

Chapter 4 Malaysia

1. The evolution of development policy

Since independence in 1957, Malaysia has attained significant industrialization and economic development. Preliminary data shows that, in 2005, per capita GDP reached \$4,930 and the ratio of manufactured goods in total export was 84%. Among them, electrical and electronics (E&E) products occupied 64% of total export. Malaysia, with the population of 26 million, has successfully graduated from the status of a primary commodity-based economy into an upper middle-income industrialized country.

As industrialization proceeded and external circumstances changed, policy orientation also evolved in stages.

Initially, from 1957 to 1969, the import substitution of consumer goods was attempted under the strong performance of primary commodity exports (petroleum, tin, rubber, timber, palm oil, etc). The economic environment was largely liberal and without forced measures such as import bans or SOE creation. However, the gap between the ethnic Chinese, who were rich and urban, and the ethnic Malays, who were poor and rural, continued to grow, which erupted in the racial riot of May 1969.

In the 1970s, a clear policy shift was made from laissez-faire to ethnicity-based affirmative actions to ease social tension and secure national unity. The New Economic Policy (NEP) imposed comprehensive rules in allocating public positions, business management, workforce, and other incentives in favor of Bumiputra (indigenous Malays).

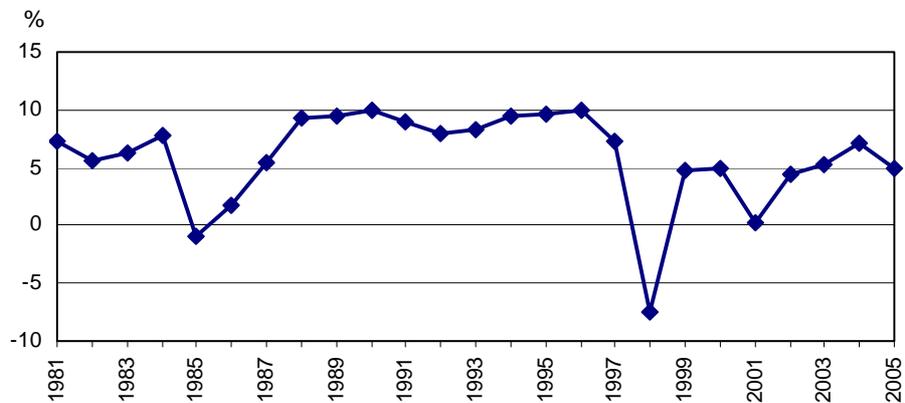
With the coming of power of Dr. Mahathir in 1981, and under recessionary pressure of the early 1980s, aggressive industrial policy was introduced. Look East Policy and heavy industrialization, including automobiles, were initiated. With the help of the yen appreciation starting in 1985, Malaysia succeeded greatly in absorbing manufacturing FDI and turning itself into the world's major electronics exporter. However, heavy industrialization was less successful¹.

Since 1986, policy emphasis shifted back partly from social equity to wealth creation. There was a gradual easing of Bumiputra policy, and more pro-market, outward-oriented measures were adopted. Industrial Master Plan 1 (IMP1, 1986-95) laid the foundation of manufacturing industries and promoted the processing of natural resources instead of exporting them in raw form. Industrial Master Plan 2 (IMP2, 1996-2005) tried to broaden manufacturing capability through the strategies of cluster-based industrial development and *manufacturing plus plus*. Industrial Master Plan 3 (IMP3, 2006-2020), which is currently being prepared, is likely to further broaden the scope by including services and

¹ Today, few of the heavy industries prosper or even survive. Proton, the only major exception, also remains uncompetitive and faces serious difficulty as Malaysia integrates further into the global market—see below.

featuring functional targets such as SMEs, HRD, technology, logistics, marketing, and so on. IMP2 and IMP3 will be discussed in detail below.

