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Economic Commission for Latin America and the Caribbean

**MALAYSIAN INDUSTRIAL AND TRADE POLICIES  
UNDER THE NEW INTERNATIONAL  
TRADING SYSTEM \***

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## ABSTRACT

This study examines the impact of trade and industrial policies of Malaysia on the country's economic performance over the past three decades, and to look into their future evolution under the new international trading system, such as the World Trade Organization and the regional trade agreements.

In the main we can characterize trade and industrial policies as mildly interventionist, with varying degrees. A set of relatively more focussed and concerted industrial measures were introduced to steer the export-industrialization process. Initially they were broad-based incentives but later were more concentrated with the introduction of the Promotion of Investment Act of 1986. On the other hand, the trade regime was relatively less interventionist and thus transformation from the import substitution to export promotion strategy was not too difficult. Nevertheless, a highly distortive trade policy was introduced for the second round of import substitution to promote heavy industries.

Malaysia's obligations to the new international trading system, the General Agreement on Tariff and Trade (GATT) and regional trading arrangements, namely ASEAN Free Trade Area (AFTA) and Asia Pacific Economic Cooperation (APEC), will have a far-reaching impact on industrial and trade measures that can be employed in the future. This study shows that the Malaysian industrial and trade policies do not need to be significantly changed to comply with the GATT. Notwithstanding this, liberalization will require new approaches for the development of the services sector. APEC commitments will support the GATT liberalization process. However, the ramification of AFTA will be more substantial and extensive: it may involve fundamental shifts in domestic economic structure such as industrial restructuring and resource allocation.

This study is structured as follows: *Chapter 1* is an overview chapter that reviews the process and factors influencing the Malaysian economic growth. It evaluates the sources of Malaysian economic growth and also highlights the future directions of Malaysian industrial and trade policies in the context of the new international and regional trading arrangements. *Chapter 2* analyses the evolution of the Malaysian industrial and trade policies for each of the four phases – import substitution, export-promotion, second round import substitution and technology- and capital-intensive industrialization. *Chapter 3* studies the adjustments needed to ensure that Malaysia's obligations conform to the GATT requirements. *Chapter 4* analyses the measures to strengthen endogenous capabilities in response to the shifting comparative advantage and a more liberal trading environment. *Chapter 5* evaluates the role of institutions in charge of industrial and trade policies. *Chapter 6* discusses the impact of regional integration accords on the Malaysian industrial and trade policies.



## I. MALAYSIAN ECONOMIC DEVELOPMENT

### 1. Sources of Growth

By many criteria, the Malaysian economy has performed very well, not only in terms of growth of Gross Domestic Products (GDP) but also in sectoral and social development (World Bank, 1993). Underpinning this growth was the prevalence of price stability where the consumer price index had hardly ever exceeded 7 per cent,<sup>1/</sup> except for 1973 and 1974 where it reached double digit figures. Table 1 gives a summary of key growth indicators of the 1970s. Since independence in 1957, the economy has grown at a relatively high rate, averaging about 6 per cent per annum in the 1960s and improving to 6.8 per cent in the 1970s. In the first half of 1980s, growth was still at a reasonably annual rate of 6.6 per cent but it was marred by two years of recession (1985-1986) where the economy had contracted. But from 1988 to the present time the Malaysian economy had recovered very well to register very rapid growth rates - about 8.7 per cent annually. In per capita terms, the performance was equally well; Gross National Product (GNP) per capita rose from US\$ 334 in 1970 to US\$ 4,447 in 1996.

The recession was caused by two twin deficits – the first one was trade deficits due to falling export prices and second, fiscal deficits caused by large public sector spending [Jomo, Khong and Shamsulbahriah (1987), Mahani and Lim (1989) and World Bank (1989)]. The drastic fall in export price for primary commodities has resulted in a serious shortfall of trade balance. As the services account was normally in the negative, this has further aggravated the current account deficits. The public sector has increased its direct involvement in economic activities in the early 1980s and has allowed its size to expand from 14 per cent of the GDP in 1976-1980 to over 27 per cent in 1981 and 1982 (Mahani, 1994).

To revive the economy, the government had embarked on a liberalization and deregulation approach, in addition to downsizing its activities and introducing fiscal austerity. The Malaysian economy rebounded after 1988 to the point that it now faces with a tight labour market, an upward price pressure and, once again, current account deficits [Tham (1996), Ariff and Leong (1996) and Lee (1996)]. Malaysia was able to sustain these prolonged deficits because its merchandise export sector was performing very well, with average annual growth rate of about 22 per cent during the 1987-1995 period. Due to this performance, foreign investors were very confident of the Malaysian economic growth potential and they were prepared to continue their investment. As a result, Malaysia had enjoyed a large flow of both short and long term capital inflow that help to sustain the balance of payment. This could lead to an observation, which pointed to a strong relationship between exports and investment – a buoyant export performance or high potential will attract more investment.

Malaysia had also undergone a massive structural transformation, which saw the emergence of manufacturing and private sectors as the dominant force in the growth process. In

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<sup>1/</sup> The consumer price index registered its highest level in the early 1980s where it almost reached 7 per cent.

Table 1  
MALAYSIA: KEY ECONOMIC INDICATORS

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979
Real GDP growth (%)	6.3	8.2	6.6	12.3	6.7	3.5	11.6	7.7	7.0	8.5
Manufacturing sector growth (%)	12.3	6.2	13.3	19.9	15.3	0.1	18.9	10.6	9.7	9.5
GNP per capita (US\$)	334	389	421	593	700	780	900	1045	1220	1535
Growth in CPI (%)	1.9	1.6	3.2	10.5	17.4	4.5	2.6	5.2	5.0	3.6
Balance of trade (US\$ mil)	346	246	130	676	290	280	1481	1640	2075	3046
Current account balance (US\$ mil)	8.1	-113	-0.698	100.4	-312.4	-157.9	676.7	575	134	1212
Export growth (%)	2.2	-2.8	-3.2	51.9	38.3	-9.5	45.6	13.0	7.4	41.7
Import growth (%)	19.7	3.0	2.7	30.6	66.7	-13.7	14.0	26.0	13.2	25.4
Debt service ratio	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Unemployment rate (% of labor force)	7.5	7.5	8.4	7.3	6.7	6.9	6.4	6.3	6.3	5.6
Saving (% of GNP)	20.5	16.5	17.1	24.5	15.0	21.9	29.7	28.6	27.7	31.8
Population (million)	10.8	11.1	11.4	11.7	11.8	11.9	12.2	12.5	12.9	13.2
Gross fixed capital formation (US\$ billion)										
Private	0.4	0.4	0.6	0.9	1.8	1.3	1.4	1.8	2.4	2.9
Public	0.3	0.4	0.5	0.7	0.7	0.8	0.9	1.3	1.5	1.9
% of GNP	18.6	20.8	23.8	23.9	30.5	25.9	22.8	23.5	24.6	24.8



1960, the share of agriculture in the GDP was 40 per cent, but by 1996 it was reduced to 20 per cent. On the other hand, manufacturing share rose from 9 per cent to 35 per cent during the same period. The dynamism of the manufacturing sector is demonstrated by comparing its output growth with that of the national economy - during the 1987-1995 period, manufacturing sector grew at an annual rate of 11.8 per cent compared to 7.5 per cent by the national economy.<sup>2/</sup>

However, the manufacturing sector also faces a number of structural rigidities that can seriously impede its growth [Mahani (1996), Jomo (1997), Lee (1996), and Lall (1996)]. They include limitations such as heavily reliance on a few key industries, high import content, minimal linkages and low value added. These rigidities have existed for a long time yet remedial measures have proven to be unsuccessful. In addition, recent developments, namely sustained rapid growth and trade liberalization, have also created another set of problems - highly protected and uncompetitive domestic industries, inadequate technological base and mismatch between labour productivity and wages increases.

The debate on the Malaysian economic growth has narrowed its sources to two key elements - expansion of exports versus creation of investment. Malaysia was a very open economy even during the period immediately after Independence (1957). In 1960, the ratio of total exports to Gross National Product (GNP) was 46 per cent, but by 1996 it became 82 per cent. This growth was driven by manufacturing exports, which is directly linked to export-oriented industrialization and liberal trade policies, where its present contribution amounted to 81 per cent of total exports. Manufacturing exports are expected to become even more important in the future based on its incremental growth rates; during the period 1987-1995, its annual growth rate was 22 per cent in contrast with 15 per cent of total exports.

Import pattern in Malaysia is closely linked with export movements. In 1996, the size of imports (its ratio to the GNP) was 84 per cent - larger than the export ratio - but the magnitude of import changes is much more extreme than that of exports. For example, in 1995, when exports increased by 20 per cent, imports expanded by 23 per cent. But when there was a slow down in exports growth, imports reduced even more; in 1996, exports grew only at 6.3 per cent but imports expansion was very much smaller at 1.5 per cent.

Ariff (1994) showed that, for the period 1970 to 1991, exports have led the Malaysian economic growth by estimating a significant positive relationship between GNP and exports. Similar conclusion was obtained by Athukorala and Menon where they studied the close association between growth and the degree of export orientation. The contribution of manufacturing exports to income and employment growth is particularly important; although its per unit value added is low, the high volume of output has produced large revenue and has created large employment opportunities which absorbed unskilled labour and provided a solution to the potential problem of rural unemployment (Warr, 1987). This is more than compensate for the problems of minimal linkages and high import content prevalent among these export

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<sup>2/</sup> Data was obtained from the various issues of the Economic Report.

industries. The success of export-led growth was very much dependent on government policies that were designed to promote manufacturing exports (Ariff and Hill, 1985).

An equally strong case was also made out for an investment-led growth. The contribution made by investment to growth is evident not only by the amount invested but also by its sectoral composition. Gan and Soon (1996) showed that the ratio of real fixed investment to GDP rose from 22 per cent during the early 1970s to 44 per cent by 1995. They also argued that these investments were channeled into the manufacturing sector which yielded high returns - about half of the annual increase in capital expenditure were spent by the manufacturing sector and 60 per cent of it was for plant and machinery expenditure. A large proportion of this investment came from Foreign Direct Investment (FDI); between 1984 to 1988, the average annual flow of FDI was about US\$ 0.56 billion whereas from 1989 to 1994, the average rose to US\$ 3.7 billion (Table 2). In addition to its role in closing the country's domestic resource gap, Malaysia also benefited from FDI contribution in bringing modern technology and extensive export marketing network [Ariff (1991) and Ariff and Chee (1987)].

Table 2  
FLOW OF FOREIGN DIRECT INVESTMENT INTO MALAYSIA

Year	US\$ million
1980	270.3
1985	355.2
1986	625.2
1987	762.0
1988	1 806.6
1989	3 204.8
1990	6 529.3
1991	6 316.6
1992	6 582.2
1993	2 328.5
1994	4 199.6
1995	3 386.5

Source: Economic Report, various issues.

Savings features as an important component in domestic investment. On the whole, Malaysia's savings rate is considered as one of the highest in the world – since the 1960s, Malaysia saved an average of 24 per cent annually and in 1996 it has reached 38 per cent. But Kharas (1991) argued that savings, although high, is unlikely to be sufficient in generating growth. During the period from 1960 to 1980, national savings has been able to finance investment outlays without significant recourse to external financing (Lin, 1992). However, in the 1981-1985 period, large public sector investment has resulted in the emergence of a savings-investment gap, thus rising the external debt. Fortunately, this shortfall was turned into surplus by 1987 as a result of fiscal restraint. Nevertheless, with rising investment requirements and increasing consumption, the gap had emerged once again in the first half of 1990s. Table 3

showed that during the period 1992-1997, while public savings- investment surplus increased, the private sector registered larger deficits.

Malaysian economic growth is led by both exports and investment depending on the phase of development. In the early phase of export-oriented industrialization, exports was definitely the source of growth through the generation of income, diversification and deepening of industrial activities and employment creation. However, since 1980, this role was taken over by investment, firstly through public sector investment (1980-1985) and secondly by the private sector with large inflow of FDI and privatization.

Perhaps one unique feature of the Malaysian development process is its ability to manage economic growth in a multiracial society. In such a situation, growth must be shared between the various ethnic groups to maintain harmony and political stability, an essential ingredient for growth. The New Economic Policy (1970-1990) and its successor, the National Development Plan, have two main objectives: the eradication of poverty and economic restructuring. The first target was achieved as evidenced by the reduction of the incidence of poverty from 49.3 per cent in 1970 to 10.5 per cent in 1993 (Ishak and Ragayah, 1995). On the other hand, the attainments of the second objective can be further improved [Ismail and Meyanathan (1993), Mehmet (1986) and Jomo (1990)].<sup>3/</sup>

## **2. The Role of Malaysian Industrial and Trade Policies**

The above summary points to the importance of industrialization and trade in the Malaysian development experience. This study will analyze how industrial and trade policies were designed to support this growth process and the measures. In the main, we can characterize these two policies as mildly interventionist – with varying degrees. A set of relatively more focussed and concerted industrial measures were introduced to steer the export-industrialization process. Initially they were broad-based incentives but later were more concentrated with the introduction of the Promotion of Investment Act in 1986. On the other hand, the trade regime was relatively less interventionist and thus the transformation from import substitution to export promotion strategy was not too difficult. Nevertheless, a highly distortive trade policy was introduced for the second round of import substitution to promote heavy industries.

Malaysia's obligations to the new international trading system, the General Agreement on Tariff and Trade (GATT) and regional trading arrangements, namely ASEAN Free Trade Area (AFTA) and Asia Pacific Economic Cooperation (APEC), will have a far-reaching impact on industrial and trade measures that can be employed in the future. This study shows that the Malaysian industrial and trade policies do not need to be significantly changed to comply with the GATT. Notwithstanding this, liberalization will require new approaches for the development

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<sup>3/</sup> The Bumiputera corporate ownership rose from 2 per cent in 1969 to 19 per cent in 1988, but it was still below the target of 30 per cent. The employment attainment was much better because the intake of Bumiputera students in local universities was increased from 40 per cent in 1970 to 67 per cent in 1985. Similarly, the number of Bumiputera professional; in fields such as legal services, accountancy and medical services have also increased significantly.

Table 3  
MALAYSIA: SAVING-INVESTMENT GAP, 1992-1997  
(US\$ million)

	1992	1993	1994	1995	1996	1997
Public sector domestic capital formation	7770	8799	9187	10225	11503	13382
Public savings	9033	10125	12349	12263	13448	16505
<b>Deficit/surplus</b>	<b>1262</b>	<b>1326</b>	<b>3162</b>	<b>2038</b>	<b>3426</b>	<b>3122</b>
Private gross domestic capital formation	11527	14333	19298	24800	26620	31276
Private savings	8182	10072	11630	15840	19870	22663
<b>Deficit/surplus</b>	<b>-3345</b>	<b>-4261</b>	<b>-7634</b>	<b>-8960</b>	<b>-6750</b>	<b>-8613</b>
Gross Domestic capital formation (as % of GNP)	19297 (37.1)	23133 (39.8)	28452 (42.5)	35026 (45.4)	38125 (43.3)	44659 (44.9)
Gross national savings (as % of GNP)	17215 (33)	20198 (35)	23980 (36)	28104 (37)	33318 (38)	39168 (39)
Balance on current account (as % of GNP)	-2082 (-4.0)	-2935 (-5.0)	-4472 (-6.7)	-6922 (-9.0)	-4806 (-5.5)	-5491 (-5.5)

Source: Malaysia, Bank Negara Annual Report 1996.

of the services sector. APEC commitments will support the GATT liberalization process. But, the ramification of AFTA will be more substantial and extensive; it may involve fundamental shifts in domestic economic structure such as industrial restructuring and resource allocation.

The rapid growth since the last nine years has displayed the inherent limitations of the Malaysian economy. The manufacturing sector, including its exports, is based on labour-intensive activities, but now it has to move to a higher value added processes if it wants to sustain the previous high growth rates. As experienced by other countries, such as Korea and Taiwan, rising labour cost if not matched by corresponding productivity increases will result in the erosion of export competitiveness. For example, in chemical and chemical products industry the real unit labour cost index has increased by 18 per cent in 1993 from the base year in 1989.<sup>4/</sup> Similar trend is found in textiles and wearing apparel and transport equipment.

Infrastructure bottlenecks have also emerged – congested roads and ports and shortage of labour and energy supply. The government has responded quickly to these bottlenecks by encouraging private sector investment in the provision of these infrastructure such as tolled roads, ports and production of energy. In addition, the telecommunication sector was deregulated to allow more players that will improve efficiency and services. Although the provision of infrastructure has been vastly improved, it has increased indirect production costs, which ultimately can impair Malaysia's competitiveness.

The rapid economic growth has also caused upward price pressure, which is manifested through asset inflation and high wage increases. More importantly, current account deficit has emerged and it reached a peak of 9 per cent of the GDP in 1995. The persistent current account deficits were primarily caused by the structural imbalance in the services account. These limitations have, in part, caused the recent deep depreciation of the Ringgit – the nominal exchange rate of the Ringgit against the US dollars went down from RM2.5 to US\$1 in May 1997 to, at its worst, RM3.03 in August. The depreciation of the Ringgit has adversely affected the Malaysian stock market and has prompted the government to delay some of the major infrastructural projects. These have cast serious doubt on the ability of the Malaysian economy to maintain its high growth pace.

These recent developments together with the GATT and AFTA, demand policy reformulation to enhance Malaysia's endogenous capability. The most likely route is to move Malaysian industrialization process to a higher level through increment in labour productivity and improvement in human capital. Other critical complements to this strategy are the expansion of domestic technological capability and creation or reorganization of industries to bring new comparative advantage.

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<sup>4/</sup> Government of Malaysia. Treasury Economic Report, 1996/97, page 86.

