

## Investment Priorities and Government Assistance Policies

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### INTRODUCTION

This paper reviews briefly the national investment priorities and policies to promote industrial development in Malaysia. It highlights the progress on industrialization and concludes with some challenges and prospects for the industrial sector in the 1990s.

In the early phase of Malaysia's industrialization, the predominant theme was on an import-substitution strategy to save on foreign exchange. This phase covered roughly the early part of the 1960s. Incentives to attract foreign capital were covered under the passage of the Industries Ordinance 1958, which provided generous tax relief and tariff protection to selected industries. The decade of the sixties marked the start of the manufacture of electronic chips by foreign computer firms from Japan and the United States. These firms were located mainly in the Free Trade Zones (FTZs) of Peninsular Malaysia. Another common feature to foreign ventures in Malaysia in the 1960s and the 1970s, was the establishment of manufacturing firms and the so called "nuts and bolts" variety by which components of a product were imported and reassembled in Malaysia. A typical example is found in the automotive industry where car parts are imported completely in knocked down (CKD) form and reassembled here.

Looking at the development pattern of the manufacturing sector in the country over the last three decades, there was a significant shift in industrial development strategy in the early 1970s. This shift is reflected both in the various Malaysian economic development plans as well as in the policy legislation passed by the Government. A notable one was the introduction of the Investment Incentives Act 1968, which was superseded later by the promotion of Investment Act 1986. The 1986 Act gives generous tax incentives designed to provide either total or partial relief from payment of income tax and development tax to enterprises that are in the manufacturing, agricultural and tourism

sectors. A common trend that can be observed in these policies has been the focus given on promoting export-oriented, local resource use and labor intensive products. These policies have been modified by the passing of the Industrial Coordination Act 1975, to achieve the objectives of the country's New Economic Policy (NEP). Essentially, it covers conditions for expansion of production capacity and guidelines on equity ownership. The other important contribution to the pattern of growth of industries has been the implementation of the Industrial Master Plan (IMP) which was drawn up to chart the industrialization strategy for the period 1986-95.

The IMP rearticulated past policies to promote outward-oriented industries with particular emphasis on the use of local resources. However, it now clarifies in a more cohesive manner the Government's position on heavy industries, and the twelve other industries (both resource-based and non-resource based) that it wishes to promote. It should be added that this policy has been since revised because of the deep economic recession suffered in 1985-86. It is now sharply in favor of small and medium-scale industries. An added wrinkle to the policy, is the policy on privatisation of Non-Financial Public Enterprises (NFPEs). This is part of an economic reform project which is essential to minimize the Government's direct investment in commercial activities and also the result of the government's experience with economic adjustment in 1982-1986 which had caused domestic and external imbalances.

However, the emphasis placed on industrialization should go beyond these governmental acts, guidelines and plans. It should also cover among others, the Government's policies on immigration and labor, exchange control, transfer of technology and facilities for investment. It is not the intention of this paper to review all the policies in these areas that have been mentioned. It is sufficient perhaps to say that the thrust of Government policies throughout, remains one of trying to attract investors, especially from abroad.

The results have been impressive. In the 1970s, continued investments in the manufacturing sector generated nearly 500,000 new jobs compared with a total labor force of 803,000 in the manufacturing sector. The average annual rate of growth in the sector was a strong 12 percent, compared with 6 percent for agriculture. Total private investment in industries by the end of the decade was an impressive \$1.9 billion. Most of these investments were in electronics, chemical products and food products. Their significance can be observed from

the significant shift in the structure of output in Gross Domestic Product (GDP).