Figure 4-1. Real GDP Growth



Many interviewees agreed that Malaysia was a lucky country enjoying political stability, strong leadership, no prolonged war of independence, a rich endowment of natural resources relative to the population size, administrative mechanisms inherited from the colonial era, high transparency and low corruption, and so forth, which enabled the country to rise to the current level. Business environment in Malaysia is ranked as one of the best in the world². The timing of large FDI inflows (late 1980s) and the unique response to the Asian crisis (1997-98) may also be counted as fortunate occurrences.

The prominent feature of Malaysia is multi-ethnicity, which must be handled with care to maintain economic growth and social stability. At present, the three major ethnic groups (Malays 51%, Chinese 24%, Indians 7%) seem to live in harmony and mutual respect.

2. New challenges

Malaysia has achieved much, but its days of FDI-led high growth may be over. For an upper middle-income industrialized country, further development requires stepping up from mere industrial agglomeration to strengthening of domestic capability. The challenge of transition from quantity to quality is also faced by Thailand, but at a higher income level, Malaysia's challenge is more urgent. The Malaysian government is well aware of this and formulating policies to overcome it.

Like Thailand, Malaysia has absorbed manufacturing FDI for many decades, especially in E&E. FDI inflows accelerated greatly two decades ago. However, during the last decade, the Asian crisis, the rise of China, and progress in regional and global integration posed new problems which must be resolved by improving domestic capability and moving into a new development phase. However, it can be said that Malaysia, like

² The mission asked the representative of JETRO Kuala Lumpur to list main constraints for foreign investors. He paused, and replied that he could think of none as far as policies and institutions were concerned.

Thailand, has largely failed in this “leveling-up” after many decades of FDI absorption—or at least its process has been excruciatingly slow. To break away from foreign dependency in management and technology, and to become more self-sufficient in design, production management, marketing, and other value-creating activities is the core issue for Malaysia. The success or failure of this endeavor will determine whether its economy will continue to rise or slow down, or even stagnate³.

Researchers at the Malaysia Institute of Economic Research (MIER) emphasized that the key problem for Malaysia was the quality of education. Under Bumiputra policy, quantitative allocation was pursued at the cost of qualitative excellence. Education in particular and the quality of human resources in general are surely at the heart of the Malaysian question. Whether this difficulty comes mainly from the characteristics of the people which are deeply embedded in society and history, or from policy inadequacy which could be amended relatively more quickly, is an open question.

Malaysia has begun to lose some FDI to China and other newly emerging destinations, including Vietnam, through relocation of existing factories and a reduced inflow of new investors. In a sense, this is natural and even welcome since Malaysia is already an upper middle-income country with relatively high wages. Labor-intensive operations should leave Malaysia, as it happened in Singapore, Hong Kong, Taiwan and Korea in the past. But at the same time, new industries and services must be created to match the now higher wages. Technology-intensive FDI should be attracted and, more importantly, local firms should innovate and produce more value. This is an inevitable process in economic development, and Malaysia should worry more about improving productivity than losing FDI to China. This is yet another way to state that building domestic capability is crucial.

3. Key documents

Malaysia’s planning documents are organized as follows.

Vision 2020, set by Former Prime Minister Dr. Mahathir in 1991, remains the overarching national goal. It aims to develop Malaysia into a “fully developed country” by 2020 and nine challenges for this purpose are listed in general language⁴. Vision 2020 itself does not contain numerical targets, and the path and criteria to become a fully developed country are to be concretized by other documents listed below, with continuing revisions and adjustments. One practical criterion often mentioned is to surpass the per capita income of \$10,000, which is supposed to be the condition to be admitted into OECD. This particular hurdle will be cleared if Malaysia sustains moderate growth in the next fifteen years⁵.

