009



Source: Department of Statistics, Malaysia

CHART 3

Percentage of GDP by sector (constant prices 2000), 2000-2010



Source: Department of Statistics, Malaysia

caused yet another side effect — the contribution of the manufacturing sector to GDP reached a plateau *(Chart 3)*. The services sector, on the other hand, has been showing steady progress since 2000.

Is Government Intervention Necessary?

There are many scholarly articles on Malaysia's economic policies debating the extent to which the government should intervene in the economy. The only consensus found is that government intervention was necessary in the early years of Malaysia's industrial development to address market failures.

A big push was needed to structurally change the overall composition of GDP. Statistical analyses on this subject have shown positive correlations as a result of the government's investor-friendly policies. They were highly adaptable to the needs of the private sector and contemporaneous with changes in the global investment climate. As such, the reason for intervention was justifiable.

Since 1970, intervention by the Malaysian government has had two underlying objectives — poverty reduction and correction of the economic imbalances amongst social groups and regions. Such affirmative action has been effective and relevant. The share of the economic pie was successfully restructured, albeit partially, by widening access to a quality life and employment for the *bumiputeras*. As a result, there was a marked increase in internal migration of *bumiputeras* from rural to major industrial centres. The strategy has been the bedrock of Malaysia's medium to long-term socio-economic policies even until today.

Malaysia's Industrial Master Plans (IMP) assert the same objectives but focus more on building the nation's manufacturing capacity as one of the biggest sources of growth. The first IMP (IMP1) of 1986-1995 was a continuation of the previous export-led growth strategies and it was deemed a success. All of its growth projections were achieved before the end of the policy period. Ten out of 13 (initially 12) sub-sector development targets scored higher than the projected average annual growth rates. The participation of *bumiputeras* in the manufacturing sector increased and the affirmative policy has continued via the *Bumiputera* Commercial and Industrial Community initiative. However, the downsides of the IMP were identified and candidly highlighted in the 1994 Ministry of International Trade and Industry's (MITI) IMP Review. This included a labor supply shortage, low level of technology and modernization, lack of inter- and intra-industry linkages, low level of local content, sluggish domestic investment, limited access to the global market, excess capacity, low value-added activities and lack of R&D. IMP2 (1996-2005) and IMP3 (2006-2020) have addressed these issues but most of them are still present to this day.

The second rationale for intervention was to support domestic and foreign investors to compete in global markets. In order to promote exports, the government undertook two main initiatives. One, legislative reforms to subsidize manufacturers through fiscal means, and two, restructuring institutional arrangements according to the needs of federal and state governments, as well as industry-specific bodies. Among other steps, MITI expanded its external trade division into a full-fledged government agency, the Malaysia External Trade Development Corporation in 1993. It has since become an important point of reference for exporters and buyers in major markets. Government-led trade and investment missions abroad were successful in connecting local players to the world.

Another rationale for intervention was to accelerate supporting policies for industrial modernization such as fiscal incentives, supply of labor, a technology policy and infrastructure development in order to encourage technology upgrading.

Why Didn't It Work?

Malaysia's gross output continues to distance itself from the value-added component despite three phases of IMP and a series of other interventionist policies. Constant fine-tuning of intervention policies has not brought about further progress.

The underlying objectives of the IMPs were retained beyond the NEP period (1970-1990) as the government believed that it could potentially build capacity for the *bumiputeras*. However, interventionism should never be static. It should take into account the changing variables and dynamics of the global economic climate. Simply put, there is no one-size-fits-all industrial policy.

The profitability of Malaysia's manufacturing industry as approximated by value-added is strongly linked to foreign direct investment (FDI). A small economy such as Malaysia's is reliant on FDI as an injection to productivity by bringing modern technologies and technical know-how. As FDIs are indeed market-driven, there is a limit to how much government intervention can encourage large inflows to upgrade value in manufacturing.

The China Effect

Malaysia has endured the booms and dooms of the world economy but the country still lacks foresight into changes in the global economy. The tipping point of the 21st century is the rise of China as a global economic powerhouse.

The impact of China's rise started after the "South China tour" by Deng Xiaoping in 1992. China understood the dynamics of the global market and knew that reforms had to be accelerated in order to gain wider access to global trade. China's reformist policies resulted in a spike in FDI inflows from $4 billion to $11 billion a year after the tour, and the uptrend continues.