#### SELECTED INVESTMENT TRENDS IN THE 1980s

A clear evidence of investment growth was the gradual transformation of the Malaysian economy. The share of industrial output to GDP was about 9 percent at the beginning of the 1960s with agriculture taking up a strong 40 percent. Rapid growth in industrial output raised its share by the end of the decade to a significant 12 percent. The agricultural sector continued to dominate the economy in the 1970s accounting for 32 percent of output at the beginning of that decade. It was during the period of the 1970s and 1980s that a far more rapid transformation could be observed. In the second half of 1970s, rapid economic transformation was made possible by a strong economic expansion (8.6 percent annual growth in GDP during 1976-80). Its dynamism made it possible for the share of industrial output to GDP to reach 22.5 percent, surpassing for the first time the share of agriculture (21.9 percent) in 1987. By 1988, the share of industries to GDP again rose to an estimated 24 percent. The substantial increase in the manufacturing share was made possible by a high rate of capacity expansion. This was primarily the result of large investment spending by both the local and foreign companies. The manufacturing sector grew at a remarkable rate of 12 percent during the 1970s, but slowed down somewhat to 9 percent during the 1980-88 period, because of the prolonged world economic recession.

The export pattern also reflect the shift from agriculture into manufacturing. The early dominance of commodity exports, in particular rubber and tin exports, has since been replaced by manufactured exports. Since 1985, manufacturing exports have overtaken agricultural exports as the major foreign exchange earner. By 1988 exports of manufactures took up a share of 48 percent of total exports. Electronics and electrical products and textiles dominated the market. Although growth in the other categories of manufactures especially the rubber-based and wood-based products, have risen rapidly in the last three years in terms of export share, however they continue to account for only a minor share (6 percent) of overall manufactured exports.

By comparison, other Association of South East Asian Nations (ASEAN) members, namely, Indonesia had also attained a high rate of industrialization, with the share of manufacturing sector averaging 17

percent of GDP in the 1984-86 period from only 9 percent in the 1970s. Thailand, which suffered severe setbacks from the impact of the global recession, experienced a deceleration in the growth of the manufacturing sector in the early part of this decade, but it appears to have regained strongly its growth momentum in industrialization over the recent years.

A close look at the strong rise in investments in manufactures in Malaysia during the three decades revealed several interesting patterns. Firstly, the manufacturing base had continued to be dominated by the electrical and electronics industries which accounted for nearly 57 percent of exports in 1988. A distant second was textiles with 9 percent. In terms of destination, the United States market took the largest share of electronics and textiles exports at 44 percent for electronics and 40 percent for textiles. Another aspect to the narrow base was the concentration of products within the industry-group. For example, rubber gloves dominated the rubber products sub-sector and in the electronics sub-sector, an over concentration was seen in the output of component parts rather than industrial and consumer electronics.

Secondly, despite the presence of direct foreign investment, there was little evidence of industrial linkages especially between the industries in the Free Trade Zones (FTZs) and other sectors of the economy. Demand for local intermediate products by industries in FTZs was insignificant, resulting in little technology transfer, adaptation and infusion. There was also weak spin-off from direct foreign investment in terms of research and development activity. In spite of these strong characteristics, lately there have been a trend towards diversification.

Data from Malaysian Industrial Development Authority (MIDA) on project licensed under Industrial Coordination Act, shows another interesting pattern. Investments from overseas tend to concentrate strongly in the electronics, chemicals and chemical products, basic metal products, food products, rubber products and non-metallic products in that order. In terms of approved equity the major investors by ranking are, Japan, Taiwan, Singapore, United Kingdom and United States. Since 1987, there is also a discernible shift in the major sources of foreign investment from traditional countries, like United States, United Kingdom and Japan to Taiwan, Hong Kong and South Korea. Likewise, wholly foreign-owned manufacturing projects to total proposed capital investments have risen markedly from 2 percent in 1984 to 57 percent in 1989. This is probably in response to the recent relaxation on foreign investment guidelines.

## INVESTMENT PRIORITIES IN THE 1990s

It is extremely difficult to come up with a definite list of priority projects for the coming decade. It is clear that the economy has staged a vigorous recovery with an economic expansion that has already spanned for nearly 5 years. To a large extent, it is a reflection of the positive results of the Government's economic restructuring program which restored external economic balance and rehabilitated the public sector financial position. These are reflected in the surpluses achieved on the current account of the nation's balance-of-payments since 1987, from a deficit that reached a peak of 14 percent of Gross National Product (GNP) in 1982, and a narrower and more sustainable Federal budgetary deficit (from 18 percent of GNP in 1982 to 4.5 percent in 1988).