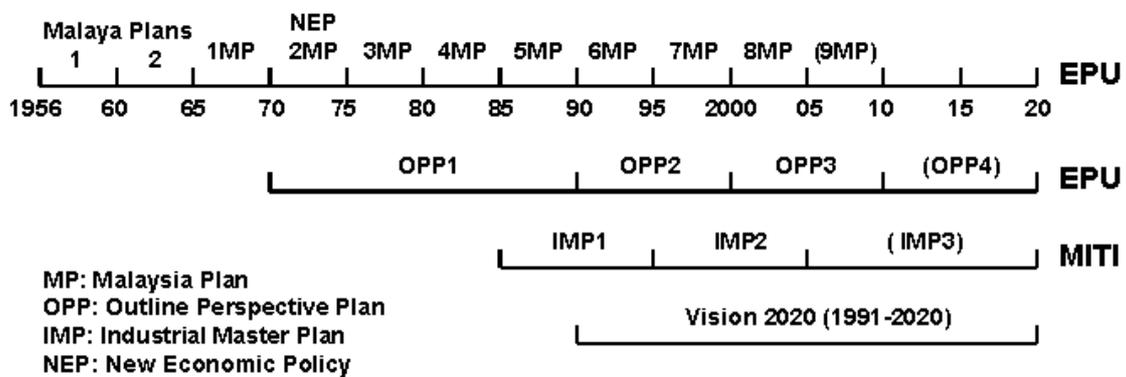
³ See the discussion on breaking the “glass ceiling” for ASEAN countries in chapter 1 (pp.24-26) of VDF’s *Improving Industrial Policy Formulation*, edited by Kenichi Ohno and Nguyen Van Thuong, and published by the Publishing House of Political Theory, 2005. Also see the section on Proton at the end of this chapter.

⁴ The nine central strategic challenges are national unity, confidence, democracy, moral and ethics, tolerance, science and technology, caring culture, economic justice, and prosperity.

⁵ Simple exponential computation shows that from the base of \$4,930 in 2005, an annual average growth of 4.8% is sufficient to achieve this. However, inflation, exchange rate movement, and unexpected shocks

Other key documents include the Malaysia Plans (MPs) and the Outline Perspective Plans by the Economic Planning Unit (EPU) of the Department of Prime Minister, and the Industrial Master Plans (IMPs) of the Ministry of International Trade and Industry (MITI). MPs are five-year plans with second-year review and a broad coverage which includes social issues and infrastructure. IMPs are documents focused on the manufacturing sector with a longer time scope, namely ten years for IMP1 and IMP2 and fifteen years for IMP3. Generally, MPs contain more targets than IMPs.

Figure 4-2. Key Policy Documents



The scope of authority of the Malaysian MITI is far broader than that of the Vietnamese MOI in the sense that MITI covers international trade, FDI and SMEs, which are handled by other ministries in Vietnam. Under MITI, there are special agencies for these functions, such as MIDA (FDI), SMIDEC (SMEs), MATRADE (trade), and MPC (productivity). But MITI's authority is narrower than the Vietnamese MOI in the sense that it oversees manufacturing only. It does not supervise utilities, mining or construction.

IMP3 is currently in the final stage of preparation. It was supposed to be finished by December 2005 but expected completion is now moved to the spring of 2006. According to MITI, 80% is already finished and postponement is due to the time needed to obtain data up to 2005 in the remaining 20% of the draft. IMP3 is being prepared in parallel with EPU's 9MP. EPU and MITI feel that consultation between them is sufficiently frequent to produce mutually consistent output. The official language of IMPs is English.