## II. MALAYSIAN INDUSTRIAL AND TRADE POLICIES

### 1. Introduction

In Malaysia's pursuit of industrialization, its industrial and trade policies have been complementary. Industrial policy instruments have been primarily fiscal incentives such as tax benefits and subsidized infrastructure investments. Trade policy has mostly worked through tariffs and later exchange rates, while quantitative restrictions and import licenses have been used sparingly. In all four phases of industrialization -import substitution; export promotion; heavy industrialization; and liberalization and technology-intensive industrialization- policy has been consistently applied by these means.

As in many other developing countries, the Malaysian industrialization process started with import substitution, which was prominent from the late 1950s to the late 1960s. Fiscal incentives and tariff protection were the key measures, being used to encourage the development of domestic industrial. but the provision of subsidized infrastructure had also significant impact. This import substitution strategy was aimed at final consumer goods. An important feature of this strategy was that the level of protection was moderate, thus easing the later transition to export promotion.

The second phase of Malaysian industrialization, the promotion of exports, began in the late 1960s. Although a wide range of industries was encouraged, both resource and non-resource based, one industry (electrical and electronics) registered exceptional growth; in 1970 electrical and electronics industry share in manufacturing output was only 3 per cent but by 1990 this has reached 26 per cent. The growth and success of export-oriented industrialization, particularly electrical and electronic, can be largely attributed to the inflow of foreign direct investment. Both industrial and trade policies were directed at creating a conducive environment. Many incentives were offered including allowing import of inputs at world prices through the establishment of free trade zones duty drawbacks and lower import duties. The increased industrialization was also intended to meet the socio-economic objective the New Economic Policy, namely increasing the Bumiputra (indigenous) group participation in modern economic activities.

Import substitution was reintroduced in the third phase of the industrialization, specifically for the advancement of heavy industries. This phase started in the early 1980s with the objectives of encouraging industrial deepening and broadening the industrial base through the formation of supporting industries. A more interventionist approach was adopted for this phase, in that high protection was given to the selected industries. In addition, in a departure from earlier practice, the government participated directly in the industries through direct equity participation. This measure was regarded as necessary because most of the heavy industries required large investment. An equally important reason was that it was regarded as a more effective and faster way of increasing Bumiputra participation in industries.

The economic downturn in the middle of 1980s had changed the approach of industrialization towards increased liberalization and greater emphasis on exports. A comprehensive package of incentives was introduced in 1986 to vitalize exports, and this included

reduced tariffs in many sectors. This period also saw a change in trade policy instruments, for the purpose of maintaining export competitiveness. Tariff and duty drawbacks were now replaced by exchange rate as the key trade policy instruments. As part of the liberalization approach, the government also increased private investment and participation through a privatization program, including heavy industries. In the 1990s, because of a tighter labour market, a key policy shift took place. The industrialization process was encouraged to move to higher value-added and capital-intensive activities.

Sections 2 and 3 evaluate the industrial and trade policies employed in the four phases of industrialization. Section 4 assesses the effectiveness of these two policies and shows that although the policies used for promoting exports are less distortive than those for import substitution, they still produce some negative outcomes. Section 5 concludes that industrial and trade policies have been regarded as an integral instrument in Malaysia's industrialization process and they are changed relatively quickly in the light of prevailing conditions and to meet the objectives set out.

## **2. Industrial Policy**

Malaysia has been an independent country for 40 years, and its industrial policy dates from independence in 1957. Our industrialization process can be divided into four sometimes overlapping phases – import substitution, export promotion, heavy industrialization and liberalization and technology- and knowledge-intensive industrialization. This section will examine the evolution of each phase and describe the industrial policy instruments applied.

### **a) Import substitution Industrialization**

As many other developing countries have done, Malaysia adopted an import substitution strategy for the first phase of its industrialization process. This phase did not last very long, only from the late 1950s to the late 1960s. Thereafter import substitution was applied only to selected industries or activities. The primary objective of import substitution was to encourage investment to create an industrial base. Because the creation of investment was paramount, there was no special preference towards formation of domestic companies, and many of the companies set up during this phase were owned by the former colonial power.

Due to the lack of domestic technological capability and following the normal pattern of import substitution industrialization, most industries that were established during this phase produced final consumer goods. Most notably food and beverages became the largest industry in terms of output and employment share. For example, in 1963, this industry employed about 20 per cent of the total manufacturing sector workforce. The wood products industry also became an important part of the manufacturing sector. There was also some investment in final assembly of consumer durables such as motorcars. However, not much indigenous industrial capability was built up and little technology was transferred. This was quite logical and inevitable because the industries formed were operating at a low level of technology with low level of technology.

The most important industrial policy instrument during this phase was fiscal incentives. The Pioneer Industries Ordinance (1958) and the Pioneer Industries Act (1965) granted pioneer status to all new companies that met a specified investment level. Under this incentive, companies were exempt from income tax and any losses could be carried forward to be set off against future income. This incentive promoted import substitution industries because it was given mostly to those manufacturing products not available in Malaysia. Hand in hand with the investment incentive was tariff protection - while incentives promoted formation of companies, tariffs ensured their survival. Heavy import duties were levied on final goods while intermediate goods did not enjoy such a high level of protection. The level of protection given could be considered moderate when compared with other import substitution regimes in that period (Mahani and Ariff, 1995). The average nominal rate of protection was only 10 per cent in 1963 while the effective rate was 21 per cent (Mahani, 1992).

Another instrument to encourage investment was subsidized infrastructure provided by state governments <sup>5/</sup> or at the federal level by the Malaysian Industrial Estates Limited. Special industrial locations were prepared with road and sometimes rail access, water and electricity connections and companies sited in these locations paid subsidized rentals and charges for these facilities.

### ***Performance***

During the period 1957 to 1965, the manufacturing share of the Gross Domestic Product (GDP) grew by 4.1 per cent per annum while employment increased by 3.4 per cent annually. This showed that manufacturing output grew much faster than its ability to create employment, thus the industrial policy could be considered successful in meeting the primary objective of creating an industrial base.

#### **b) Export-oriented Industrialization**

The second phase, namely export-oriented industrialization started in the late 1960s as a solution to some of the constraints of import substitution and in response to the flow of capital from industrialized countries. Although the economic growth rates generated in the first phase were reasonably high, there were signs that such growth might not be sustainable; the domestic market was too small to continuously support such growth rates and existing industries showed no sign of venturing into export markets. On the other hand, Malaysia, with abundant low cost labour, offered an ideal location for those who sought to relocate their export-oriented, labour-intensive operations.

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<sup>5/</sup> Malaysia constitutes a federation of fourteen states and federal territories. Each of the twelve states is governed by their own government with financial autonomy. There are two federal territories, which are under the jurisdiction of the central government. State governments, through their own development corporations, have taken initiatives to attract investment by establishing industrial areas and sending missions abroad to attract investment.



Two separate sets of plans were developed, one for resource-based and the other for non-resource based industries (there was some common ground, such as in encouraging foreign investment in both types of industry). The approach to resource-based industries involved an upgrading of the old agriculture activity (rubber) as well as the encouragement of new cash crops and primary commodities (palm oil, cocoa and timber and wood products). This came in the form of governmental support for technological improvement and market promotion. By contrast, the non resource-based industries were new ones, involving foreign capital with much less linkage to the domestic economy. Consequently, efforts to attract foreign investment and policies to promote exports were extensively directed towards non-resource-based industries.

The non resource-based export industries were, by far, more important than the resource-based ones, and were concentrated in two sectors - electrical and electronics, and textile and wearing apparel. By any measure the electrical and electronics industry growth was phenomenal. By 1992, it contributed about 40 per cent of the total manufacturing output and 60 per cent of manufacturing exports. However, its real contribution was much smaller because of high import content, little transfer of technology and minimal linkages to domestic suppliers or customers.

The Malaysian government implemented an aggressive export promotion policy to attract Foreign Direct Investment (FDI) through a comprehensive set of incentives, provision of good infrastructure, creation of a conducive investment environment and relaxation of equity ownership requirements. The push for export-oriented industrialization started with the Investment Incentives Act (1968) which, besides offering the pioneer status and investment tax allowance incentives, also included export incentives, which were given, based on volume exported. This incentive package also granted benefits for industrial location and employment generation. To complement the incentive packages, the Malaysian government provided facilities in which companies could operate in a "world price" environment. Inputs could be imported free of duties and output could be exported without taxes - in other words, Free Trade Zones (FTZ). The Free Trade Zone Act was introduced in 1971 and to date there are twelve such facilities. The importance of FTZ as one of the key instruments in the success of export-oriented industrialization is acknowledged (Warr, 1987) because they facilitate the manufacturing operations of exporting companies and act as a model for the rest of the country.

When it was neither practical nor desirable to establish a FTZ, a similar facility called a Licensed Manufacturing Warehouse (LMW) was accorded to specific companies. To qualify for such facility, a company must export at least 80 per cent of its output and import almost all of its input. These measures were necessary to make Malaysian companies internationally competitive because there remained still some import tariffs from the import substitution phase. Export promotion and import substitution were found in quite separate industries, and so the government was able to prolong import substitution into the second phase of development to further develop a domestic industrial base.

To complement the growth in investment and business facilities, the government expanded the infrastructure at ports, airports, telecommunication and electricity supply.

The starting of the export-oriented industrialization phase coincided with the introduction of a national socio-economic restructuring programme. The New Economic Policy (NEP) was promulgated in 1970 to eradicate poverty, restructure the economy, and eliminate the identification of ethnic groups by their economic activities.<sup>6/</sup> Through the NEP, the government participated actively in the manufacturing sector by creating public sector companies or acquiring them. Besides helping to meet its socio-economic engineering goals, these moves expanded the pool of domestic industries. Economic growth generated by the export-oriented industrialization could provide business opportunities and Malay business involvement would be strengthened as a result.

### ***Industrial Co-ordination Act, 1975***

To ensure orderly development of the manufacturing sector, the government required that manufacturing companies including export companies with a capital base of US\$ 1 million or engaging 75 or more full time workers to obtain a license. Initially, this measure met stiff resistance because manufacturers believed it to be some form of indirect enforcement of the NEP economic restructuring objective. Furthermore, there were concerns that this new regulation might deter FDI from investing in Malaysia. The licensing requirement was later relaxed to exclude small and medium scale companies. Thus far, the licensing requirement has not posed any major obstacle to the growth of the manufacturing sector and to the expansion of export-oriented investment.

### ***Performance***

Export-oriented industrialization has produced sustained growth for the Malaysian economy from 1970 up to almost the present time with the exception of the recession years of 1985 and 1986. The importance of the manufacturing sector can be gauged from its increased share in GDP from 13 per cent in 1970 to 20 per cent in 1985. The role of manufacturing exports has been central to this growth process – during the same period the manufacturing exports share in total exports has increased from 12 per cent to 32 per cent. Although the export-industrialization strategy has been successful in generating growth, it requires as argued by Rajah (1996) heavier subsidies than domestic companies. But of a more serious concern is the extensive reliance on foreign capital and the footloose nature of these industries which made them easily transferable out of Malaysia if the investment environment is no longer conducive (Jomo, 1993). In addition, there were also questions about the real contributions of these industries since their products have very high import content.

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<sup>6/</sup> The racial riot in 1969 was a manifestation of the unbalanced economic power among the ethnic groups where economic activities and wealth could be distinctly identified with ethnic groups. The Malays were normally in agriculture, Chinese in commerce and manufacturing while foreigners in trade and corporate sector.

c) Heavy Industrialization

Although as early as the beginning of the 1970s, the Malaysian government had embarked on an export promotion policy, a second round of import substitution phase was adopted in the form of a heavy industrialization policy, introduced in the early 1980s, which formed the third phase of industrial development. Its primary objective was to encourage capital deepening and expand the domestic industrial base since both the previous two phases had signally failed to do so. In addition, the heavy industrialization policy also was a crucial instrument for the government to fulfill the NEP objectives. Almost all the heavy industries have direct public sector equity participation, held in trust for the Malays, and which are to be distributed to the Malay masses through mechanisms such as unit trusts. These public sector investments were made through a newly created public sector agency called Heavy Industries Corporation of Malaysia (HICOM). Companies were created to operate in the steel, cement, automotive, aerospace, petrochemical and pulp and paper industries.

Heavy industrialization was made possible by high protection and direct government equity participation. For example, the national car project (PROTON) pays a preferential tariff rate of 13 per cent for its imported components while other automotive manufacturers have to pay 42 per cent. PROTON was also assisted when the tariff on imports of fully built cars was increased to 200 per cent. Further restriction was imposed in the form of import permits for completely built vehicles. As a consequence, PROTON now has over 70 percent of the passenger car market. Quantitative restrictions on imports were imposed for cement and steel. Furthermore, competition in the domestic market was controlled by increasing the barriers to market entry. This ensured a large enough market share for each domestic company to survive (Jomo, 1997). The government has invested massively in heavy industries - in the Fourth Development Plan period (1980-1985) the allocation was US\$ 411 million, US\$ 926 million for the Fifth Plan (1986-1990) and US\$ 210 million in the Sixth Plan (1991-1995).<sup>7/</sup> Some of these high investments were made when there was a reduction in the volume of public expenditure, especially during the 1984-1986 period.

The heavy industrialization programme was sustainable for only for a short period of time; by 1985 many companies faced financial difficulties and some had to receive new capital or be reorganized. In addition to low competitiveness and limited domestic market, these industries were also handicapped by the deep economic recession experienced by Malaysia during the 1985 and 1986. The problems encountered by this industrialization strategy were even acknowledged by the government - *"In general, the performance of heavy industry projects was far from satisfactory. A number of these projects suffered heavy financial losses due to the sluggish domestic market and the inability of the industries concerned to compete in international markets"* The Mid-term Review of the Fifth Malaysia Plan. (1984)

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<sup>7/</sup> Source: various Malaysia Development Plans. The exchange rate used in US\$ 1 = Ringgit 2.7.

Aside from capital deepening, the heavy industrialization strategy was also used to expand domestic manufacturing capability, especially among small and medium scale industries. The most successful programme was in the automotive industry where local content and single sourcing policies created about 300 local vendors of components for the national car. The local content rule required that by 1997, 80 per cent of the components used in the national must be sourced locally. Under the single sourcing policy, selected vendors were guaranteed a market for their products and this has enabled them to become profitable and expand.

d) Liberalization and Technology-intensive Industrialization

As a response to the recession in 1985, the government decided to liberalize the economy, and push for more technology content. This is the fourth and present phase, which co-exists with the second and third phases. Under its liberalization approach, the source of growth was shifted from the public to the private sector while the government continued to promote a good business environment. A key liberalization instrument was the privatization of public sector companies, which saw the transfer of equity in these companies from the government to private ownership. In a way, this has reduced the interventionist stance of the government in the manufacturing sector because it allows companies to respond to market conditions. Notable among the privatized companies are those in heavy industries such as the national car and steel mill. The government had continued this privatization policy for activities which were established after the heavy industrialization period but were considered as “national projects”, for example the second national car, manufacture of a national motorcycle and a semi conductor wafer fabrication plant.

Measures to attract investment and accelerate exports were embodied in the First Malaysian Industrial Master Plan (FIMP) launched in 1985 to chart the growth of the manufacturing sector for the ten year period from 1985 to 1995. The Plan was an indicative one which identified twelve industries, ( seven resource-based and five non-resource-based), to be developed with the ultimate aim of diversifying the manufacturing sector. As an indicative plan, it did not quantify industry performance targets but only the types of products and activities to be promoted. Thus far, the structure of the manufacturing sector was very distinct – export industries are different from those serving the domestic market – but to achieve to diversify the manufacturing activities, domestic industries were encouraged to export while exports industries were urged to extend backward linkages to domestic sources of goods and services. Beside these targets, the Plan also proposed the dispersal of industries to areas outside the main growth centres, as part of its overall objective of diversification.

Shortly after the First Industrial Master Plan began (1985), the Promotion of Investments Act, 1986 (PIA) replaced the Investment Incentives Act, 1968. The PIA offered a much wider range of incentives, available to more industries and promoted through many parameters: investment and reinvestment exports, capital expenditure, industrial location and equity requirement. It had similar key benefits, namely pioneer status and the investment tax allowance, but the parameters used to grant benefits changed from level of investment to types

of products or activities. The promoted products and activities were expected to find export markets and reduce economic dependence on electrical and electronic exports.

Export promotion was given greater emphasis both in terms of coverage and benefits. Benefits included an allowance based on export sales, double tax deduction for expenses incurred on export marketing activities and on export credit insurance. In addition, abatement of adjusted income for exports was given, based on the use of local and indigenous material, and value added generated. This reduction of pre-depreciation profit, generally by 50 percent, meant often that no tax was payable after capital allowances were deducted. An export credit-refinancing scheme providing exporters with credit at a reduced rate of interest was also offered. Another feature of the PIA was its focus on capital expenditure: larger benefits could be accrued with higher use of capital such as reinvestment and depreciation. This set of capital based incentives was intended to encourage capital deepening.

Since its introduction, the PIA has been successively amended to address three economic aims – industrial deepening, more cohesive export promotion and locational and small and medium scale industries development. Details of these changes are given in Appendix A. The exceptional growth of the manufacturing sector has been accompanied by little capital deepening and diversification; most industries are still overly dependent on labour-intensive activities and import content continues to be high, particularly for the electrical and electronic industry. To overcome these problems, additional incentives were given for:

- Investment in high technology industries - a percentage of local R&D and technical personnel is a pre-condition;

- Strategic projects - identified as those with large capital investment, uses high technology and can generate extensive linkages;

- R&D – for fostering R&D activities in industry and for encouraging the establishment of companies and institutions to undertake R&D;

- Training – for upgrading of skills, productivity and quality of employees; and

- Industrial adjustment - to improve the technology used, increase productivity, enhance the use of natural resources and for efficient manpower management.