In spite of these impressive achievements, there are several important factors and issues that perhaps should be considered in framing the investment priorities for the decade of the 1990s. Some of the issues are as follows.

1. Malaysia is a resource-rich country with abundant natural resources. It possesses sufficient supply of energy (both hydro and fossil fuel, mainly petroleum) to potentially support twice the existing industrial base. Its oil reserves can last for an estimated 15 years at the current rate of production (about 570,000 barrels per day) with a new gas reserve of 53 trillion standard cubic feet that can last a hundred years at the current rate of production. Malaysia's agricultural products have provided the country with a solid foundation for the series of successful five-year Development Plans, produced regularly in a 5 year cycle since 1966. The most notable of these agricultural products are natural rubber, palm oil and timber. Any plan to develop the country's industrial base cannot afford to ignore Malaysia's abundant resources which it enjoys a comparative advantage.

2. Malaysia has a population of approximately 17 million. The country's growth rate is estimated at 2.6 percent in 1990. At the same time, new entrants into the labor force are at the rate of about 3.2 percent per year, whereas the existing pool of unemployment is about 8 percent of the labor force. In the Fiscal Year 1990 Federal Budget, it was projected that the rate of unemployment was 7.6 percent for 1990 and the economy will decelerate slowly from 7.8 percent in 1989 to 6.5 percent in 1990. It is somewhat unlikely that under these

circumstances, a significant gain can be made on the employment front unless overall growth can be sustained on a more rapid pace for the rest of the decade. The key lies in investments. It needs to be emphasized here that the quality and the choices made on the type of investment will become critical.

3. The distribution of the industries of the industries remain extremely lopsided with continued heavy concentration in the electronics sector. Although double digit growth rates have been observed in some minor sectors, such as in the manufacturing of rubber – and wood – based products, their combined total account for only 7 percent of the share of the industrial sector. Such rate of growth must therefore be sustained for a prolonged period before it can catch up with the electronics industry in terms of production and export share. If one were to presume a standstill on the expansion of the electronics industry, the whole industry (excluding textile) would need to grow at the rate of about 31 percent per year in order to stay level with electronics by the end of the next decade. With reference to employment, the manufacturing sector has created jobs for an estimated 1.2 million Malaysians. Of this figure, the electronics sector employs the highest number, followed by wood products and food manufacturing. The vulnerability of an economy to over specialization or concentration is well known. For example, should the electronics market overseas shift against Malaysia's favor, the affected industries in Malaysia probably will extend a heavy toll on employment and growth of the industry.

4. In terms of industrial linkages and value-added in the manufacturing sector, there is neither a linkage of any significant scale nor a high build-up of value-added. *Depth* of the manufacturing process indicating, for example a more *round about* means of production has yet to be achieved. There is little evidence that the producer process from raw material to the final stage of production has undergone two or three stages in Malaysia. More *depth* in industrialization should not be expected now in view of the industrial structure and maturity of the economy. The laying of the foundation should instead be promoted.

5. During the five-year period of 1985-89, the economy is estimated to grow on average at the rate of 4.3 percent approximately equal to the projection of the Fifth Malaysia Plan for the period. Total private investment per year is estimated at \$12 billion or equivalent to 16 percent of GNP with an average growth rate of 4.6 percent per year. The role played by Direct Foreign Investment (DFI) is significant. DFIs'

share to total investment has reached nearly 60 percent. Concern is expressed here and elsewhere regarding the need for economic diversification, not only to add to the growth of the economy but also to insulate it from adverse fluctuations. There is also concern over the economy's ability to generate employment, especially when the agricultural sector has started to show signs of stagnation in other related areas. Issues have been raised over the DFIs contribution to the primary source of technological change. Obviously the role that DFIs should play and the policy relating to it needs a review as the country enters the next decade. Some of these pertinent issues are about ownership and control, net capital flows and national objectives in the next decade. If GDP growth is projected at an average of 6.5 percent per year in the Sixth Malaysia Development Plan 1991-95, therefore an estimated \$16 billion worth of investments per year will be required. From the experience of the Fifth Malaysian Plan, such an amount cannot be easily met from domestic savings alone despite the present extremely high savings rate of about 30 percent of GNP. The flow of DFIs is vital in order to achieve such an objective. In the past, the policy response towards DFIs was manifested through various means. Among them, were joint-ventures between Government-controlled enterprises and foreign investments; investment incentives through income tax reliefs; fiscal incentives relating to location, labor utilization, exports, training and tariff; licensing policies relating to output, equity ownership and borrowing; and special status such as the pioneer status which are given to certain industries producing new products. An evaluation of their benefits and effectiveness is timely.