A study carried out in 2004 suggested there is a positive correlation in FDI inflows between China and East and Southeast Asian economies. This is due to the growing production network within Asian economies and China where multinational companies locate factories around the Asian region to accommodate the global supply chain. However, the same study argues that the China effect is not the sole reason for accelerated FDI inflows into the region, but that market size and policy variables play larger roles in attracting investments.

Despite the China effect, Malaysia's industrial policy gave little boost to its competitiveness for FDI. As illustrated in the *Table*, cumulative FDI inflows for the period 1980-1995 show that Malaysia was second behind Singapore, but Thailand trumps Malaysia in the race for FDI for the period 2000-2011. Malaysia could not find a niche to strategically place itself as an attractive destination for FDI among the ASEAN-6 despite a series of interventions.

There is another dimension to the China effect. China's accession into the WTO in 2001 breathed new life into intra-regional trade as a result of higher investments and interconnected the global supply chain. Southeast Asian economies have inevitably "calibrated" their trading pattern with China since 2001. In the case of Malaysia, China has become its largest trading partner since 2009, whereas Malaysia has been China's largest trading partner amongst ASEAN countries since 2008. Prior to 2001, China was hardly in Malaysia's top 10 largest trading partners.

The rise of China poses significant challenges for Malaysia in many aspects that are outside the scope of its IMPs. Firstly, IMPs are unable to capture the complementary benefits of China's rapid growth in trade and investment. Despite being closer to China in terms of trade, Malaysia's level of FDI is not in sync with that of China's, as seen in *Chart 4*. Secondly, Malaysia cannot compete directly with China in labor-intensive exports and needs to upgrade its manufacturing to a higher value-added level. And thirdly,

TABLE

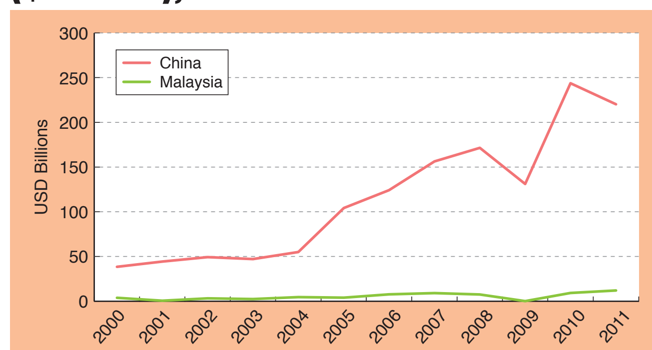
FDI net inflows based on BoP ($ billion), 1990-2011

Country	1990-1999	2000-2011
Malaysia	41.31	80.46
Brunei	neg	3.43
Indonesia	21.58	68.99
Philippines	11.88	26.70
Singapore	84.76	368.84
Thailand	31.46	101.63

Source: World Bank

CHART 4

FDI net inflows based on BoP ($ billion), 2000-2010



Source: World Bank

competition also exists between countries in some industries through reliance on similar export markets, namely the United States, Japan and the European Union.

Wage Levels Determine Type of Industry

China's economic upsurge owes much to low production costs and abundant supply of labor. In this respect, Malaysia will place itself in a very difficult position if it continues to compete in labor-intensive exports as its manufacturers do not enjoy such a low-cost structure and large-volume production capacity like China. Employing low-wage foreign labor is the most convenient way to continue to suppress costs. Presently, foreign labor accounts for almost 21% of the Malaysian workforce, of which 35% are employed in the manufacturing sector. It is evident that the over-reliance on foreign labor is blamed on the tight labor market conditions and growing reluctance of local workers to perform dirty, demeaning and dangerous (3D) jobs in Malaysia.

The supply and demand of foreign labor has varied according to the cycle of the Malaysian economy over the years. Demand for foreign labor heightened during the manufacturing boom in the mid-1990s and 2000s. Conversely, economic crises in the late 1990s and 2000s created an oversupply of foreign labor.

The fact remains that Malaysian manufacturers keep wanting more foreign labor despite the surplus position. But instead of utilizing the current pool, the government liberalized another import source from

other low-wage nations, such as Nepal, Bangladesh and Myanmar. They work mostly in the manufacturing, services, plantation and construction sectors.