Some of the earlier export incentives such as local content criteria, which were primarily aimed at increasing export volumes, have been withdrawn <sup>8/</sup> and replaced by incentives for improving trade facilities. These cover export credit refinancing, export credit insurance

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<sup>8/</sup> The withdrawal of these incentives was perhaps due to their low utilization rate – since there are other incentives that could bring similar benefits, companies did not have to meet, for example the strict the local content requirement, in order to be given incentives.

premiums, export promotion and warehouses used for export activities. The incentive is usually in the form of a double deduction of those costs in computing taxable profits.

Industrial activities remain concentrated along the Western Corridor of Peninsular Malaysia, around major cities. A special tax package is now available to companies to set up in other less developed areas. Similarly, small and medium scale industries have not expanded in line with overall growth; additional incentives in the form of automatic granting of pioneer status and import duty exemption on input were added to facilitate their development.

Other supporting measures complemented the industrial policy:

**-Favourable investment environment**

The government has liberalized the financial sector allowing for interest rates to be determined by the market, deepening and expanding the financial market and developing new financial instruments. Another supporting step was the reduction of the corporate income tax rate to make it comparable with that of other countries in the region (30 per cent).

**-Equity guidelines**

One of the instruments used to restructure the economic ownership pattern was the requirement that at least 30 per cent of a company's equity must belong to the Malays (Bumiputeras). In order to attract more foreign investment and to create a freer investment climate, the government has now relaxed this requirement. Full foreign ownership is allowed for projects that export at least 80 per cent of their products and for those exporting less, the share of foreign equity varies with the percentage of product exported. The equity requirement now is dependent on the level of technology, spin-off effects, size of investment, location, value added and the utilization of raw materials and components.

Although the guidelines appear complex, in practice some measure of flexibility is incorporated provided that the primary objective of local participation is observed. Apparently the guidelines have not yet hindered the flow of foreign investment because the FDI has been almost entirely for exports activities. Most crucially the government has given an assurance that the existing or approved equity distribution will not be affected by any future restructuring. To further increase investors' confidence, the Malaysian government has entered into investment guarantee agreements with more than forty countries to disavow nationalization and expropriation as well as to allow free transfer of profits.

***Performance***

The manufacturing sector had performed exceedingly well during the period of the FIMP (1985-1995), and has exceeded the sectoral performance target set out in this Plan (Table 4). Most encouraging was the export growth rate, which was about three times the targeted rate. During the last nine years, that is since the liberalization measures were introduced, the

manufacturing sector expansion has brought its contribution to GDP to the 35 per cent level – it is now the engine of growth in Malaysia. Its output, exports and employment growth rates have been higher than that of the national economy overall (Table 5).

**Table 4**  
**GROWTH OF THE MANUFACTURING SECTOR DURING THE FIRST**  
**INDUSTRIAL MASTER PLAN, 1986-1995**  
(Per cent per annum)

	Target	Actual
GDP	6.4	7.8
Manufacturing value added	8.8	13.5
Share of manufacturing value added to GDP (1995)	23.9	33.1
Manufacturing exports	9.4	28.6
Manufacturing employment	6.8	8.9
Manufacturing employment ('000 workers) (1995)	1 464.0	2 051.0

Source: The Second Industrial Master Plan Report, 1996-2005, Ministry of International Trade and Industry, 1996.

**Table 5**  
**MALAYSIAN MANUFACTURING SECTOR AND ECONOMIC GROWTH, 1987-1995**  
(Per cent per annum)

	Total Economy	Manufacturing Sector
Output growth	7.5	11.8
Employment growth	3.2	8.6
Export growth	15.5	22.0

Source: Malaysia, Treasury Economic Report, various years.

The non resource-based industries registered a higher growth rate of 18.3 per cent, compared with 9.1 per cent by the resource-based ones.<sup>9/</sup> Among the former, fabricated metal products, electrical and electronic products and textiles posted the highest value added growth while for the latter, rubber products, plastic and non-metallic products were top. This exceptional performance may be attributed not only to the structural changes driven by Malaysia's industrial and trade policies changes but also to the large capital flow following the

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<sup>9/</sup> Mahani (1996).

currencies alignment and the Plaza Accord. Growing world demand for goods and services has also played a part.

Perhaps inevitably the exceptional growth has revealed structural constraints and some major rigidities in the manufacturing sector. Rapid growth has caused labour shortages and upward wage pressure. Malaysia is now losing its comparative advantage in labour-intensive activities because its wage rate is now higher than in other emerging countries in the region such as Indonesia, Vietnam and China. In fact, Malaysia has reached the limit of its labour intensive industrialization and has to move soon to the next level where industrial activities will add more value per person.

The manufacturing sector also needs fundamental transformation to redress some of the structural rigidities. Electrical and electronic industry remains in a dominant position, with little diversity in the manufacturing sector. Linkages within the industry and between industries are still weak. Vendor development programmes to foster support industries are too dependent on a handful of key manufacturers. In addition, many of these supporting industries require high protection and find it difficult to compete internationally. Heavy industry faces similar limitations as they rely completely on the domestic market for their growth.

Transformation of the manufacturing sector from labour-intensive to technology-intensive will be governed by a number of factors. Malaysia has an inadequate supply of skilled labour and its technological base is still in its infancy. Increasing the supply of skilled labour and developing technological capability requires a good period of gestation. In the meantime, new markets are opening under regional trading arrangements (ASEAN Free Trade Area and Asia Pacific Economic Cooperation) and multilateral trading system commitments (General Agreement on Tariff and Trade). These developments will require the manufacturing sector to be internationally competitive if high growth is to be sustained. To respond to these challenges, late in 1996 the Malaysian government launched the Second Industrial Master Plan (SIMP). Chapter 4 will review this Plan and its instruments.

### **3. Trade Policy**

Malaysia's trade policy was designed to be complementary to the Malaysian industrialization process and to meet the objectives of each industrialization phase. After 1987 Malaysia's various commitments to multilateral and regional trading arrangements have taken liberalization trade policy along the liberalization route. Tariffs have been the key instrument in the Malaysian trade policy all along while the exchange rate became more important after 1987. Quantitative restrictions and import licensing have also been used in a secondary role, as circumstances required them. An export duty was imposed on primary commodities such as rubber and petroleum; this had the twin attractions of earning revenue and encouraging higher value added processing within the country.



a) Tariff regime

Prior to industrialization, Malaysian external trade was concentrated on exports of primary commodities, namely rubber and tin. Import tariffs were minimal and were mainly for revenue purposes. During the import substitution period, import tariffs were used to protect infant and import substitution industries but they were not excessive. In the 1950s, tariff rates were low but the Nominal Rate of Protection (NRP) was increased somewhat to 10 per cent in 1963. Further rises were made, until the NRP reached a peak of 25 per cent in 1979, before declining in line with the export promotion strategy.<sup>10/</sup> The Effective Rate of Protection (ERP) showed a slightly different pattern. In the period 1973 to 1978, when NRP was increasing, ERP actually declined (Table 6). Nevertheless, it later rose to 46 per cent in 1982. This shows us that manufacture of intermediate goods was less protected than final goods. This supports the earlier comments about the protection of final goods manufacturing industries.

**Table 6**  
**UNWEIGHTED NOMINAL (NRP) AND EFFECTIVE (ERP)**  
**PROTECTION RATE OF MALAYSIA**

Year	NRP (%)	ERP (%)
1963	10	21
1965	12	24
1970	15	44
1973	19	40
1978	20	38
1979	22	43
1982	17	46

Source: 1963 and 1965 rates from Power (1971), 1970 Rates from Tariff (1975), 1973 and 1978 from Lee (1986) and 1979 and 1982 from Economic Planning Unit (1984).

There are wide variations of NRP and ERP among industries. For example, the lowest NRP is consistently rubber remilling and latex processing, while the highest is always tobacco products. The range between the lowest and the highest NRP is 93 per cent in 1963 and by 1978

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<sup>10/</sup> There was no complete series of estimates on nominal and effective rates of protection. However, a series was constructed from estimates from 1963 and 1982 from studies by Power (1971), Panchamukhi (1972), Ariff (1975), Edwards (1975), Von Rabenau (1975), Lee (1986) and the Government of Malaysia (1984). Issues such as different methods used, sources of data and varying underlying parameters must be taken into account in considering the compatibility of the estimates.

this is 210 percent 1978.<sup>11/</sup> The ERP has an even wider range. The industry with the lowest ERP is always rubber remilling and latex processing. On the other hand, the industry that has the highest ERP changes from textiles (337 per cent in 1963) to chemical fertilizers (248 per cent in 1970) and motor vehicles (317 per cent in 1978).

These data are indicative of the industrialization transformation from production (and protection) of consumer goods to the manufacture of heavy industries and consumer durables. If we examine the protection according to major product groups, consumer durables were least protected in 1963 but became highly protected by 1978. Effective protection for intermediate products with a low level of processing was consistently far less than for industries producing intermediate goods with a higher level of processing. The import substitution period (1957 to 1968) lasted longer than according to the industrial policy, as Lee (1986) showed that importables had a higher ERP than exportables even in the export promotion phase.

The support for export-oriented industrialization was carried out smoothly due to the moderate rate of protection under the import substitution policy. For example, in 1979 only 46 per cent of the total tariff lines were less than 5 per cent but by 1982 this share had increased to 50 per cent.<sup>12/</sup> In addition, the proportion of items with high tariff rates (50 per cent and above) fell from 16 per cent to 13 per cent during the same period. The liberalization was carried out gradually, giving time for import substitution industries to adjust. Since export-oriented companies generally operate in different industries from import substitution ones, it was possible to use the tariff regime selectively. The exports were aided through the combination of tariffs (duty free environment in the FTZ or duty exemptions) and industrial policy (incentives).

#### b) Exemption from Import Duties

Exemption from import duties on raw material and machinery was used quite widely for both import substitution and exporting industries. In particular, full exemption was given to imports by domestic companies if without it, they could not compete against imports. The approach was even more liberal for exporting industries. Exemption would still be given, even if imported inputs have to be used because the quality of local ones was inferior, or its price was higher than imports. For import substitution industries, duty exemptions provided an additional level of protection.

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<sup>11/</sup> For more detailed discussion see Lee (1986) and Economic Planning Unit (1984). Lee's discussion included classification by major product groups and resource-based sectors. The Economic Planning Unit analysis was even more disaggregated – by 5 digit Malaysian industrial classification.

<sup>12/</sup> See Government of Malaysia/UNDP/World Bank (1984), Malaysian Industrial Policy Studies Project Report No. 1.. 'Tariff and Tariff Related Incentives in Malaysia, unpublished report.

c) Quantitative Restrictions

Import restrictions and quotas are not now widely used. In the earlier stage of industrialization, the degree of import restriction or quota was based either on the industry's expected production capacity or the previous year's imports. In practice, if restriction was the method chosen, imports were usually set at 60 to 70 per cent of the previous year's imports. On the other hand, quotas were based on the capacity rather than the production level and therefore often more protective of domestic producers. By any standard, import restrictions and quotas were not widespread. In fact shortly after the introduction of a more open trade policy, there was a move away from quantitative restriction as a form of protection. In 1973, for example, 135 items or 4.2 per cent of the total number of import items were subjected to quantitative restrictions. By 1980, quantitative restrictions applied only to 12 items.

Presently, quantitative restrictions and import licenses are in force only in some heavy industries (automotive), selected agriculture products (poultry) and textiles (batik). Import permits are only needed for the import of completely built vehicles.

d) Exchange Rates

To a large extent, the massive flow of FDI into Malaysia and its fast export growth after 1987 could be attributed to the competitive Ringgit exchange rate. The role of exchange rate in trade performance was not strong in the earlier export promotion phase (1970 to mid 1980s), but during the period of high export growth (1987 onwards) "the government was committed to maintain a low exchange rate protection policy" <sup>13/</sup> to ensure export competitiveness.

Before March 1973, the Ringgit together with the Singapore Dollar and the Brunei Dollar were tied by a currency interchangeability agreement which allowed the three currencies to be exchanged at par with one another. From June 1973 onwards the Ringgit was allowed to float. In September 1975 it was pegged to a basket of currencies of its major trading partners.

Table 7 shows the indices of the Ringgit nominal and real effective exchange rates from 1980 to 1988 for a group of Malaysia's leading 18 trading partners.<sup>14/</sup> During the period from 1980 to 1985, both the Ringgit nominal and the effective real exchange rates appreciated caused mainly by massive capital inflow and increase in government spending. As a result, prices of non-tradable goods and services were relatively higher, thus eroding the competitiveness of exports. The subsequent severe recession marked the beginning of the Ringgit deep depreciation, which continued until 1990. World currency alignment has also contributed to the

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<sup>13/</sup> Gan (1992) discussed extensively the impact of real exchange rate on the Malaysian manufacturing sector for the period 1985 to 1990.

<sup>14/</sup> See Gan (1989), page 24. The weight is assigned to each trading partner's currency according to the partner's merchandise trade (imports plus exports) share in the total trade flow of the 18 countries. The deflator is the consumer price index.

shift in the value of the Ringgit and in particular the appreciation of the Yen could be directly linked to the Plaza Accord. During this period, increases in labour productivity and decrease of nominal wages had enhanced the competitiveness of manufacturing exports - exports grew at an annual average rate of 16 per cent (Mahani, 1996).

The growth of manufacturing exports was supported by the government's commitment to maintain a competitive exchange rate regime. The central bank intervention started from 1987 in response to the large foreign exchange flow and improvement in the terms of trade. For example, capital flow increased by 140 per cent from 1988 to 1989. Under such circumstances, the Ringgit should appreciate but the government has managed to stabilize the exchange rate.

**Table 7**  
**INDICES OF THE RINGGIT NOMINAL AND REAL EFFECTIVE**  
**EXCHANGE RATES, 1970-1988 (1979-1981 = 100)**

Year	Multilateral Trading Partner Weights		
	NEER	REER (CPI)	REER (GDP)
1970	83.4	112.8	99.0
1971	83.8	109.1	95.0
1972	85.9	111.5	91.9
1973	92.7	122.1	106.9
1974	95.7	129.0	109.5
1975	95.9	119.2	95.4
1976	95.1	114.4	97.9
1977	97.1	109.8	99.0
1978	96.0	106.4	99.8
1979	99.6	104.7	103.3
1980	100.1	100.1	100.0
1981	105.3	104.8	970.5
1982	112.9	110.4	100.6
1983	120.0	115.8	106.5
1984	127.8	122.1	114.6
1985	125.1	115.2	106.1
1986	103.3	93.8	77.8
1987	97.1	86.8	n.a
1988	89.2	78.3	n.a

Source: Gan, W.B., 1989, "Macroeconomic Policy, Real Exchange Rate and International Competitiveness - the Malaysian Experience during the 1980s", Faculty of Economics and Administration.

Large inflow of capital and long period of high economic growth have increased the relative price of non-tradables as reflected by the high asset inflation and the growth in

construction activities. At the same time, Malaysia has also experienced continuous large current account deficits, primarily due to services imports. Coupled with uncertainties in the export sector, the Malaysian Ringgit has experienced a massive depreciation beginning May 1997. To date (end of August 1997), the Ringgit has lost nearly 17 per cent of its nominal value against the US dollar.

### ***Trade Policy Liberalization***

Commitments to the General Agreement on Tariff and Trade (GATT) Uruguay Round, the ASEAN Free Trade Area (AFTA) and Asia Pacific Economic Cooperation (APEC) have given further urgency to the liberalization on the Malaysian trade policy. The liberalization measures, particularly under AFTA, will be substantial and more immediate but the GATT commitments are more comprehensive and extensive. On the other hand, APEC's obligations allow greater flexibility in trade policy management because implementation is on a voluntary basis over a longer period of time with minimal institutionalization. The GATT commitments are studied in detail in Chapter 3 while Chapter 5 discusses AFTA and APEC provisions.

## **4. Assessment of the Industrial and Trade Policies**

Industrial policy was engineered and designed to direct the industrialization process in Malaysia. On the other hand, trade policy was employed for similar purposes only until the middle of 1980s but thereafter it has been liberalized, with the exception of exchange rate regime, to be in line with the global and regional trends. Industrial and trade measures to protect heavy industries were very much stronger and costly than those for industries producing consumer goods. The result is, however, debatable; some of the heavy industries have failed with grave financial implications while others have become new sources of manufacturing activity and have supported the development of intermediate industries. On the other hand, final consumer products industries have not expanded to compete effectively with imports.

Although the industrial measures introduced were more extensive, and were further consolidated by the FIMP, their degree of intervention in terms of sectoral preference was less compared to that of import substitution regimes. Creating a conducive investment environment to encourage growth was the focus of later industrialization strategy as ascertained by later changes in the industrial policy and the maintenance of a competitive trade policy. Notwithstanding this general objective, the export promotion measures may have induced resources allocation to the tradable sector where the major benefits could be accrued, especially by foreign-owned companies (Jomo, 1997).

One area in which the interventionist stance is obvious is the link between industrial and trade policies and NEP objectives. Clearly, these policies were employed to restructure the inter-ethnic economic and wealth ownership pattern through the creation of the Malay entrepreneurial class or equity participation. Although equity participation may not be achieved for export industries, which are mostly fully foreign owned, at least the employment targets are met. In this

regard, Malaysian industrial policy intervention is different from other countries because it is linked with social and ethic issues.

The expansion of the export sector and the rapid economic growth since 1987 do not produce a well integrated manufacturing sector: electrical and electronic industry dominates the sector; there lack of industrial linkages and deepening; and manufacturing is still heavily dependent on labour-intensive activities. But, at the same time, it is losing comparative advantage due to increasing wage rates. Thus, industrial policy interventions took a different direction after 1990 to overcome these structural constraints.<sup>15/</sup> Incentives are now given for technological deepening, improving labour skills, increasing value-added and developing small and medium scale industries. To diversify and up-grade industries to higher value added activities, the Malaysian government has proposed the establishment of selected strategic industries.