4. Industrial Master Plans

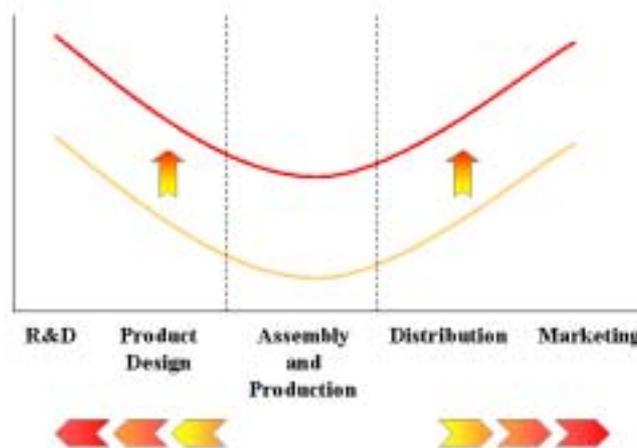
IMP1 (1986-95) laid the foundation for manufacturing to become the leading sector of the economy. Its main objectives were (i) accelerated growth of manufacturing; (ii) efficient utilization (i.e., domestic processing) of the nation's natural resources; and (iii) development of indigenous technological capability. The plan overlapped with a period of high growth driven by increased FDI inflows. Export growth, the share of

must be taken into account. Some interviewees mentioned an average growth of 7% as a necessary condition, but we do not know where this number comes from.

manufacturing in GDP, and the growth of value-added in manufacturing all exceeded plan targets.

IMP2 (1996-2005), whose implementation just ended, was 453 pages long and had a clear policy orientation. The first two chapters presented challenges and an analytical framework. Its basic message was to improve the competitiveness of manufacturing by broadening and raising its base. Its two key thrusts, which were closely related, were *manufacturing plus plus* and *cluster-based industrial development*.

Figure 4-3. Manufacturing Plus Plus



Manufacturing plus plus expresses a two dimensional desire to (i) expand along the value chain to encompass higher value-added activities; and (ii) uplift the whole value chain to raise productivity. Since Malaysia started as a conventional assembler, which was the lowest point in the value chain, it wanted to master R&D, design, product development, distribution, marketing, etc. horizontally, and also improve skills vertically.

Cluster-based industrial development broadens the concept of industry. A cluster is defined to be “an agglomeration of inter-linked or related activities comprising industries, suppliers, critical supporting business services, requisite infrastructure and institutions” (IMP2, p.23). Eight clusters were identified and analyzed in chapters 3 to 10 of IMP2: E&E, textiles and apparel, chemicals, resource-based industries, food processing, transportation equipment, materials, and machinery and equipment.

The fact that the background paper was prepared by one researcher at the Malaysian Institute of Economic Research (MIER) perhaps gave IMP2 a lucid academic style⁶. In more common language, this framework is basically saying that Malaysia must enhance competitiveness, improve productivity, and promote supporting industries and related services. But placing them in value-chain language provided more focus and consistency.

⁶ By contrast, IMP3 has been produced in a more decentralized fashion, with each chapter written by a different group without a common structure imposed from above—see below.

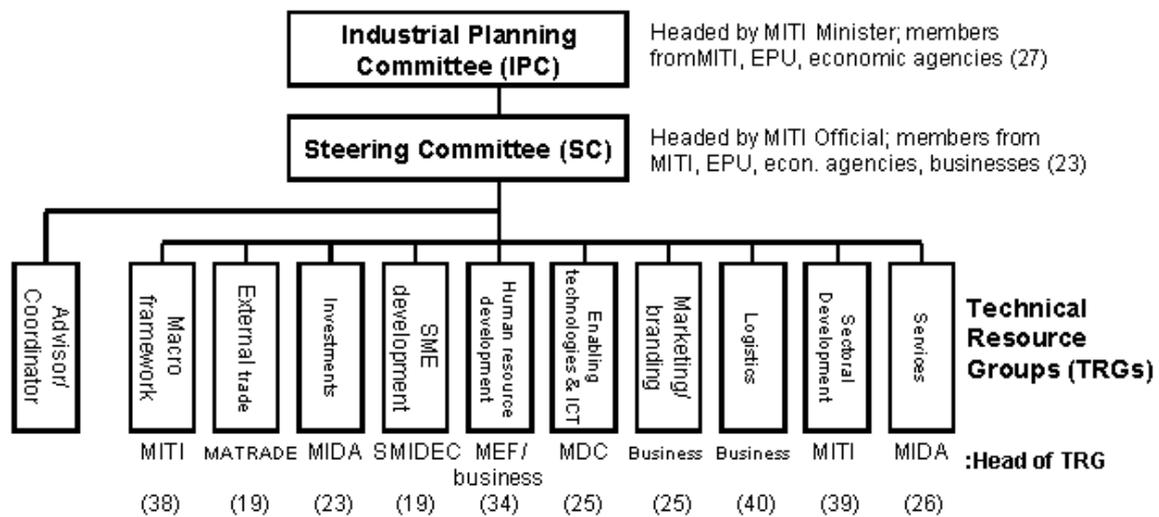
The mission raised three questions regarding IMP2: (i) application of one analytical procedure to all industries seems too mechanical and ignores specific features of each industry; (ii) there is no selectivity since eight clusters cover virtually all key industries of Malaysia; and (iii) aiming to broaden and raise all industries and related services is a full-set orientation which goes against international division of labor under globalization and FTAs. Some officials replied that these concerns were not addressed at the time of drafting IMP2, but they thought that the analytical framework was flexible enough to accommodate global linkage or each industry's specific issues.