6. What is not apparent but of crucial importance in promoting a dynamic manufacturing sector is the maintenance of a flexible and realistic foreign exchange regime which helps to maintain external competitiveness. The ringgit depreciation since the Plaza Accord of September 1985 was a primary factor for the vigorous recovery of the manufacturing sector. The depreciation has maintained the ringgit comparability to the other major ASEAN countries. While a competitive ringgit is an advantage in the short term, it cannot be maintained for long unless the productivity of the relevant sectors is kept ahead of wages in order to contain a rise in unit labor cost. Therefore, over the medium-term, price stability will be a crucial factor. Up to date Malaysia has been successful in containing price inflation. It needs to continue to do so with the appropriate policies and stances over the medium-term.

The Government has already introduced policies and programs to address some of the issues discussed above. A comprehensive review of the existing IMP is underway and a final report is being prepared on the Privatisation Master Plan. The efforts to resolve the problem of unprofitable NFPEs is not only timely but also most commendable. This should result in a greater flexibility in the Government's financial position. The Privatisation Master Plan should also ensure greater efficiency in the economy since the Government will no longer be in direct competition with the private sector. It seems appropriate to mention that some cautionary measures be taken, particularly when a review is made over the future of Government-owned heavy industries in the country since these industries play important roles in promoting expertise and experience in such fields as automotive engineering, shipbuilding and repairs. The spinoff these areas may well provide the needed industrial linkages both upstream and downstream.

It might also be noteworthy to look at the employment potential of those industries. This is especially so when the country is saddled with a stagnant pool of unemployed. It is well-known that a venture into heavy industries requires a vast quantity of investment. This cannot be undertaken without raising heavy loans and equity participation from abroad. Records show that several NFPEs in this sector are enjoying operational surpluses in the current upswing in the business cycle. Nevertheless, debt servicing is an extremely heavy burden to bear by these same enterprises. Interest rate burden and exchange rate exposure are two major factors that affect their viability. In the medium-term, any resolution to these issues must address directly their external debt position. The Privatisation Master Plan must take this opportunity to link itself to the resolution of these problems facing some NFPEs. Priority should be placed first on the loss-making enterprises. In short, this calls for the privatisation of the unprofitable, inefficient and unproductive public enterprises.

The Government has made a commendable move to shift the emphasis of the IMP towards the small and medium scale industries (SMIs). This shift is congruent with the need to promote resource-based and labor intensive industries. This move is also timely because it occurs in the period when the Newly Industrialized Economies in this region, notably Taiwan, Singapore, South Korea and Hong Kong are looking to Southeast Asia to relocate their industries. The situation presents itself as a welcome opportunity for the Malaysian Government to review and change when necessary its industrialization policies and legislations.



## CONCLUSION

The challenges ahead are by no means small. Some issues are discussed and solutions are posed. Besides these, there are other considerations to ponder. On the external front, market access abroad needs to be carefully assessed. Among them are, the imminent unification of Western Europe in 1992, and the changing nature of the economies and political structure of some Eastern European countries. These events will have extensive impact on the future of Malaysian trade in those areas. Within the country, urgent attention is required towards improving the infrastructure, especially in the area of transportation. Particular attention must be given to alleviate traffic snarls and port congestions which can be the main causes of slowdown in the production process. An investment in human resource development, strengthening of institutional framework such as MIDA and Standard Institution and Industrial Research Malaysia (SIRIM), emphasis on science and technology, streamlining and improving administrative efficiency must accompany the industrialization program. The Sixth Malaysia Plan, 1990-94 is a good starting point to implement these policies.

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