### 5. Conclusion

Malaysia has achieved considerable success in industrialization – manufacturing share in GDP has reached 34 per cent while manufacturing exports contribute 81 per cent to total exports in 1996. This achievement is supported by strong growth performance especially since 1988; manufacturing output and exports grew at an annual average rate of 12 and 20 per cent respectively. The promotion of export industries was not at the expense of import substitution industries; in fact the latter still contribute significantly because they concentrate on different activities.

Fiscal incentives have been very effective in attracting foreign investment but beside this general objective, they have been fine-tuned from time to time. In the initial phase of industrialization, the aim of attracting investment was widened to include employment creation and regional development. During the export promotion period, more benefits were given to exporters, including trade facilities such as export credit refinancing. Recently introduced benefits based on the use of technology reflect the current interest in more added value industrial activities. Beside direct tax benefits, other provisions of fiscal incentive and some administrative measures have ensured that industrial activities can operate relatively efficiently, ensuring Malaysia's competitiveness in the global market.

The role of trade policy in the industrialization process is relatively indirect when compared to industrial policy. This approach is further manifested by the preference of using exchange rate as the main instrument of trade policy instead of tariff especially after the middle of 1980s. In the implementation of trade policy, there is no clear bias against export industries because the protection rate for import substitution industries was rather modest, with the exception of heavy industries where the application of tariff protection was high and very interventionist in nature. Subsequently, tariff rates were reduced substantially across the board with the objective of allowing the market to allocate resources.

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<sup>15/</sup> Lall argued that Malaysian interventions was not enough to ensure adequate support for skills and technology development.

The role of industrial and trade policy will be tested when Malaysia tries to upgrade its industrialization. The industrialization success is not without some shortcomings, for a number of structural constraints will have to be resolved before industry can upgrade. The Malaysian manufacturing sector has lost comparative advantage in labour-intensive activities because rising wages have not been matched by greater productivity. Furthermore, the manufacturing sector is too dependent on a single industry (electrical and electronics) which is very dependent on imports and has limited local technological capacity. Domestic industrial capacity is still undeveloped. Structural transformation and diversification are sorely needed if growth is to be maintained. The question is whether the combined imperatives of industrial and trade policy can make this transformation a success.

### III. FUTURE TRADE AND INDUSTRIAL POLICIES IN THE NEW MULTILATERAL TRADING SYSTEM

#### 1. Introduction

The Uruguay Round (UR) GATT Agreement requires a major and significant commitment to trade liberalization. The impact of these commitments will vary according to the degree of openness in trade policy adopted prior to the Agreement. For a country with a relatively closed trade policy, the adjustment as required by the GATT is expected to be substantial. The GATT obligations also affect the industrial policy that can be utilized to promote industrialization, for instance, measures that accord advantage to domestic products in export markets are considered not consistent with the basic principles of the GATT and therefore must be removed.

For Malaysia however the impact of the new multilateral trading system is not expected to be great, because its trade is already liberalized and trade-related industrial policy measures do not create massive distortions. Despite this openness, Malaysia still offers substantial liberalization; for manufacturing goods, tariff reductions are offered for about 6000 products with the maximum bound tariff of 30 per cent. In addition, agriculture import quotas are relaxed and textile exports may benefit from expansion of export quotas. A new area included in Malaysia's offers is the services sector where limited foreign participation will be allowed in selected activities. Some of Malaysia's practices will have to change, however, for example in the areas of intellectual property rights and antidumping. Existing laws will have to be toughened in order to comply with the GATT relevant provisions.

Section 2 discusses the offers made for industrial goods, which cover manufactured and agriculture goods and textiles and wearing apparel. Sections 3 covers the implications of liberalization of the services sector, and Sections 4 and 5 review the anticipated changes to the domestic intellectual property rights and anti-dumping legislation. As shown in Section 6 no substantial changes are needed for Malaysia to comply with the trade related investment measures agreement while Section 7 discusses the possibility of introducing a competition policy. Section 8 summaries the benefits and concerns about the new trading arrangement.

#### 2. Industrial Goods

The discussion on industrial goods will comprise three parts - manufactured goods, agriculture and textiles and wearing apparel. The tariff regime for industrial goods, including agriculture, textiles and clothing, is not expected to be much different in the post-UR era because Malaysia already has quite a liberal trade regime. However, there are strong indications that the trade policy will have to be further liberalized to meet Malaysia's regional trading commitments.

##### a) Manufactured goods

In general, Malaysia's tariff liberalization is relatively moderate because its pre-UR tariff rates were not high, with the exception of a few selected items (Table 8). Nevertheless,



Malaysia still offered further tariff liberalization in its UR commitments. 6000 tariff lines will be reduced and bounded with most of the offers having tariff rates ranging between 5 and 30 per cent (Table 9). The largest reduction of tariff lines are for agriculture (1297 lines) and textile products (1100 lines). The biggest quantum of reduction is for agriculture products, for example the tariff for wheat will fall from 272 per cent to 13 per cent and that for grains will fall from 327 per cent to 95 per cent.

**Table 8**  
**MALAYSIA: UNWEIGHTED AVERAGE PRE- AND POST-URUGUAY ROUND**  
**TARIFF RATES**

Product	Pre-UR	Post-UR	Product	Pre-UR	Post-UR
Paddy/rice	49.0	49.0	Milk	111.0	111.0
Wheat	272.0	13.0	Beverages and tobacco	29.5	20.8
Grains	327.0	95.0	Textiles	23.3	17.6
Non grain crops	51.7	47.7	Leather	22.3	18.2
Livestock	118.0	83.0	Lumber	24.5	17.9
Forestry	6.4	6.3	Pulp paper	5.9	5.3
Fishing	7.5	4.8	Chemical	7.7	6.7
Coal	1.8	1.8	Non-metallic mineral prod.	22.7	19.3
Oil	0.9	0.9	Ferrous metals	4.9	4.9
Gas	1.5	1.5	Non-ferrous metal	6.0	5.2
Other minerals	3.5	3.5	Fabricated metals	16.7	13.6
Processed rice	78.0	41.0	Machinery	8.4	5.4

Source: The Pacific Economic Cooperation Council for APEC, 1995, Survey of Impediments to Trade and Investment in the APEC Region.

For Malaysia's ten main exports - natural rubber, wood products, crude petroleum, natural gas, vegetable oil and fats, radio broadcast receivers, sound recorders, telecommunication equipment and transistors - improvement in market access is not expected to be substantial because the pre-UR tariffs in these markets are already low. For example, in the US market, the highest pre-UR tariff rate was 8.5 per cent (telecommunication equipment) while four of the items are already duty free. The post-UR rates saw the number of duty free items being extended to four while the other rates are halved. Although in the Japanese market tariff reductions were more substantial (majority of these items will be duty free and the maximum post-UR rate is about 5 per cent), other non-tariff barriers such as health regulations and distribution system may limit the improvement in market access.

With regards to quantitative restrictions, Malaysia has only a small number of measures in place. The most significant is for automotive industry; the annual quantity quota and import permit limit the import of completely built vehicles. These measures will have to be eliminated by the year 2000. The relaxation of these restrictions will severely test the competitiveness of the domestic automotive manufacturing industry because of the high protection it currently enjoys.

**Table 9**  
**INDUSTRIAL OFFERS MADE BY MALAYSIA IN THE URUGUAY**  
**ROUND AGREEMENT, COVERING 5900 TARIFF LINES**

Product	Tariff lines	Bindings
Fish products (including processed)	74	Majority at 0%
Mineral products	56	Ceiling rates of 5% and 10%
Chemicals (inorganic and organic)	509	At reduced or applied rate between 5% and 30%
Pharmaceutical products	53	Between 5% and 10%
Rubber products	214	Between 5% and 30%
Wood products	170	At reduced and ceiling rates of 5% to 25%
Paper products	197	At reduced and ceiling rates between 20% and 25%
Plastic and articles thereof	500	Ceiling bindings of 30%
Textile related products (yarn and articles)	1 100	At reduced, applied or ceiling rates between 5% and 30%
Footwear and headgear products	58	Majority ceiling bindings at 30%
Ceramic products	35	Reduced, applied and ceiling of 5%, 10% and 30%
Glass and glassware	64	Largely ceiling bindings at 5% and 30%
Iron and steel products	282	At reduced, applied or ceiling rates between 25% and 30%
Electronics and electrical products	450	At reduced, applied or ceiling rates from 0% to 30%
Machinery and mechanical appliances	650	At reduced, applied or ceiling bindings ranging from 5% to 30%
Furniture products	75	At reduced or base rates ranging between 5% and 30%
Scientific equipment (including optical photographic apparatus)	178	Between 0% and 20%
Toys and games	73	0% and 5%
Agricultural sector	1 297	Bound at various levels of tariff

Source: Ministry of International Trade and Industry, Malaysia.

#### b) Agriculture Goods

There is a clear dichotomy in the Malaysian agriculture trade - agriculture exports are mainly primary commodities and cash crops <sup>16/</sup> while imports comprise mostly of food items. The agriculture export industries are open, competitive and receive very little or no government support at all. On the other hand, some basic food product industries are protected and enjoy substantial support from the government. For example, import of live poultry is banned and rice cultivation is subsidized. The import regime for food is quite mixed. Basic food items are generally exempted from import tariffs, with some notable exceptions such as temperate and tropical fruits and milk based products. Strict quantitative restrictions measures are limited to only a small group of products; some food items such as live poultry, live swine, meat of poultry, meat of swine and liquid milk which face import ban.

Malaysia's general offer for agriculture products is a reduction from a pre-UR tariff level of 30 per cent to 19 per cent in the post-UR period. No change is expected for primary commodities while most of the reductions will take place in the food product category.

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<sup>16/</sup> The major primary commodities exports are crude palm oil and its processed products, sawn logs, rubber, cocoa beans and peppers.

For food products under quota,<sup>17/</sup> a minimum of 3 per cent quota expansion must be given but this will be raised to 5 per cent of consumption by the year 2004. The withdrawal of the subsidy for rice cultivation may also be considered marginal because the subsidy rate is at most 10 per cent of the average price.

c) Textiles and Wearing Apparel

About 70 per cent of Malaysian textile and clothing exports are to quota countries, namely USA, European Union (EU), Canada, Finland and Norway while exports to major non-quota markets (Japan, Singapore, Hong Kong and Australia) equal about 19 per cent. Although currently Malaysia's comparative advantage is in exports of clothing, the share of textile yarn and fabric is also increasing. Exports of textiles are concentrated in Japan and EU, some through the presence of foreign direct investment from those countries in Malaysia.

Two developments are expected to have a major influence on trade and industrial policies for the textile industry:

(i) The phasing out of the quota is critical to the development of the domestic textile industries well as the policy governing it. Even though Malaysia will benefit from the expansion of quotas for wearing apparel, it will also increase the competition in international markets. Malaysian wearing apparel exports have utilized almost all of their quota. Therefore, with the expansion of quotas, competitive exporting countries, such as Malaysia, whose exports have been constrained, will now be able to increase their export volumes. But, the relaxation of the quota will also increase competition, particularly from lower cost producers. Importing countries will not have to source from a less competitive country to meet domestic demand. This scenario is particularly applicable to exports from countries such as China and India, whose relatively lower labour costs have been a serious threat to other low-end clothing and textile producers.

(ii) Malaysian exports, which are mainly wearing apparel, are sensitive to increasing labour cost. In fact, the quota system has worked as a protective measure to curb inflows from other Asian producers and has thus guaranteed Malaysia its market.

Most crucially, since 1990 production costs have increased substantially for Malaysian textile and clothing manufacturers, as a result of higher labour cost. Because the majority of textile and clothing activities are still labour-intensive, a number of these manufacturers plan to relocate soon to lower cost countries such as Indonesia and Vietnam. To encourage local producers to be more competitive and increase productivity the Malaysian government is likely to lower further the import tariffs for textile and clothing products. Keener competition at the lower end of the product range should encourage domestic production to move to higher value added products.

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<sup>17/</sup> The products under quota are live swine, live poultry, birds' eggs, hens eggs, milk and cream, wheat or meslin flour and sugar cane or beet sugar.

The Malaysian textile and clothing trade regime has always been liberal - imports are freely allowed except for one product. The only quantitative restriction is imposed for "batik sarong".<sup>18/</sup> Such a small restriction is not expected to be a major hindrance to Malaysian textile and clothing imports.

### 3. Services

Malaysia is committed to open more of its services sector to foreign participation in the General Agreement on Trade in Services (GATS). In its current GATS offers, the services industries included are business services, communication, construction and related engineering services, health related social services, tourism and travel related services, recreational, cultural and sporting services, transport, financial services and insurance (a list of the services offered is given in Table 10). The pattern of Malaysia's offers follows closely that of other developing countries.<sup>19/</sup> None or very few offers have been made by Malaysia in activities such as distribution, education and environment services.

The offers are little changed from Malaysia's pre-UR policies on foreign participation in these services industries. For the cross-border transaction mode and consumption abroad <sup>20/</sup> mode of services trade, almost complete foreign participation is allowed, but some restrictions are imposed for the last two modes, namely commercial presence and movement of natural persons.<sup>21/</sup> These restrictions primarily relate to ownership of services activities, conformity to professional standards and employment of workers:

-Ownership - In the commercial presence mode, approval is required when a single foreign interest in a Malaysian company exceeds 15 per cent or the aggregate foreign interest exceeds 30 per cent or US\$1.85 million. Similarly, approval is needed when control is passed to a foreign interest through a management arrangement. In addition, most of the supply of services should be carried through or with Malaysian participation.

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<sup>18/</sup> This product is protected due to cultural sensitivity, namely to preserve a traditional industry.

<sup>19/</sup> By comparison, developed countries offer services industries in which they have strong comparative advantage such as distribution, construction, business services, environment management, finance, transport, education and health services.

<sup>20/</sup> There are four modes of services trade:

Cross-border transactions – the supply of a service from the territory of one country into the territory of any other country.

Consumption abroad – the purchaser travels to the country in which the service is produced in order to consume the service.

Commercial presence – the foreign services producer supplies the services by establishing a commercial presence in the consuming country.

Movement of natural persons – the supply of services through the presence of natural persons of one country in the territory of another country.

<sup>21/</sup> Detailed elaboration on the restrictions is given in Sieh, Mahani and Loke (1996).

**Table 10**  
**MALAYSIA'S SERVICES OFFERS IN THE GATS**

(a) BUSINESS SERVICES	<p><u>Professional Services</u> Legal, accounting, auditing and bookkeeping, taxation, architectural, engineering, integrated engineering and medical speciality.</p> <p><u>Computer and Related Services</u> Consultancy service related to the installation of computer hardware and software implementation, database and computer software development service.</p> <p><u>Research and Development Service</u> Research and experimental development services on social sciences and humanities.</p> <p><u>Rental/Leasing Services without Operators</u> Relating to ships (excluding cabotage and offshore trades), aircraft, construction and mining equipment and industrial plant and equipment.</p> <p><u>Other Business Services</u> Advertising; management consulting on transmission of non-conventional energy, assessment service, and pharmacy; international value-added telecommunication network; service incidental to agriculture, fishing and manufacturing; technical testing and analysis; student placement; market research and public opinion polling; translation and interpretation; convention and exhibition management; and landscaping.</p> <p><u>Operational Headquarters Services</u> Limited to sea and air, communication, tourism and professional and consulting services.</p>
(B) COMMUNICATION SERVICES	<p><u>Telecommunication Services</u> Data and transmission, mobile data and telex and telegraph services.</p> <p><u>Audio-visual Services</u> Motion picture, videotape and audio recording distribution and broadcasting service.</p>
(C) CONSTRUCTION AND RELATED ENGINEERING SERVICES	Construction work
(D) HEALTH RELATED SOCIAL SERVICES	Private hospital service.
(E) TOURISM AND TRAVEL RELATED SERVICES	Hotel, tourist resort and restaurant service and travel agency and tour operator service.
(F) RECREATIONAL, CULTURAL AND SPORTING SERVICES	Entertainment and sports event management service.
(G) TRANSPORT	International maritime transport, maritime agency and vessel salvage and refloating.

(cont. Table 10)

(H) OTHER SERVICES	Skills training service for technical, supervisory and production related functional levels in new and emerging technologies in automated manufacturing technology; advanced materials technology; biotechnology; electronics; information technology; and avionics/aviation technology.
(I) FINANCIAL SERVICES	<ul style="list-style-type: none"> <li>- Acceptance of deposits, and other repayable funds from the public, wholesale and retail.</li> <li>- Lending of all types, including consumer credit, mortgage credit, factoring and financing of commercial transactions.</li> <li>- Financial leasing.</li> <li>- All payment and money transmission services - credit and debits cards, cheque and bankers drafts.</li> <li>- Charge card.</li> <li>- Guarantees and commitments.</li> <li>- Money and foreign exchange broking services.</li> <li>- Trading for own account or account of customers in money market instruments, foreign exchange, transferable securities, exchange rate and interest rate instruments, derivate products, including futures and options, other negotiable instruments.</li> <li>- Services related to the issues of all kind of securities and placement as agents.</li> <li>- Underwriting.</li> <li>- Asset management.</li> <li>- Advisory, intermediation and other auxiliary financial services, including credit reference and analysis, investment advice on acquisitions, corporate restructuring and strategy.</li> <li>- Operational headquarters for the financial sector.</li> <li>- Securities broking.</li> <li>- Commodity futures broking.</li> </ul>
(J) INSURANCE SERVICES	<ul style="list-style-type: none"> <li>- Direct insurance (life and non-life).</li> <li>- Reinsurance (life and non-life).</li> <li>- Insurance intermediation, insurance broking (excluding agency).</li> <li>- Insurance intermediation - insurance underwriting and insurance management.</li> <li>- Services auxiliary to insurance - consultancy; actuarial risk assessment; risk management; maritime loss adjusting.</li> </ul>

-National treatment - Another limitation is also imposed on commercial presence with regards to national treatment. One of the GATS principles is that foreign service suppliers should receive the same treatment as domestic producers. However, Malaysia has decided to make an exception for the national interest. Incentives will only be offered to Malaysian-owned corporations and there are no limits to the measures that the government can introduce to help the Bumiputeras (Malays) under the New Economic Policy and the National Development Policy.<sup>22/</sup> Furthermore, any deals involving land property and real estate must have the approval of the relevant domestic authorities.