IMP3 (2006-2020) is in the final stage of preparation and its content has not been released. However, MITI officials discussed its general orientation. Its objective will continue to be achieving international competitiveness under global integration. IMP2 tried to strengthen clusters across the board and IMP3 will also continue to do so, with added emphasis on inter-cluster linkages. At the same time, IMP3 will introduce some new elements. It will designate subsectors within each cluster to be targeted more selectively. For example, within E&E, nano-technology, photonics, microelectronic mechanisms, etc. will be listed. Bio-technology and pharmaceuticals will also be mentioned. There will be more emphasis on services such as marketing, utilities, environment, and attracting regional headquarters and international procurement offices (IPOs) to Malaysia. Human resource to carry out innovation will be promoted. "Networking" (any form of cooperation between local and foreign companies) and "cross-border investment" (outward FDI) will also be featured.

5. Drafting and review processes

IMP2 and IMP3 were prepared by a three-level organization. Figure 4-4 shows the case of IMP3. Teams at the bottom level correspond to proposed chapters. IMP2 was drafted by a similar mechanism, but the three levels were then called, from top to bottom, the Industrial Coordination Council, the Industrial Policy and Incentive Committee, and the Industry Task Forces.

Figure 4-4. Drafting Mechanism for IMP3



Source: MITI website.

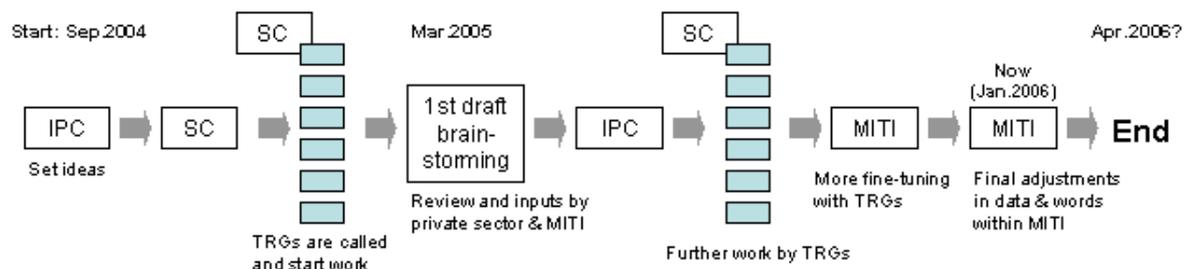
Note: Numbers in parentheses indicate the number of members in each committee or group.

The total number of people mobilized in the three levels was 338 although there are some overlaps among members. Besides this, under each Technical Resource Group (TRG), secretariat, writers, research assistants, and so on, were arranged as needed. Under the general guidance and coordination of the Steering Committee, how each chapter was drafted was largely left to each TRG.