There are two sides of a coin here. One is the demand side whereby manufacturers are still refusing automation and adopting higher technology due to low-cost production. The other is the supply side whereby the government refuses to close the tap on foreign workers due to demand from the multinationals.

Despite various industrial incentives, government intervention has failed to bring about a transfer of higher technology. And as technology transfer requires foreign investments, Malaysia chooses to exclusively liberalize its economy in order to transform the country as an attractive investment destination.

FTAs Lessened Importance of Industrial Policy

Foreign trade and investments bring about positive changes in increasing the value of output and productivity. Production efficiency is inculcated though more effective resource allocation and higher economies of scale. Beneficiary countries record higher annual rates of growth, higher quality employment and foreign exchange gains. An FTA encourages FDI further by reducing trade barriers and ensuring that foreign firms are treated equally and without prejudice (national treatment). It supports the need to increase competition in the market by developing its own competitive advantages. FTAs intensify competitiveness and force local enterprises to innovate at a much faster rate.

Malaysia is not an advocate of bilateral free trade by design. Following the impasse in the WTO's Doha development negotiations, Malaysia like many other countries is compelled to negotiate FTAs. This is due to two main reasons. One, the country faces intense global competition beyond trade liberalization; and two, the private sector is increasingly unresponsive to industry-specific policies.

Malaysia initially relied on the ASEAN Free Trade Agreement (AFTA) as a means to achieve its development agenda. Following the Japan-Singapore FTA, the government changed its view on free trade and chose Japan, its closest trade and investment partner outside the ASEAN region, as its first bilateral FTA partner.

The fact remains that FTAs limit the policy options for industrial policy. Trade barriers and interventionist strategies remain as significant tools to develop local industries but the proliferation of bilateral and plurilateral FTAs has serious implications not only for development but also the survival of locally-owned enterprises. Industrial policy relies on trade barriers and intervention to develop local industries, but FTAs prohibit discrimination between local and foreign firms. And even if the government does intervene through its industrial policy, the cost of doing so will probably be very high.

The Price of Intervention

Proponents of *laissez-faire* policies would argue that flawed government intervention is far worse than neutrality, as poor targeting of resources will amplify inefficient economic activities. Complementary industries will also suffer as a result of flawed intervention. Furthermore, even correctly interventionist policies have costs. Subsidies and tax incentives to artificially stimulate specific industries are lost revenues for the government.

Highly industrialized economies such as Japan and South Korea have their own record of flawed interventionist policies. These typically involve state-owned enterprises embarking on risky business ventures that demand a high rate of returns. As state-owned enterprises are usually large and dominate the economy, investment failures tend to cost billions of dollars.

Malaysia has probably seen more than its fair share of spectacular failures in government intervention. Owing to the country's big push for heavy industries in the 1990s, Perwaja Steel failed with accumulated losses of billions of ringgit. The government-backed Port Klang Free Zone's scandal arose because of huge cost overruns despite receiving government loans. More recently, the government's direct participation in a big-scale cattle farming project at the National Feedlot Centre was described as "a mess" in the auditor-general's report due to poor management and subsequent misuse of public funds.

Most of these corporate scandals were not only due to bad planning but, more importantly, the close relationship between local politics and the national economic agenda. The political-economic aspect of government intervention is indeed a strong case against the industrial policy.

Conclusion

This paper attempts to answer three main questions: 1) What is industrial policy in the Malaysian context? 2) What are Malaysia's rationales for its industrial poicy? 3) Did a series of government interventionist measures work? Answering these questions will enable us to understand why Malaysia's growth prospects have weakened considerably despite interventionist policies.

A continual process of critical reviews and assessments, and drawing lessons from similar emerging economies, must be taken into account for future action. MITI published the IMP1 Review in 1994 but has been silent on subsequent IMP reviews. The lack of assessment can be disastrous. If industrial policy is still relevant for Malaysia, it is absolutely crucial to identify missed targets and how the government should address them in future policies.

The ultimate goal of a high-income status by 2020 seems further away rather than closer. The government acknowledges this problem and introduced the New Economic Model in 2010 and a series of transformation programs to assert Malaysia's relevance in the race for economic prosperity. Interventionism still exists today in the selection of major industry players to lead the changes in the economy. But should we continue to pick the winners just as was done in the past? JS

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