-Movement of natural persons - The restrictions applied to movement of natural persons are the common ones adopted by most countries. The only movements allowed are intra-corporate transfers involving a specified number of senior management or experts not exceeding a total stay of five years. In addition, these persons must be employees of the foreign services producers for not less than a year.

-Qualifying criteria - For many professional services, such as accounting, auditing and book-keeping, taxation, architectural, legal and engineering services, foreign producers are required to register with relevant local qualifying bodies.

Compared with other services industries, financial services and insurance offer the largest number of activities under the GATS, but they also have the most complex restrictions. The restrictions include: maintaining the existing shareholders structure, foreign shareholding limits, entry limited to locally incorporated foreign companies and foreign employees subject to market tests and eligibility criteria. In addition, a substantial number of financial and insurance activities are not open to foreign participation and no licenses are given to new financial and insurance companies. For all types of financial and insurance institutions, the cross-border and consumption abroad modes are not offered because they are not technically feasible.

The Malaysian GATS offers are the initial stage of liberalization of the services sector. Progressive liberalization as stipulated by the GATS will see further opening up of this sector to foreign participation through relaxing some of the restrictions. For example, the Interim Agreement for Financial Services reached on 28 July, 1995 has agreed to increase maximum foreign shareholding from the present 30 per cent to 49 per cent on July 1, 2000 and to extend Most-Favoured-Nation and National Treatment to all countries. Similarly, further liberalization is expected for telecommunication and legal services when the present negotiations are concluded.

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<sup>22/</sup> The New Economic Policy stipulated that 30 per cent of ownership and employment in any company must be allocated to Bumiputeras. Similarly, most of the government projects must be jointly owned or operated with Bumiputera partners. The National Development Plan is the successor of the NEP when the latter expired in 1990.

#### **4. Intellectual Property Rights**

Malaysia has already quite an extensive system of laws and regulations that allows it to meet and meets the majority of Trade-Related Intellectual Property Rights (TRIPs) requirements. The Malaysian intellectual property rights system comprises:

- Copyright Act (1987) - this Act complies with the Berne Convention and includes the protection of computer programs, compilation of data as literary works, rental rights to all eligible works and sound recording and broadcasts.

- Trade Marks Act (1976) - specifies the types of signs that are eligible for protection as a trademark or service mark as well as the minimum rights conferred on their owners. It also clarifies the obligations in the use of trademarks and service marks, their terms of protection and their licensing or assignment.

- Trade Description Act (1972) - together with the Trade Mark Act gives protection to products geographical indications.

- Patents Act (1983) - protects new inventions, whether products or processes, in all fields of technology for a period of 20 years from the date of filing.

- Registered Design Act (1949) of United Kingdom - protects new or original industrial design.

Although the Malaysian TRIPs regime is quite comprehensive, there are areas that need strengthening or new legislation:

- The proposed Industrial Design Act will be introduced soon to provide for a more comprehensive protection of industrial design.

- Additional provisions need to be incorporated in the existing laws for the protection of performers and for plant varieties.

- Compulsory licensing provision in the Patent Act (1983) would have to be cut to meet the requirement of Article 31 of the TRIPs Agreement.

- New legislation needs to be enacted for the protection of layout designs, undisclosed or confidential information and legislation governing anti-competition practices in contractual licenses. The present licensing agreement, which is under the purview of the Ministry of Domestic Trade and Consumer Affairs, is considered inadequate to meet the requirements stated in the TRIPs.

The Malaysian intellectual property rights regime is not expected to be drastically changed to conform to the provisions of the TRIPs. However, there are two areas for improvement; firstly



the strengthening the existing laws as mentioned earlier and secondly improving the enforcement capability. Administrative and enforcement cost implications and shortage of manpower may hamper the effectiveness of the intellectual property rights laws.

## 5. Anti-dumping

As with the TRIPs regime, Malaysia has a reasonably extensive anti-dumping law. The Malaysian anti-dumping law – the Countervailing and Anti-Dumping Duties Act – was introduced in 1993 and came into effect in April 1994. With this law, Malaysia has initiated anti-dumping proceedings against import of PVC floor covering from Thailand and the Republic of Korea.<sup>23/</sup> The investigation has proved the existence of a dumping margin and material injury to the domestic industry. An investigation was also conducted for a similar product imported from Singapore but a dumping margin and injury could not be established.

The Malaysian anti-dumping and countervailing law still requires some amendments to meet the provisions of the GATT anti-dumping agreement. These changes lie mainly in the areas of definition of terminology, inadequate provisions for information and for a procedural mechanism.

- a) Definition – many need further clarification because their legal interpretation is less precise than those in the GATT agreement. For example, the definition of “dumping” needs a legal interpretation, the definition of “domestic industry” is too restrictive and the use of different terms in describing the same product.
- b) Inadequate provision - the Malaysian law should include the requirement that an initiation of an investigation must be supported by at least 25 per cent of the total domestic production and to allow for “price undertaking” <sup>24/</sup> measure to be practiced.
- c) Procedural mechanism – the Malaysian law should specify in detail the steps, requirements and information needed in the initiation of anti-dumping investigation.

As tariff rates are lowered under GATT, anti-dumping measures are expected to be employed more as trade barriers by importing countries. Malaysia will strengthen its own anti-dumping law to educate its exporters and help them counteract such action in importing countries. Through a strong and well-defined domestic anti-dumping law, Malaysian exporters can obtain detailed information about market requirements and procedures for their products and anti-dumping regulations in importing countries. Local institutional and legal capacity will also be expanded in order to provide more effective support.

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<sup>23/</sup> Malaysia has initiated only a small number of anti-dumping cases against its imports. In contrast, there were 21 cases of anti-dumping proceedings initiated against Malaysian exports from 1991 to 1995.

<sup>24/</sup> “Price undertaking” measure is where an exporter agrees to revise its prices or to cease exports to area in question at dumped prices so that injury is eliminated.

## **6. Trade-related Investment Measures (TRIMs)**

Even though Malaysia has a number of measures to promote investment, only one that is in current practice contravenes the TRIMs Agreement – the local content requirement for the automotive industry. In the earlier incentive package, measures incompatible with TRIMs such as a general provision for local content, which serves as a qualifying condition for Pioneer Status or Tax Investment Allowance, have been withdrawn. Similarly, a number of export incentives have also been phased out, such as the abatement of income for exports and export allowance incentive. Adjustments to the Malaysian investment incentives will thus be minimal because most of them are GATT consistent. Even the local content requirement for the automotive industry is expected to be phased out soon as result of internal moves to source components globally. Malaysian's commitment to the regional trading arrangement, that is the ASEAN Free Trade Area (AFTA), demands that the domestic automotive industry be internationally competitive. To achieve this, domestic manufacturers must seek components from the cheapest source.

In adopting GATT-consistent TRIMs, one area that may cause difficulty is transfer of technology. As a country that is still trying to develop its technological capability, Malaysia cannot now offer incentives to foreign direct investment conditional upon the transfer of technology. This will hamstring some efforts to encourage small and medium domestic firms in supplying intermediate products to multinational companies.

## **7. Competition Policy**

Malaysia is in the process of drafting a competition policy with the aim of creating a fair and competitive domestic trade environment. The earlier objective of a competition policy in Malaysia was to protect consumers' interests but now this has been expanded to broader economic issues such as allocative efficiency, productivity, inflation control and the provision of equal opportunities. The proposed competition policy is based on the concept of "workable competition", namely to ensure all players in the market, including new entrants, can participate fairly and fully. Market concentration, mergers and takeovers and market manipulation are expected to be addressed by this policy. Existing legislation on competition is:

- Price Control Act (1946) – provides control of certain basic goods.
- Control of Supplies Act (1961) - ensures sufficient supply of essential goods at competitive prices.
- Trade Description Act (1972) – prohibits false trade descriptions and other misleading trade conduct.
- Hire Purchase Act (1967) – regulates trade practices in hire purchase transactions.
- Sale of Goods Act (1957) - governs transactions in purchase of goods.

-Weights and Measurements Act (1972) – regulates the specification and calibration of weighing and measuring instruments.

The new competition policy can either be expanded and improve some aspects of these Acts or even combine related ones.

## **8. Summary**

The new multilateral trading arrangement is likely to benefit Malaysia through better market access, when its trading partners lower their tariffs: for example, wearing apparel exports are expected to gain market share when export quotas are relaxed. Additional benefits could also come from increased efficiency as a result of keener competition in the domestic market as well as from tougher international trade regulations. The reduction of import duties in many industries and increased openness in previously closed ones such as food products will assuredly improve efficiency. For instance, increased competition in textiles and wearing apparel may drive producers to either relocate or up-grade their activities. Furthermore, exporters will be more aware of any trade protection measures that may be taken through trade-related intellectual property rights and investment measures agreements.

Despite this optimism, there are concerns about the effect of liberalization. Malaysia's major manufacturing exports may not grow much more due to their low pre-Uruguay Round tariff rates. The quota expansion for wearing apparel may actually decrease Malaysia's existing market share in the world market, losing markets to lower cost producers such as China. Moreover, the services sector may face new challenges in the areas of domestic production capability, regulatory environment and trade. Since Malaysia's services industry is still not well developed, the progressive opening as stipulated by the GATS might push the liberalization beyond a level where it will benefit the industry.

Malaysia's immediate concern is the successful implementation of the present arrangements. Particularly, since tariff rates have been reduced significantly, there is a fear that some countries may use TRIPs and anti-dumping provisions as a way to protect their own industries. In such a situation, it would be much more difficult for Malaysian exporters, with their limited experience and resources, to put forward a rebuttal. Similar misgivings have been expressed in relation to new issues to be included in the GATT, such as competition and investment policies, labour and the environment.

## IV. ENHANCING MALAYSIA'S ENDOGENOUS CAPABILITY

### 1. Introduction

Malaysia's engine of growth, its manufacturing sector is seeking a new direction to overcome the structural constraints discussed in Chapter 1. In charting this new path, the rationale is fourfold. First, a new source of growth has to be found because Malaysia is now losing its comparative advantage in labour-intensive activities. Second, global trade liberalization limits the continued use of industrial and trade policies to nurture domestic industries. Third, market opening measures demand that protected and inefficient domestic industries be internationally competitive. And fourth, more investment from domestic sources is needed, because of keener competition for foreign capital from emerging economies, such as China and Vietnam, which offer cheaper labour.

With insight gained from observing countries such as Korea and Taiwan, Malaysia has embarked on a technology- and knowledge-based industrialization and this is embodied in the Second Industrial Master Plan (SIMP). The key features of this Plan are more advanced labour skills and a bigger technological base as well as an expansion of intermediate industries. Furthermore, small and medium scale industries are expected to increase their participation in manufacturing activities. Simultaneously the Multimedia Super Corridor will be established to promote strategic industries. Domestic productive capacity is also to be strengthened with more infrastructure and industrial facilities.

Section 2 analyses the total integrated approach to manufacturing advocated by the SIMP, which calls for the development of R&D, design and production of components as well as that of marketing and distribution. Industries are to be developed in clusters so as to maximize vertical integration within each cluster. The clusters are of three types, namely internationally-linked, resource-based and policy-driven industries, and the measures to be implemented are fine-tuned to suit their respective cluster characteristics. Sections 3 and 4 discuss human resource development and technology, the two key elements to enhance Malaysian endogenous capability. Section 5 examines the Multimedia Super Corridor initiatives. Sections 6 and 7 present incentives for small and medium scale industries, which are critical to expand industrial linkages, and discuss how funds are to be made available to support them. The broader issue of incentives that can be employed to accelerate domestic industrial development is analyzed in Section 8 while Section 9 reviews the overall efforts to strengthen Malaysia's endogenous capability.

### 2. Second Industrial Master Plan (SIMP)

The SIMP will guide the development of manufacturing sector from 1996 to 2005 and has set an annual growth target of 10.7 per cent for the first half of the Plan period and 8.3 per cent for the second half. The SIMP proposes solutions to the structural constraints and the impact of market opening measures on domestic industries. Unlike the more quantitative First Industrial Master Plan (FIMP), the Second Plan deals mostly with broad strategy of improving competitiveness through labour productivity, skills improvement and acquisition of technology.

Thus far, no new incentive package has been proposed, and those in the Promotion Investment Act (1986) are still applicable. This Plan, instead, advocates rolling plan, which translates these broad solutions into more detailed measures. Instead it is expected that incentives will be continuously monitored and changed according to their applicability.

The SIMP also breaks new ground in that it integrates all the components of manufacturing into a value-added chain. Presently, Malaysia's comparative advantage is at the middle point and at the lowest level of the value added chain, namely at the assembling stages. SIMP proposes that both the initial part (R&D, design and production of components) and the last part (marketing and distribution) also be emphasized. In drawing up this plan, the government was very conscious of its GATT and AFTA commitments and therefore cannot introduce incentives contrary to these commitments.

The Plan laid out six strategies:

- Global orientation;
- enhancing competitiveness;
- developing Malaysia-owned world scale manufacturing companies;
- adopting information-intensive and knowledge-driven processes;
- improving economic foundation; and
- strengthening industrial linkages both in terms of depth and breath.

Increasing global orientation for protected domestic industries, such as in automotive, is essential to sustain their growth, as the Malaysian market is obviously too small. An essential condition for such a move is for domestic companies to be internationally competitive which can be achieved through gradual reduction of tariff protection as well as operating under efficient cost structure. In this regard, scale of production is also a critical factor; with world scale production unit cost can be significantly reduced. As discussed earlier, the new source of comparative advantage will have to come from information-intensive and knowledge-driven activities. To achieve this transformation, improvement in economic foundation, namely increasing the supply of human capital and expanding the technological base is crucial. The government's role in promoting industrialization in a liberalized multilateral and regional trading arrangement is to take the lead and to support enhancement of economic foundation. In particular, public sector support for R&D and product development works is expected to feature more prominently in the future.

Dependence on foreign-owned export companies should be balanced with the development of locally-owned ones, especially those with high domestic inputs such as resource-based industries; Malaysian palm oil industry not only dominate global production but also have strong linkages. For these industries, R&D on improved product quality has the potential to increase growth and develop supporting industries. Although foreign-owned export-oriented industries have been the mainstay of the manufacturing sector, it is essential that their links with the domestic economy be strengthened. One area that could be addressed is the forward linkage; for example, electronic components produced locally should generate more downstream consumer products manufacturing activities.

Value-adding strategies are much more difficult to implement and generally entail higher capital expenditure. The SIMP proposes that firms should produce advanced components and capital equipment, expand design capability and increase automation and use of information technology in production activities. Investment in industries with high domestic demand such as plastics, machine tools, packaging and information technology will help to deepen linkages.

The SIMP strategy also includes the cluster concept, where related industries are grouped together to take advantage of common externalities. In each of the clusters, industries producing final or export products are vertically and horizontally linked with intermediate producers and economic foundation factor and institutions. There are three types of cluster:

- a) Internationally linked - Industries in this cluster are primarily multinational corporations, produce mostly for global markets and their growth is dependent on global factors. Electrical and electronics and textiles and wearing apparel belong to this cluster.
- b) Resource-based - These are resource-based, agro-based and food products industries. The degree of indigenous involvement and ownership is high and they have relatively advanced local R&D capability.
- c) Policy driven – These are strategic industries, which are fundamentally technology-driven. Direct government initiatives are needed to develop their productive activities and competencies. Industries in this category are automotive and motorcycles, aerospace, transport equipment, chemicals, advanced materials and machinery industries.

Multilateral and regional trading arrangements commitments have severely limited the industrial policy instruments that can be used to implement the SIMP. High tariffs may no longer be key measures while incentives must be more broad-based and neutral with the primary objective of encouraging investment. Instead, the likely policy measures will be those that will increase human capital, such as training and skills development and expanding the R&D base, which are already offered. One avenue, in particular for policy-driven clusters, is to initiate more public sector-private sector joint ventures to expand productive capability. But such ventures must be judged by strict commercial criteria in measuring their viability and performance.

### **3. Human Resource Development**

The availability of an adequate supply of skilled labour will be the focus of Malaysia's strategy to strengthen endogenous manufacturing capability. Total factor productivity, which includes labour and capital, is estimated to double its contribution to the GDP growth from 17.9 per cent during the 1971-1990 period to 8.7 per cent for the 1996-2000 period (Seventh Malaysia Plan, 1996). Under the SIMP, human resources development will follow two directions - increasing the supply of skilled labour and up-grading productivity through training. Liberalization of the education sector now permits private sector participation in the provision of educational services,

especially at the tertiary level.<sup>25/</sup> Tertiary educational institutions are also required to enroll 60 per cent of their students into science and technology courses.

A major area that can contribute significantly to productivity improvement is the expansion of training, both formal and on-the-job. Some of the measures proposed include increasing the number of training institutions especially private ones and the introduction of an apprenticeship programme. Training programmes should be market driven and continuously monitored to respond to market demand and special programmes should be designed to meet the demand of specific industries. The Human Resource Development Fund was established to encourage training; firms are required to pay a levy (a percentage of their payroll), to this Fund and firms can claw back their contributions through approved training programmes.