Compared with Vietnam where small official teams draft master plans, this is a very complex organization. The mission asked how consistency was ensured under this system involving a large number of people. The general answer from concerned officials was that, since communication among relevant ministries and agencies was active, information was shared and potential conflicts were solved in daily contacts, and there was little scope of remaining serious differences by the time an IMP began to be drafted. Since various views, including those from businesses, are absorbed in advance, top-down directives do not generate any friction at lower levels. This sounds ideal, but we did not have sufficient time to confirm that the process actually proceeded as smoothly as described. However, it is undeniable that inter-ministerial consultation in Malaysia is far more frequent and effective than in Vietnam.

More specifically, MITI officials explained the process of drafting IMP3 as follows.

Figure 4-5. Drafting Process of IMP3



The overall direction of IMP3 was initially set by the Industrial Planning Committee (IPC) headed by the MITI minister. Ideas emerged naturally from many previous meetings. Unlike IMP2, they were not formed by one person or one report. There was no serious disagreement about the content. After this, the Steering Committee (SC) was set up. SC in turn established TRGs and coordinated drafting. TRGs submitted first drafts to the MITI secretariat, which were reviewed by the private sector as well as within MITI. There were no foreign experts at IPC, SC or MITI level, but TRGs were free to invite them if necessary. The private sector was deeply involved through TRGs and at the first-draft brainstorming. Many issues were raised by the private sector, while MITI tried to add long-term policy concerns. The budget for conducting the whole process was probably RM5-10 million, of which RM2-3 million went to fees and publication⁷.

The mission also met with the writers of chapters in three TRGs: macro-framework, SME development, and marketing and branding. The positions of the writers varied from public servant to researcher and private consultant. Each team had a series of intensive meetings and the drafters worked hard with little remuneration. In the case of TRG on SME development, work began in July 2004 and the draft was completed in December 2005. Members met monthly over eight months to discuss different aspects such as marketing, technology, and finance. Coordination among related agencies required effort. Theoretical ideas by academicians had to be modified for more practicality. TRG also requested the Department of Statistics to conduct a new business census since data on SMEs was lacking or out of date. The writer had to draft the chapter while doing her regular work, which she said was very tough.

The co-writers of another chapter were worried that IMP3 had much less focus than IMP2 because there were “too many cooks.” They thought that MITI should have steered the process more effectively to keep wild ideas away and produce clear messages. They also felt that fixation with Vision 2020 was inappropriate and the planning period of fifteen years was too long and impractical. They reported difficulty in obtaining necessary data.

Compared with the drafting process, implementation and review processes are less well-organized. IMP3 does not contain detailed action plans or policy matrices. It may contain a chapter on implementation, but this will not be detailed. Concrete implementation is left to annual budgets, MPs (five-year plans), and measures of relevant committees, ministries and agencies.

⁷ One US dollar is approximately 3.7 Malaysian ringgit.

Similarly, there is no structured mechanism to monitor, assess, or revise an IMP. IMPs are not revised during implementation. MITI officials we met expressed satisfaction with the performance of IMP2, but it is also reported that the MITI Minister herself was unhappy with some aspects of the result. More than one observer outside MITI, belonging to different organizations, also felt that IMP2 fell short of achieving targeted cluster development.

A number of people told us that IMP2 had not been reviewed but IMP3 would be reviewed every five years. In fact, according to the MITI website we witnessed in 2005, IMP2 did have a mid-term review in 2001 where numerical targets and cluster-based industrial development were assessed, and actions to improve the performance were proposed⁸. The final review of IMP2 may now be similarly conducted. But the fact that most people do not recall the mid-term review of IMP2 suggests the amount of attention that it receives.

The lack of proper review may be considered a serious flaw in the Malaysian IMP. It may lead to missed lessons and insufficient design in the future. However, it may also be argued that spending more time on designing new policies than evaluating old ones is natural and understandable. If new challenges are already identified in daily contacts among officials and with the private sector, as the Malaysian officials claim, resources should be directed mainly toward meeting these challenges rather than assessing the goals which were set ten or fifteen years ago and may now be obsolete. On this issue, the mission remained divided. We can at least say that proper balance between design, implementation and review is essential since time and resources are limited.