These human resource solutions will need a reasonably long gestation period. Considering the low proportion of science and technology enrollment in Malaysian educational institutions when compared with other East Asian countries, an adequate supply of skilled workers may not be achieved in the time period expected.<sup>26/</sup> The Human Resource Development Fund has not been well utilized especially by small and medium scale industries (SMIs) because the administrative aspects are cumbersome. Thus, the levy is written off as an additional cost. The shift to higher skilled labour can only be successful if the inflow of unskilled foreign labour is controlled. Currently, their large presence in low value added activities does not encourage manufacturers to move into introducing capital-intensive activities and improve the skills of the workers.

#### 4. Technology

Just as much as labour, technology will determine the structure, pace and quality of Malaysia's future manufacturing performance. Its development will take two directions - access to and acquisition of foreign technology and expansion of indigenous technology.

Malaysia has to increase its R&D activities as much as other industrialized countries; for example in 1992, Malaysia's R&D expenditure was only 0.4 per cent of GDP whereas Japan and Korea spent 2.8 and 2.3 per cent respectively (Lall, 1996). Public sector capacity needs to be expanded and specialized technology development bodies such as the Standard Industrial Research Institution of Malaysia (SIRIM) are encouraged to provide extension services especially to SMIs and to set up technology benchmarking. But the biggest imperative is to increase private sector R&D technology activities; presently the private sector share of national R&D expenditure is about 46 per cent while in Japan and Korea it is 68 and 83 per cent respectively (Lall, 1996). To encourage R&D, incentives are already available and industrial and technology parks were

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<sup>25/</sup> Prior to 1995, all universities were in the public sector.

<sup>26/</sup> According to Lall (1996), percentage of science and technical in total tertiary level enrollment was 96 per cent for Korea, 92 per cent for Taiwan and 90 per cent for Singapore. Similarly, Malaysia's enrollment for vocational training was low compared to these countries.

established. Furthermore, large local companies are also urged to lead the indigenous R&D. Research collaboration and links between the public and private sector need be strengthened, to match research output with industry's demand. Indigenous technology research is mostly carried out by public institutions but collaborations with industries are still weak. In this regard, the government has proposed a matching grant to support joint public sector-private sector R&D.

Access to foreign technology may be the quicker route to up-grade technological capability but this route also has problems - the questions on the appropriate technology, cost and technology transfer have yet to be solved. In efforts to build technology competency, the government may participate directly initiating links with leading global R&D centres to undertake collaborative R&D with Malaysian companies and institutions. Domestic manufacturers are encouraged to forge network with leading world technology centres to keep abreast with developments. However, a more immediate approach is through the information and technology highways. This will allow industries to have access to R&D projects, design centres and high technology companies. Other potential sources of leading global technology are the multinational companies from electronic industries operating in Malaysia. They should be encouraged to locate some of their R&D activities in Malaysia.

The government also has the option of fostering technology development efforts by establishing links, investing directly or offering incentives. The first two options provide broad based economic foundation support and industries will also make significant cost contribution. Thus, government support, in this case, does not give direct advantage to Malaysian industries vis-à-vis its trading partners. Similarly, incentives to encourage R&D investment may not bear any productive result and therefore, it cannot be assumed that these investments will automatically and directly give an advantage to industries, particularly exporting ones.

### **5. Multimedia Super Corridor (MSC)**

The Malaysian government has created the MSC as its principal instrument to venture into strategic industries. This is an area equipped with the latest information technology infrastructure <sup>27/</sup> developed from a greenfield site. This area provides an environment that will facilitate the establishment and operation of information technology activities; for example, foreign skilled workers needed by industries located in this area are subject to minimal immigration requirements. Promoted industries and activities are not from the manufacturing sector but are service-related. Thus far, the flagship activities are electronic government, telemedicine, education services, R&D and multi-purpose smart cards.<sup>28/</sup> Leading foreign companies have been invited to participate, jointly with the public sector, in these activities. The broader aim of this project is to encourage R&D.

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<sup>27/</sup> This corridor is an area fifteen km by fifty km south of the capital city, Kuala Lumpur.

<sup>28/</sup> The smart card will contain key information about the holder that will allow financial transactions and some other government services.



The direct links and benefits of these strategic industries to the manufacturing sector are still unclear; new endogenous capability is most likely to accelerate the role of the services sector as the next source of growth. Multimedia projects require significant government expenditure, even though the private sector will be active and sizable partners. These expenditures are justified if they create new industries and if the forecasts of additional GDP can be realized.<sup>29/</sup>

## **6. Small and Medium Scale Industries (SMIs)**

To lead the institutional structure for development of the SMIs, the Small and Medium Scale Industries Development Corporation (SMIDEC) was established. It is responsible for formulating development programmes as well as planning, implementing and coordinating them. These programmes include marketing, incentives, technical support and R&D, training and management, finance and infrastructure. SMIs development should nurture domestic companies to be market- and export-oriented and promote them as supporting industries, but this is difficult. There are many institutions involved. The formation of the SMIDEC is intended to cut through the bureaucracy and give a clear lead in policy.

To help SMIs adjust to more liberal trading, the government has strongly encouraged larger companies, (in particular the multinationals), to develop SMIs as their vendors. An umbrella programme has been introduced, in which large companies are matched with SMIs. For public sector companies, direct intervention in the form of technical support and quality control was introduced. Financial assistance to these SMIs includes non-collateral and low interest loans, technical and management advice and dedicated industrial locations.

## **7. Domestic Investment**

Targeted incentives will generally be more effective in raising domestic investment than tariff protection and they will not be inconsistent with the GATT commitments.<sup>30/</sup> These incentives do not burden public finances as they are aimed at the private sector. In addition, their effect will not cause inefficiency in resource allocation and they will support the development of marginalised industries. In 1995, the Malaysian government introduced the Domestic Investment Fund (DIF) to consolidate several existing funds to improve their effectiveness. This fund is meant for the acquisition and commercialization of technology, enhancement of technological development for SMIs and the provision of soft loans to furniture and food-based industries. A large proportion of the fund is allocated to SMIs.

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<sup>29/</sup> The expected annual value of output that will be generated by the multi-media industry in the MSC after the first five years is US\$ 9.3 billion (New Straits Times, July 27, 1997).

<sup>30/</sup> The multilateral investment agreement, which is under consideration, may rule that measures, which give preference to domestic investors, are GATT inconsistent. Until such agreement is concluded, domestic investment incentives are applicable.

## 8. Incentives

Above we have described proposed measures to improve the domestic economic capability and to take into account Malaysia's obligations to the GATT and to AFTA. In view of this, the incentive system also needs to be reviewed.

Investment incentives that have minimal contribution in developing domestic industries will have to be removed, because Malaysia has reached a stage where creation of investment per se is no longer the main aim. For example, even though the FTZ and Licensed Manufacturing Warehouse were instrumental in promoting export-oriented industries, these incentives encourage (or at least do not penalize) minimal linkages to the domestic economy and thus no longer effective. There are questions on the real benefits of incentives that give tax exemptions (such as pioneer status) because such incentives have been shown to be only marginally important in companies' decision-making process.<sup>31/</sup>

Since Malaysia now has more specific development targets, its incentive package must be designed to meet those objectives. For example, a new package will be formulated to cater for the MSC, to encourage greater use of information technology. Such targeted incentives can also be effective in helping fledgling industries and upgrade existing ones such as wood products and food processing. To date incentives for the SMIs have not been received well: complex application procedures being one of the commonly cited reasons for the low response rate. Thus any review of incentive packages must not overlook administrative aspects.

There is now also a shift towards direct grants, instead of fiscal incentives. This mode of assistance is also preferred by the GATT because it is not distortive. It is proposed that grants be used to alleviate shortages of skilled manpower and to finance R&D. However, grants are particularly subject to abuse and disbursements are difficult to control. Moreover, this type of assistance depends almost entirely on the financial resources of the government.

## 9. Conclusion

The strengthening of endogenous capability is a pre-requisite if Malaysia is to move to a higher level of industrialization. The industrialization achievements thus far have been hollow or superficial, with no strong domestic linkages or technological capability. The SIMP proposals are medium to long term in nature, aimed at enhancing the industrial foundation. One key proposal covers the development of labour skills; the expansion of the pool of technical workers is regarded as pressing, and the funds needed for such a program, will be large. For that and other reasons, the private sector must come forward both with the resources and the technical training programs.

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<sup>31/</sup> Other factors such as political stability and good infrastructure weight heavily when a companies decide where to invest. In the case of Indonesia, elimination of incentives did not slow down the inflow of foreign direct investment.

A yet more serious issue is the development of technological capability, because most of the technology will have to be acquired from foreign sources. Key decisions are needed on how to make effective technology transfer, R&D capacity and which type of technology is needed. Valuable lessons can be learnt from the export-oriented industrialization, which was heavily dependent on foreign firms; there was limited transfer of technology and many firms were reluctant to base their R&D activities in Malaysia. One of the reasons given for this situation was the lack of local technical manpower capability. Thus technological and skilled manpower development programs must be integrated and closely coordinated.

The Multimedia Super Corridor is a step function initiative to launch Malaysia onto an advanced technological level. Yet, it also faces similar challenges; the fundamental ones have been mentioned above, namely domestic human resources and technological competence. In addition, questions can be asked of its spill over benefits to the local economy, and how it can be expected to improve manufacturing sector competitiveness.

Initiatives to enhance endogenous capacity can benefit significantly by learning from earlier industrialization; both import substitution and export promotion. Pointers include: what incentives can be employed; which are most effective and at the same time compatible with the new international trading system; how to link foreign firms to the domestic economy; what was the cost of strong intervention measures to create selected industries (policy driven industry); and why past and existing programs to promote small and medium scale industries were not very successful.

## **V. TRADE AND INDUSTRIAL POLICIES INSTITUTIONS**

### **1. Introduction**

Malaysian trade and industrial policies are within the ambit of two ministries — the Ministry of Finance and the Ministry of International Trade and Industry. Close cooperation in trade and industrial decision-making is practiced not only by these two Ministries but also by other government agencies, most prominent being the Economic Planning Unit of the Prime Ministers Department. Similarly, the implementation of trade and industrial policies will by its very nature involve many other Ministries, such as the Human Resources; Science, Technology and Environment; Transport and the Department of Immigration, as well as the administration of each state of the Malaysian Federation.

Section 2 studies the functions and organizational structure of the Ministry of Finance. The responsibilities of the Ministry of International Trade and Industry are analyzed in greater detail in Section 3, which also includes major organizations under the Ministry's jurisdiction, namely the Malaysian Industrial Development Authority, the Malaysian External Trade Corporation and the Small and Medium Industries Development Corporation (whose functions and role have been discussed in Chapter 4). The success of Malaysian industrialization was partly dependent on the support from the state governments and Section 4 examines the role of state agencies in facilitating investment and in the provision of infrastructure. Section 5 studies the Malaysian Export Credit Insurance Berhad, an emerging important agency in the promotion of exports which provide credit insurance and guarantee schemes to trading firms and manufacturing exporters. Section 6 evaluates the challenges faced by these institutions in efforts to bring Malaysia to a higher level of development.

### **2. The Ministry of Finance**

The Ministry of Finance has overall responsibility for national economic and financial development through its control of public sector expenditure and has jurisdiction over the financial sector of the economy. Figure 1 shows the organization of this Ministry. For financial sector development, the Ministry operates through Bank Negara Malaysia (the central bank), which is directly responsible to the Minister, while the development of the capital market is monitored by the Securities Commission. Bank Negara Malaysia is also instrumental in the provision of many finance- and insurance-related export incentives and facilities. For example, the export credit refinancing scheme, which gives a preferential interest rate to exporters, is operated by commercial banks with the central bank refinancing export credits that have been extended.

For promoting investment, tax relief offered by the incentive package was given under the Income Tax Act 1967. Similarly, trade policy measures such as import duties exemption and drawbacks are also directly determined by the Finance Ministry. Among the relevant components are the Tax Division, Department of Inland Revenue and Royal Customs and Excise Department.

### **3. The Ministry of International Trade and Industry**

The Ministry of International Trade and Industry (MITI) has direct responsibility for the country's trade and industrial development and it is regarded as the next most important institution after the Ministry of Finance. It works closely with the Ministry of Finance and the Economic Planning Unit to coordinate policy and the financial resources needed to implement these policies. In the early phase of industrialization (import substitution), the Ministry's approach favoured protecting domestic industries but it changed quickly to export promotion to respond to external conditions and to potentially serious unemployment.

It has developed industrial policies to promote investment, target sectoral growth and expand exports. These strategies have changed over time, depending on both the internal and external environment. For example, recent changes to the incentives to encourage R&D and high-technology industries reflect the Ministry's response to changing comparative advantage and the need to add value to manufacturing activities. Compared with earlier years, the Ministry's relationship with industry has become closer. Since the middle 1980s industries' feedback has been regarded as an essential part of the policy-making process. Many of the measures to promote investment and exports were the outcome of consultation between the government and the private sector. In this regard, two forums — the Ministry's Annual Dialogue and the Malaysian Business Council — are the most effective channels for the private sector contribution to policy.

Since the middle of the 1970s, the Ministry of International Trade and Industry has pursued both investment and export promotion strategies vigorously. Many delegations overseas have sought investment and export markets for domestic producers. In some quarters it is felt that such actions have only served to benefit the foreign-owned companies operating in the export sector, and that this has been at the expense of domestic companies [Jomo (1996) and Edwards (1990)]. This opinion gained wider acceptance when the measures employed to develop domestic small and medium scale industries have proved not to be very successful.

In regional and multilateral trading negotiations, the Ministry is at the forefront in presenting Malaysia's point of view, and sometimes will speak about the views of all developing countries. The main thrust of the Ministry's argument is that developing countries should be allowed to liberalize at their own pace to be sure of stable economic development at home. For example, the Ministry made a very strong stand against linking of labour standards and environment with trade. Similarly, in the Asia Pacific Economic Cooperation (APEC) summits, Malaysia has also advocated the principles of voluntarism and flexibility.

MITI was recently reorganized and now has two main Divisions — the Industrial Development and International Trade (Figure 2). This change is intended to reflect the equal emphasis given to the Ministry's two functions.

The Industrial Division consists of three sections - industrial policy and planning; sectoral development; and small and medium industries. It is responsible for promoting and guiding Malaysian industrialization. Some of its functions include formulating and monitoring industrial

plans, promotion of investment, assisting sectoral development and support and encouraging the growth of small and medium scale industries.

The International Trade Division has four sections, namely ASEAN economic cooperation; trade support; trade policy; and negotiations and planning and trade development. It is in charge of external trade relations, in particular the promotion of exports and development of regional and multilateral cooperation. This Division helps to prepare Malaysia's position in trade negotiation, especially in ASEAN, WTO and other regional blocks.

The Ministry also has specialized organizations to focus on specific industrial and trade matters. The main ones are the Malaysian Industrial Development Authority (MIDA), the Malaysian External Trade Corporation (MATRADE) and the Small and Medium Industries Development Corporation (whose functions and role have been discussed in Chapter 4).

### ***Malaysian Industrial Development Authority (MIDA)***

MIDA's primary role is to encourage investment, process and approve investment applications and provide support for industries. Figure 3 shows MIDA's organization. It has two parts — development and operations. The development part is further separated to meet the specific needs of industries; these industries are resource-based, engineering, electrical and electronics and food, beverages and chemical industries. Each division identifies investment and industrial opportunities; evaluates applications for manufacturing licenses, incentives and duty exemptions; reviews and assesses the incentives structure and licensing requirements and responds to any investment inquiries.

MIDA's operations part consists of three divisions — industrial promotion, tariff and planning, research and international cooperation. The Industrial Promotion Division is in charge of the promotion of domestic and foreign investment, coordinates the activities of MIDA overseas centres, maintains a registry of potential investors and publishes investment promotion information. The Tariff Division evaluates applications for tariff protection, quantitative restrictions and exemption from import duties on raw material as well as reviews the level of tariff assistance given to local industries. The Planning, Research and International Cooperation Division has the broader duty of planning within the national industrial strategy, licensing and incentives provisions and formulating strategies for international cooperation, particularly activities concerning ASEAN members. It also provides assistance to state governments, assesses applications for double deduction for training, evaluates joint venture management and other technical agreements and provides statistics on the manufacturing sector.

MIDA has proven to be a very important institution for promoting investments and has done much to encourage investment in its role as a one-stop investment centre. Its success is acknowledged, particularly by other developing countries and it has given advice to other countries that are pursuing similar strategies. However, its role in charting sectoral growth can be strengthened. It should give a lead in the future direction of the industries. Presently, its contribution in this area is limited to addressing current constraints faced by industries.

### ***Malaysian External Trade Corporation (MATRADE)***

MATRADE was formed in 1994 to undertake much wider and more aggressive export promotion, to expand Malaysia's export markets, particularly among the South countries. MATRADE has set up trade representative offices in major cities in the world, disseminated information to Malaysian exporters and conducted many promotion missions in export markets.

#### **4. Industrial Promotion Efforts at the State Level**

State governments are just as keen as the federal government to attract both foreign and domestic investment. Many states have established investment centres that act as a one-stop agency. These centres are to be found either in the state economic development corporations, (government-owned companies involving directly in business) or in the state economic planning units. The functions of these centres include providing investment information, processing applications for licenses, permits and approvals required by investors, monitoring the progress of projects and advising the state government industrial development. They are inquiry and implementation centres for the policies that have been determined at the federal level. States do not have their own investment policies and investors enjoy the same benefits wherever they invest, of course excluding the locational incentives such as the "Eastern Corridor" facility.<sup>32/</sup>

Notwithstanding this, States can and often do provide additional infrastructure at specialized industrial locations. State governments build industrial estates with excellent infrastructure, and these are often a strong and decisive factor in the choice of investment location. More importantly, if a state can provide faster approval, particularly in matters involving local councils, they could attract more investment. A number of state governments have sent investment marketing missions abroad to directly approach investors. In this respect, they are very competitive and States that have set up well-planned industrial estates have been more successful than others in attracting investment.

#### **5. The Malaysian Export Credit Insurance Berhad**

The Malaysian Export Credit Insurance Berhad (MECIB) was incorporated in 1977 to provide export credit insurance and guarantee schemes to trading firms and manufacturing exporters. MECIB facilities safeguard exporters against non-payment arising from various commercial and non-commercial risks. These risks include buyer's insolvency, buyer's protracted default, buyer's failure to accept goods, delay in the transfer of payment to Malaysia and imposition of import restrictions and import license cancellation.

The facilities offered by MECIB protect exporters against non-payment by overseas buyers or banks. The facilities can be grouped into three — insurance policies, banker's guarantees for export financing and overseas investment guarantees. The insurance policy is

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<sup>32/</sup> Companies located in the Eastern Corridor (the least developed areas in Malaysia) are exempted on 85 per cent of its statutory income for a period of five years.

extended to both shipments and contracts and gives up to 90 per cent coverage for non-payment resulting from commercial risks and up to 95 per cent coverage for political risks. The insurance time coverage is normally not more than 180 days but can be extended to 720 days. There is also special insurance for capital goods requiring a lengthy manufacturing or payment period and high contract values.

A banker's guarantee indemnifies against losses arising from the failure of an exporter to repay export loans because of his insolvency or protracted default. It covers 75 per cent of loss on pre-shipment and 85 per cent of loss on post-shipment loans. A guarantee is also given to loans made by a lender in Malaysia to an overseas buyer or banks for the purchase of Malaysian goods. The overseas investment guarantee, on the other hand, offers protection to Malaysian investment in a foreign country against political risks. Its covers up to 90 per cent of the losses for a maximum period of ten years.

## **6. Conclusion**

The challenge for trade and industrial policies institutions is to provide the right catalyst to continue to attract investment both from foreign and domestic resources and to up-grade Malaysia onto a higher phase of development. In view of the commitments made in the GATT Uruguay Round Agreement and as already been indicated by policy direction since 1988, the exchange rate has replaced tariff as the main trade policy instrument. Management of exchange rate is more complex than that of other trade policy instruments such as import duty and therefore it would be that much more difficult to achieve the desired aims. One area that the Ministry can play an important role is the widening and improvement of trading facilities to supplement fiscal incentives, particularly those related to export financing. Such support is valuable to exporters while at the same time does not produce serious distortions in the domestic economy.

Besides managing trade policy, the Ministry of Finance is now focussing its attention on encouraging investment, both from local and foreign sources. The task is to ensure that there is sufficient liquidity and to allow the market to efficiently determine the allocation of the fund. In this regard, the development of the capital market has become an important component for the drive of sustained economic growth.

The Ministry of International Trade and Industry will still continue to guide the Malaysian industrial development through an investment-led growth strategy. Over the years the Ministry has adjusted the incentives to meet contemporary needs. This was done smoothly because of its close relationship with industries and such cooperation is useful in meeting the industries' future needs. In addition, the Ministry should prepare the domestic industries to compete in a more liberal trading environment, namely the ASEAN Free Trade Area, and also to cope with globalization. Efforts to enhance Malaysia's development and to expose the domestic industries to a more competitive environment are mutually complementary and thus industrial and trade policies institutions will have to coordinate their measures so as not to negate one another.



**Figure 1**  
**ORGANISATION CHART**  
**MINISTRY OF FINANCE MALAYSIA**

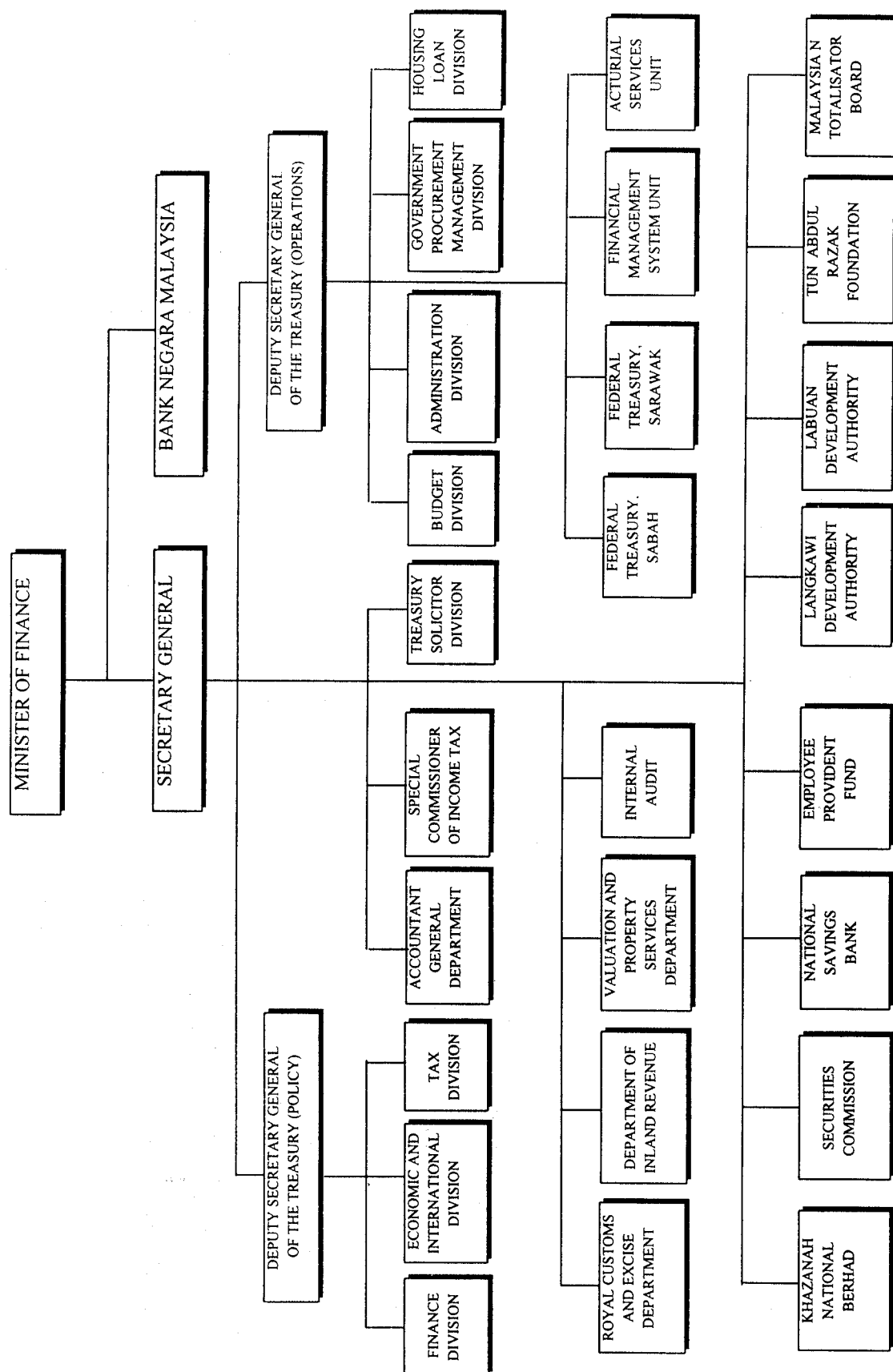


Figure 2  
MITI Organisation Chart

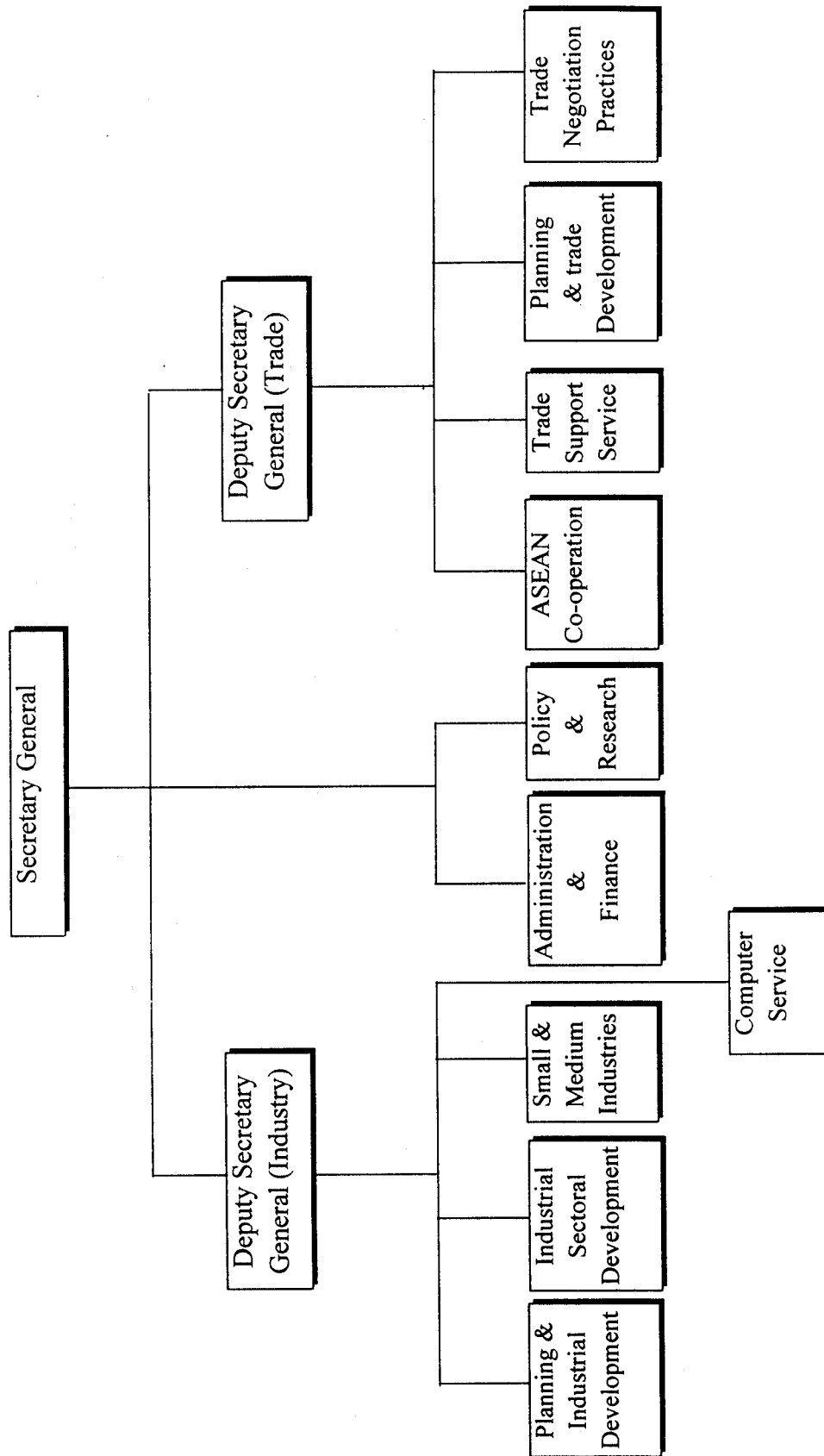
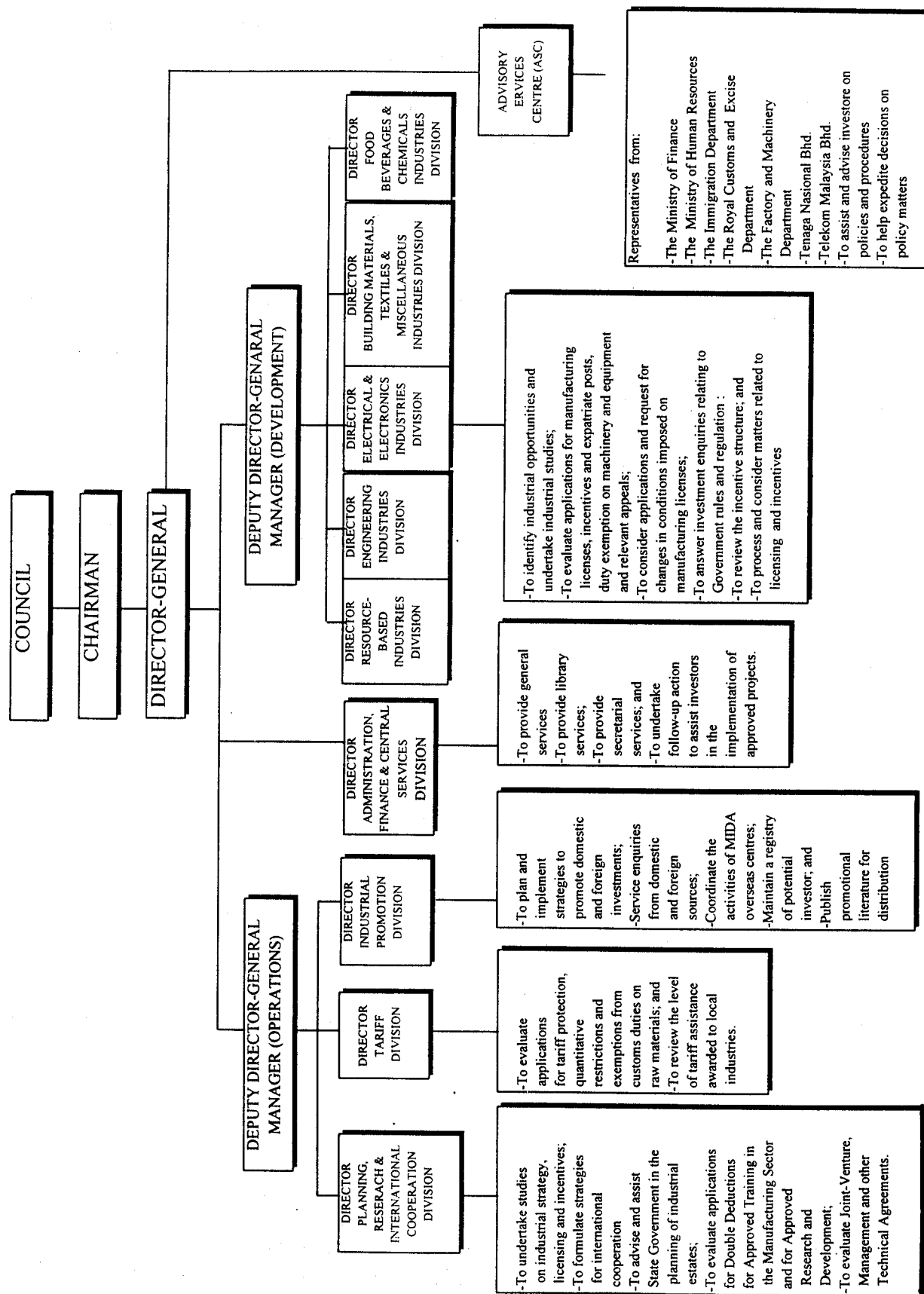


Figure 3  
Malaysia Industrial Development Authority



## **VI. ROLE OF REGIONAL INTEGRATION IN MALAYSIAN ECONOMIC DEVELOPMENT**

### **1. Introduction**

Malaysia is a member of two regional groupings – the Association of South East Asian Nations (ASEAN) and the Asia Pacific Economic Community (APEC). ASEAN was formed in 1967 for political and security reasons, in response to the threat of communism in Indochina. Economic integration was not considered a priority and economic relations among member countries changed hardly at all, probably because ASEAN economies had similar structures and export pattern, were at the same stage of development and thus in commercial competition.

The first scheme for economic cooperation in ASEAN was the Preferential Trading Arrangement (PTA) launched in 1977. Unlike other regional trading arrangements, the PTA economic integration program was very loose: it did not have the eventual aim of a customs union or free trade area. It only offered preferential tariffs on a voluntary, product-by-product basis. It was perhaps no surprise that the PTA did not grow and concessionary tariff rates were applied to less than 2 per cent of total intra-ASEAN trade (Imada, 1993). A more forceful economic integration approach was undertaken in 1992 when the grouping agreed to form the ASEAN Free Trade Area (AFTA).

Like ASEAN, the Asia Pacific Economic Cooperation (APEC), established in 1989, is a loose form of regional cooperation between 18 countries, which differ widely in their socio-economic development and economic policies. However, helped by a more formal institutional framework APEC has accelerated the integration process and is a champion of investment cooperation and trade liberalization. These obligations are in the form of broad targets, and are non-binding. Thus, the APEC integration process differs from that of AFTA in that it is not as comprehensive and strictly scheduled as in a customs union or a free trade area. In this way, the impact of APEC obligations on Malaysia is much less than with AFTA.

Section 2 discusses the AFTA timeframe for tariff liberalization as well as its implications for the Malaysian manufacturing sector. This section also examines the prospect of AFTA strengthening regional economic integration, especially in view of earlier ASEAN experience of economic cooperation. Section 3 summarizes the objectives of APEC and compares the approaches adopted by these two regional groupings. Section 4, the concluding section, evaluates whether AFTA will be the harbinger of a closer form of integration and discusses the likelihood of narrowing the present economic disparity among APEC member countries.

### **2. AFTA**

The original AFTA proposal was for tariffs to be reduced to 5 per cent or less within 15 years and non-tariff barriers to be eliminated within 8 years, beginning 1 January 1993. Under the Normal Track, tariffs of 20 per cent or less were to be reduced to 5 per cent or less in 10 years while those of over 20 per cent was to be reduced likewise in 15 years. The timetable for tariff

reduction for items under the Fast Track was much shorter, that is 7 years for tariffs of 20 per cent or less and 10 years for tariffs over 20 per cent. In September 1994 this timetable was, however, brought forward so that the Fast Track reduction should be completed by 1 January 2000 and the Normal Track by 1 January 2003. Thus, by the year 2003 most intra-ASEAN trade will bear at most 5 per cent import duty.