Another related question is how we should interpret missed targets. Some macro targets of IMP2 such as growth were underachieved, and the desired domestic investment share of 60%, as opposed to FDI, was not realized. However, it is fairly clear that this was largely due to external shocks, especially the Asian crisis and the rise of China. It is hard to quantify the effects of policy weakness relative to external circumstances. If the latter is dominant, scrutinizing past policies may not produce a proper response.

6. FDI policy

The Malaysian Industrial Development Authority (MIDA) is the central agency for FDI promotion, equivalent to the Board of Investment in Thailand. It is one of the agencies under MITI. Although it reports to MITI, it enjoys relative policy autonomy. As

⁸ In the first five years of IMP2, the following targets were met or almost met (targets in parentheses): manufacturing export growth 16.6% (16%), annual manufacturing investments RM27.4 billion (RM25 billion), and the employment share of manufacturing 27.6% (27.9%). Two clusters achieved targeted value-added shares and three clusters had high productivity growth. Capital investment per employee rose remarkably in three clusters. On the negative side, R&D remained low at 0.5% of GDP, researchers and skills remained scarce, and the number of local patent registration was small. Only 20% of manufacturing firms undertook innovation. Participation in global supply chain was weak, and ICT and integrated logistics were not used widely. This information was obtained from www.miti.gov.my/miti-imp3speech, which now is removed.

Malaysia's industrialization deepens, wages rise and labor shortages have become a problem, MIDA recently acquired a new mandate to encourage "cross-border investments" (outward FDI) by Malaysian companies. Since March 2004, it also promotes services (except finance and utilities, which belongs to other agencies). MIDA wants labor-intensive industries such as garment to leave Malaysia and become global. Instead, Malaysia wishes to attract targeted high-tech FDI.

Incentives include pioneer status, investment tax allowance, and reinvestment allowance. Regionally, two levels of incentives are given, the one for the Kuala Lumpur, Johor Baru and Penang areas and the other for the rest of the country. In addition, MIDA can offer "pre-packaged incentives" (customized special deals) to attract targeted FDI firms individually. MIDA approves all FDI projects at the federal level and provides various post-investment services. If any problem arises between a company and a local authority, MIDA solves it for them. Tax incentives are centrally administered by MIDA, but thirteen states (local governments) can offer other incentives related to land and water, such as better conditions for lease, rent and location. Incentives are given to domestic and FDI companies without discrimination. After the Asian crisis, Malaysia now accepts 100% foreign-owned projects regardless of how much the company exports.

MIDA feels that it works very closely and effectively with concerned bodies such as the Ministry of Finance (MOF), the Department of Statistics, other agencies under MITI, and foreign chambers of commerce. Every Thursday, MIDA holds meetings to approve projects and decide incentives. A representative from MOF sits in these meetings and can approve proposed tax incentives on the spot. If there is any doubt, the proposal is reported to the higher level of MOF and the issue is resolved in the following week. Such quick decision making among related economic ministries is unimaginable in Vietnam at present.

7. SME policy

The Small and Medium Industry Development Corporation (SMIDEC) is another agency under MITI. There are forty agencies in charge of SME promotion in Malaysia. Eighteen ministries are also involved. SMIDEC plays the leading role among them.

In Malaysia, the number of manufacturing SMEs and their production share have increased over the years. In 2004, they accounted for about 30% of output, 25% of value-added, and 32% of employment in the manufacturing sector. However, all of this growth cannot be attributed to policy measures, since private sector dynamism and external circumstances should have certainly influenced the result as well.