The AFTA tariff cuts are referenced to the Common Effective Preferential Tariff (CEPT) formula, which is based on sectors and hence has more comprehensive product coverage. The products are grouped into three categories — Inclusion List, Temporary Exclusion List and Unprocessed Agricultural Products. All products in the Temporary Exclusion List should be transferred to the Inclusion List within a period of 5 years at the rate of 20 per cent per year so that all will be included in the liberalization process by 1 January 2000. Agriculture products which were previously excluded are now included in the CEPT scheme. But due to the sensitive nature of some of the Unprocessed Agricultural Products, a separate liberalization exercise will be made outside the CEPT. In the liberalization scheme for Malaysia (effective 1 January 1996) there are 9,976 tariff lines in the Inclusion List, while 118 and 511 tariff lines from the Temporary Exclusion List and Unprocessed Agricultural Products respectively will be phased into the Inclusion List. This will bring the Malaysian Inclusion List to 10,494 or 93 per cent of the total tariff lines, of which 62 per cent are duty free.

The ramifications of Malaysia's AFTA obligations are both more widespread and immediate than those of GATT. Firstly, AFTA tariff rates are much lower and its product coverage is larger, which can cause greater adjustments to the Malaysian economic structure. Industries that are presently enjoying high degree of protection will have to begin to increase their efficiency level and reduce production costs to enable them to operate in a more competitive environment. These adjustments will be more serious for industries that have previously severely restricted the entry of imports, such as unprocessed agricultural goods, since some other ASEAN producers are more efficient and can now enter the Malaysian market easier under AFTA.

Secondly, the AFTA liberalization dateline is much earlier than GATT and thus, Malaysia needs to quickly prepare its industries for the year 2003. Compared to the GATT, AFTA tariff liberalization scheme will strongly affect the Malaysian domestic economic structure involving changes in scale of production, division of labour and relocation of industries.

With a total population of about 480 million, AFTA will entail a different market perspective for Malaysian domestic firms; firms will strive to increase their scale of production in order to lower unit production costs and be regional producers. However, earlier efforts to increase scale of production to tap the large ASEAN market have proven unsuccessful. The first one was the ASEAN Industrial Projects launched in 1980 that assigned large-scale government initiated projects to different member countries to serve the entire ASEAN market. In this programme, the ASEAN governments took the lead in initiating natural resources projects to maximise the utilization of potential scale economies.

However, the results were disappointing:<sup>33/</sup> of the five originally planned, only two ever got off the ground. Numerous reasons were given but the main one was the lack of a wholehearted support by all the ASEAN governments; some felt that these projects limit their freedom to invest where they pleased. Another important reason was the absence of private sector participation - the governments rather than the market decides where the industries should be located. Proximity to natural resources supply alone was not enough to ensure the success of these projects.

Learning from this experience, subsequent ASEAN projects to utilize economies of scale were designed to allow the private sector to take the lead. The ASEAN Industrial Complementation Scheme <sup>34/</sup> was aimed at dividing different production stages of an industry among ASEAN countries. Components produced in member countries for final assembly were given preferential tariff treatment. Again, this idea was to avoid duplication of capacity and to allow greater economies of scale. The project was implemented in the automotive industry, mainly involving the network of Japanese manufacturers. It met with some degree of success but the benefits were not shared equally among ASEAN members. For example, most of the automotive components were manufactured in Thailand since it has the lowest production cost structure in the region which has the effect of limiting or even reducing production in the other countries. As a result, the benefits of the scheme was not evenly spread and there was rivalry over the location of higher value added process.

Another project was also introduced in 1983, the ASEAN Industrial Joint Venture scheme, to encourage intra-ASEAN investment among private investors. The objective of this scheme was to increase industrial production through resource pooling and market sharing. This scheme was more flexible when compared to the others because it could be applied to any production scale, required the participation of only two ASEAN members and foreign partners were encouraged. Again, tariff preferences were used as an investment incentive tool.<sup>35/</sup> Its impact on intra-ASEAN trade and investment was negligible because ASEAN sourced most of its intermediate products externally. Even if ASEAN were to start such a venture, lack of technological capability and experience would restrict its capability to produce goods that could match the price and quality of imports.

Nevertheless, AFTA liberalization programme may prove more successful than the previous attempts at maximising scale of production. Its tariff reductions are substantial enough to give a price advantage to intermediate goods produced in the region; the average import duties

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<sup>33/</sup> The most successful project was the ASEAN Bintulu fertilizer project in Malaysia. This location was chosen to take advantage of the availability of large supply of natural gas nearby.

<sup>34/</sup> The programme was called the Brand-to-Brand Complementation scheme and the automotive industry was the first to adopt it. The design of the programme was modified subsequently, and it was called the ASEAN Industrial Cooperation scheme.

<sup>35/</sup> Participating countries charge 10 per cent of their prevailing rate to import from this scheme and thus granting a 90 per cent margin of preference.

into ASEAN is 20 per cent,<sup>36/</sup> which is higher than the 5 per cent level set out in the AFTA schedule. Industrial transformation, including changes in scale of production and industrial relocation, will be very much linked to labour specialization and technological capability. AFTA-induced restructuring process will perhaps become more successful since it is based on comparative advantage and cost competitiveness.

Industrial adjustment is expected to be deepest for highly protected industries such as heavy industries (automotive, cement and steel) and selected unprocessed agricultural products (rice and poultry). Thailand, which has the most active automotive industry in ASEAN, is likely to expand the size of its automotive component manufacturing industry to reach world scale and thus dominate future regional production and trade (Mahani, 1997). Thailand production cost structure is comparatively lower than the others due to the size of its domestic market and this advantage is further strengthened with investment from global automotive producers who plan to make Thailand their regional base. In such a situation, the Malaysian automotive component industry may be seriously threatened and Malaysia is most likely to concentrate on assembling and design activities, of which it has a reasonable advantage. Therefore, the future AFTA scenario will see specialization according to competitive advantage with production scale large enough to cater the needs of the entire region and these specialized activities will form the regional chain of production network. To facilitate these links, the rule of origin is set at 40 per cent because a substantial amount of inputs is still imported. A similar development is expected for rice and poultry industries, where competitive producers will expand their scale of production and a production network is formed based on specialization.

The rapid growth of the Malaysian economy for the last eight years up to 1996 has tightened the labour market and push wages to a level where wage increases were not met with corresponding productivity increases. As a result, Malaysia is losing comparative advantage in labour-intensive activities, particularly in the manufacturing of low-end electrical and electronic and textile and wearing apparel products. There are already initial relocation activities of these industries from Malaysia to low labour cost countries such as Vietnam and Indonesia. Similarly, Malaysia will gain in areas where it is competitive - vegetable oils, higher-end electrical and electronic products, chemicals and fertilizer and plastics.

Industrial structure changes due to AFTA are also closely linked with intra-industry and intra-firm trade. Multinational companies (MNCs), especially in the electrical and electronics industry, have regional production networks, to a certain extent, based on division of labour. A free flow of trade will further emphasize this production network pattern and will strongly influence MNCs' sourcing policies. This realignment is expected to benefit Malaysia as it has relatively stronger technological capacity which will attract more high value added activities, thus further enriching Malaysia's R&D capability.

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<sup>36/</sup> See Mohamed Ariff, Mahani and Tan (1996). This average was calculated from the Post-Uruguay GATT tariff rates for Malaysia, Thailand and the Philippines. Even though other ASEAN countries were not included in the estimation, their tariff rates, with the exception of Singapore, are expected to be at a similar level.

AFTA is a marked departure from ASEAN's previous attempts of regional integration. AFTA's products coverage is comprehensive - 92 per cent of total tariff lines - and it has a clearly structured tariff liberalization schedule. Adjustments to the new tariff levels will not be too painful for Malaysia because of its presently low tariff rates. But of greater importance is the industrial restructuring aspect of this integration process where competitive producers will reap the benefit of economies of scale while the highly protected ones will have to significantly increase their competitiveness. In many ways, if regional resources are efficiently allocated under the AFTA, the benefits will accrue not only to individual countries but to the entire region as well.

### **3. Asia Pacific Economic Cooperation (APEC)**

As a member of APEC, Malaysia has agreed to liberalize its trade regime with a plan for voluntary commitments on long-term trade and investment liberalization and facilitation. The target of free and open trade is expected to be achieved by the year 2010 for members of APEC from developed countries while the year 2020 for developing countries. In November 1995, at the Osaka Meeting, APEC leaders unveiled an Action Agenda and its key feature is the initiation of an Action Plan by each member country, detailing their trade and investment liberalization and facilitation programmes. The specific areas to be addressed include tariff rates, non-tariff measures, services, investment, standards and conformance, custom procedures, intellectual property rights, competition policy, government procurement, deregulation, rule of origin and dispute mediation.

More importantly, APEC has embarked on new areas of cooperation in human resources development, technology, small and medium scale industries, infrastructure, and sustainable development. Since APEC primarily focuses on trade liberalization, this extended concept of cooperation will strongly complement its broader development objectives and will bear the most productive results. This development cooperation is directed towards modernization of ports, providing energy grid links, enhancing industrial training and technology sharing. Of primary concern among the APEC members is the issue of closing the economic development gap between member countries; the push for liberalization should not marginalised any member but instead specific assistance measures must be implemented to ensure that all members benefit.

Because of its broad-base approach, the impact of APEC on the Malaysian economy will not be immediately obvious. Malaysia's obligations to APEC support its GATT commitments because they are based on the concept of open regionalism where progressive liberalization will be extended to other trading partners. In fact, some of the trade and investment liberalization and facilitation initiatives are precursor to future GATT negotiations. APEC's efforts in strengthening other developmental objectives are expected to be its key influence in enhancing international cooperation.



#### 4. Conclusion

Unlike the earlier initiatives to strengthen ASEAN economic integration, AFTA has a good chance of success. This optimism is based on the fact that the present environment in ASEAN is different from before; now all member countries have relatively more liberal trade and economic policies and all regard exporting as a precondition for growth. Industrial restructuring and adjustments as a result of AFTA will rationalize and consolidate many import substitution industries, which previously only focused on the domestic market, thus increasing efficiency and optimizing resource allocation.

With economic integration thus added to the existing security and political cooperation, the natural question to ask is: Will ASEAN will evolve as a more cohesive unit, such as a common market? The European Union (EU) serves as a useful model, allowing free movement of trade but more importantly movement of factors of production. A single currency is imminent. Notwithstanding the achievements of ASEAN, it is unlikely to become another EU because of the varying levels of development among ASEAN members. Presently, ASEAN has problems with unbalanced labor flows, with some members hosting many illegal workers from other member countries, because of the high economic growth enjoyed by the former. Free movement of labor will exacerbate this problem and may jeopardize the political and economic stability of the regional grouping. Therefore, ASEAN may only introduce free movement of labor if ever its members have similar levels of development.

The issue of varying stages of development among members of a regional grouping is also gaining prominence in APEC. The liberalization measures proposed might not bring the expected benefits to members who were at a lower stage of development and this will widen the gap between the higher and lower groups. To address this issue, APEC initiatives have included measures to support key factors for economic development such as human resources, technology, infrastructure and telecommunication.

As a member of both AFTA and APEC, Malaysia is likely to gain from the liberalization and development initiatives advocated by both groups. However, the impact of AFTA will be faster and more profound than that of APEC; AFTA measures are more comprehensive and have a definite timeframe while APEC liberalization follows only broad guidelines. If ASEAN is considering a move towards a common market, and despite the expected benefits, Malaysia needs to review the implications of closer integration. On the other hand, measures suggested by APEC to accelerate development, should be encouraged. They will benefit Malaysia.

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## APPENDIX

### CHANGES TO THE PROMOTION OF INVESTMENT ACT (1986)

Since its introduction in 1986, the PIA has undergone major changes — some of the incentives were withdrawn while new ones were added. These changes can be summarized as below:

#### A. GENERAL INCENTIVES

**(i) Pioneer Status**

Tax on 30% of statutory income and the period of tax exemption is as before — 5 years. However, companies located in Sabah, Sarawak and the Eastern Corridor of Peninsular Malaysia (Kelantan, Terengganu, Pahang and the district of Mersing in Johor), will only have to pay tax on 15% of their statutory income.

**(ii) Investment Tax Allowance**

An allowance of 60% of capital expenditure incurred within five years from the date of the approval of the project. Companies located in the Eastern Corridor will be granted an allowance of 80%.

**(iii) Reinvestment Allowance**

An allowance is given on 50% of the capital expenditure.

#### B. SPECIFIC INCENTIVES

**(i) Incentives for High Technology Industries**

Full exemption at statutory income level for a period of five years or investment tax allowance of 60% on qualifying capital expenditure incurred within a period of 5 years. However this incentives can only be given if the following criteria is met:

-Local R&D expenditure is at least 1% of gross sales annually, but a company is given a grace period of 3 years from the date of commencement of business to comply with this requirement.

-The percentage of science and technical graduates to total workforce should be at least 7%.

**(ii) Incentives for Strategic Projects**

Projects that will be eligible for this incentives are those with heavy capital investment and high technology which can generate extensive linkages. The benefits are a full tax exemption at statutory income level for a period or 10 year or investment tax allowance (ITA) of 100% in qualifying capital expenditure incurred within a period of five years.

**(iii) Incentives for Export**

The abatement of adjusted income incentive was withdrawn whereas the others remain. The remaining incentives are primarily in the form of facilities.

**(a) Export Credit Refinancing (ECR) Scheme**

This facility was expanded as it was found to be useful to exporters. Currently the preferential rate of interest is a maximum of 5% per annum. The scheme is operated by commercial banks while the Central Bank will refinance the export credits that have been extended. Exporters may invoice their exports in any currency but financing is made available only in Malaysian Ringgit. There are two types of facilities under this scheme — pre- and post-shipment facilities. The pre-shipment facility provides working capital to direct and indirect exporters while the post-shipment one enables exporters to obtain immediate funds upon shipment of goods sold on credit terms. There are, however, conditions for eligibility:

- Products should not be listed in the “negative list”.
- Products should have a minimum value added of 20%.
- Products should have a minimum 30% domestic resource content.

Flexibility is allowed in the enforcement of these criteria and currently crude rubber, vegetable oil products, agricultural food products and textile products are exempted from these requirements. For other products that do not fulfill the domestic resource content and value added criteria, exemption is given by the Central Bank on a case by case basis.

To secure the post-shipment credit facility, the necessary documents required are the invoice, customs export declaration form and transport documents. The pre-shipment ECR needs an export order or a certificate of performance. The maximum period of pre-shipment financing is four months and for post-shipment is six months. The eligible amount for pre-shipment facility is 80% of the value of the export order under the order-based method and 70% of the value of eligible exports in the preceding 12 months under the certificate of performance method. For post shipment facility, the eligible amount for financing is 100% of the invoice value.

**(b) Double Deduction of Export Credit Insurance Premiums**

This incentive is the same one as previously.

**(c) Double Deduction for Promotion of Exports**

Same as before.

**(d) Industrial Building Allowance**

This incentive is in respect to buildings used as warehouses for storing goods for export. The incentive provides an initial allowance of 10% and an annual allowance of 2%.



**(iv) Incentives for R&D**

The first R&D incentives was in the PIA — deductions for expenses on scientific research, building allowance and plant and machinery were given — but the current transformation of the Malaysian industrial base to more technology- and knowledge-based activities has stimulated the introduction of more R&D incentives. The incentives can be divided into two groups, the first one is for fostering R&D in industry while the second group is for encouraging the establishment of companies and institutions to undertake R&D.

**a) Incentives for R&D in industry**

-R&D expenses of a revenue nature is eligible for deduction while revenue expenditure incurred for approved research is allowed a double deduction.

-ITA of 50% on R&D expenditure for a period of 10 years.

-Industrial Building Allowance in the form of an initial allowance of 10% and an annual allowance of 2% is available for buildings used for the purposes of approved research. Plant and machinery used for approved R&D are eligible for capital allowances.

-Double deduction is given for cash donation made to approved research institutions and payment for the use of services of a R&D company.

**b) Incentives for establishment of R&D companies and institutions**

-A tax exemption for a period of 5 years for carrying out R&D activities for a specific industry.

-ITA of 100% of qualifying capital expenditure incurred within a period of 10 years for carrying out R&D activities for holding or associate companies.

-Industrial building allowance for building used for carrying out research.

**(v) Incentives for Training**

To complement the incentives for R&D, the government has also offered encouragement for the upgrading of skills, productivity and quality:

-ITA of 100% for a period of 10 years to companies intending to undertake technical and vocational training.

-Single deduction for cash contribution public sector technical or vocational training institutions.

-Machinery, equipment and materials used for training are eligible for exemption from import duties, sales tax and excise duties.

-Companies are given a double deduction for expenses incurred on approved training. This incentive is, however, only available to companies employing less than 50 Malaysian workers. For those with more than 50 Malaysian workers, assistance is available under the Human Resources Development Fund.

-Industrial Building Allowance for companies that have incurred expenditure on building used for approved industrial training.

**(vi) Incentives for Industrial Adjustment**

The Ministry of International Trade And Industry has embarked on an industrial adjustment program to strengthened industrial self-sufficiency, improving industrial technology, increasing productivity, enhancing the efficient use of natural resources and the efficient management of manpower. It is only opened to wood-based, textile, machinery and engineering companies in operation before December 31, 1990. Companies undertaking approved industrial adjustment programs are eligible for the Industrial Adjustment Allowance which provides an allowance of up to 100% of qualifying expenditure related to this program. The allowance is granted for capital expenditure incurred within five years from the date of incentive approval.

**(vii) Incentives for Small-scale Companies**

Small-scale manufacturing companies are those with shareholders' funds not exceeding RM500,000, incorporated in Malaysia and have at least 70% Malaysian equity. The following incentives are additional to the earlier ones:

-Small-scale companies which meet specified criteria will be granted the pioneer status automatically if their proposed products or activities are those listed in the promoted ones for small-scale manufacturers.

-Full exemption from customs duty on raw materials, components, machinery and equipment, which are not available locally.