A number of grants, soft loans and incentives, such as higher income tax threshold, pioneer status with full tax exemption for five years, and investment tax allowance, are offered to manufacturing SMEs with at least 60% Malaysian equity⁹, shareholders' funds

⁹ SMIDEC clarified that all Malaysian SMEs regardless of ethnicity were eligible for support. However, another source reported to the mission that only indigenous Malay SMEs were promoted. We cannot explain the cause of this discrepancy. It may come from the gap between stated policy and actual result.

not exceeding RM80,000, and value-added of at least 15% or contribution to rural development. Preferences are given for taking specified actions under proper documents (“concept papers”) for strengthening industrial linkage, logistics services, overseas marketing, business planning, product and process improvement, obtaining quality certification, etc. The list of eligible activities is long. Proposed actions are monitored after 3, 6 and 12 months and benefits can be withdrawn if they are not implemented. It is clear that Malaysia supports SMEs mainly for achieving excellence, not just for the social protection of small firms. Currently, policy is evolving toward supporting SMEs in services in addition to manufacturing.

The mission asked if application procedures for grants and incentives were not too complex. SMIDEC admitted that sometimes public awareness of their policies was low and applications for incentives were few. In such cases, it reviews procedure and regulation to see whether the problem is on the SMIDEC side.

8. The automobile industry

Proton, established in 1983 and started operation in 1985, is Malaysia’s national car company. It has served as a key instrument for implementing heavy industrialization and IMPs. Starting from the CKD production of Mitsubishi Lancer, it subsequently internalized capability in styling and design, platforms, engines, logistics, marketing, etc. It also acquired cooperation with Lotus, a British car maker. Proton is expanding from its original three factories to Proton City in Tanjung Malim with more automation. It employs 10,000 people directly and has created an estimated 100,000 jobs through the value chain.

The domestic automobile market in Malaysia was about 519,000 units sold in 2005, of which 72.8% was passenger cars and 27.2% was commercial vehicles. In the passenger car segment, Proton holds the top share of 41.5% (Jan.-Oct. 2005), followed by another local company, Perodua¹⁰, with the share of 33.1%. The rest is supplied by foreign-brand manufacturers. Proton procures about 5,000 parts locally from 286 suppliers, of which SMEs account for 55%. 20 vendors have the capability to design parts.

Given its large domestic market share, the quality of Proton seems acceptable to Malaysian consumers, at least as popular vehicles. But the mission also heard negative comments about its quality. The greatest problems for Proton are small domestic market size and the lack of brand recognition abroad, which together limit its production scale and raise its cost. Malaysia is now drafting a new national automobile policy, to be completed in a few months. While it has come a long way to accumulate domestic capability, the current level is not enough to compete squarely with big international names under accelerating global competition and industrial reorganization. For survival, Proton desperately needs strategic alliance with one of the large foreign producers. Under

¹⁰ Perodua was also established by the government in 1990s with Daihatsu as a partner. Unlike Proton, it undertakes assembly without acquiring design capability. Initially, there was a market division between Proton (over 1,000cc) and Perodua (below 1,000cc). But this division is now broken and the two companies have become competitors in the domestic market.

such alliance, products should be re-targeted to specific parts and selected car models for particular markets, and to become a crucial link in the global production network. However, as the recent breakup with VW shows, it is extremely difficult to reconcile national aspiration with the prospect of foreign dominance in management.

Malaysia developed the automobile industry by internalizing capability quickly with strong official support. But it has hit a thick wall due to limited scale and severe international competition. On the other hand, Thailand created a relatively free environment for FDI car makers to achieve production size, quality, and even exports. Its problem, however, is the slow pace of domestic capacity building and the continued dominance of foreign design and technology¹¹. Both paths are fraught with difficulties, but the key question is which path is more likely, under appropriate policy, to establish a competitive automobile industry in the long run. The fact that discriminatory measures are no longer permitted under WTO and FTAs also must be taken into account when Vietnam formulates its automobile industry policy.

¹¹ In this respect, Malaysia's E&E industry is closer to the Thai automotive industry than Proton.