

Chapter V Malaysia: Laying the Groundwork to Meet the Need for an Industrial structure

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Chapter V

Malaysia: Laying the Groundwork to Meet the Need for an Industrial Structure

1. A Buoyant Malaysian Economy

The overall performance of the Malaysian economy from 1970 to the present, barring the three-year period from 1985 through 1987 when global recession triggered the nation's first negative growth since independence, has been tremendous. The macroeconomic performance from the latter part of the 1980s is especially noteworthy. After recovering in 1988 from the recession, Malaysia maintained high average economic growth of approximately 9.0% through 1995 (Table 5-1). Even with growth slowing somewhat in 1996, it still held at 8.2%. In the next year, the target for growth was set at 7.8%, also below the earlier pace, but still head and shoulders above global levels.

The Malaysian economy has grown not only in quantitative terms, but also in qualitative terms, as witnessed by the sophistication of industrial and trade structures. The sophistication of the industrial structure is symbolized by the increase in manufacturing as a share of GDP and the increase in

machinery as a share of manufacturing output. Manufacturing as a share of GDP increased from 19.6% in 1980, thereafter surpassing the agriculture, forestry and fisheries share in 1987 and continuing its upward climb until reaching 33.1% in 1995. Machinery as a share of manufacturing output increased from 22.8% in 1983 to 36.8% in 1993. Reflecting these trends, manufactured goods as a share of exports rose to 79.6% in 1995 and to 81.0% in 1996, driven by exports of electrical machinery and electronics (Table 5-2).

A strong Malaysian economy, however, has translated into unemployment of below 3%, making the labor market tight. With this shortage of workers, approximately 2 million foreign laborers have poured into the country, which amounts to 10% of the entire Malaysian population. Furthermore, wages are rising at a rate that exceeds the growth rate of labor productivity. Despite this high pressure economy, the rise in the consumer price index (CPI) has remained extremely stable since 1993, fluctuating within a range of 3.0 and 4.0%.

Table 5-1 Growth Rate by Expenditure Category

(unit:%)

Category Year	Consumption		Investment		Exports	Imports	GDP	Production in manu- facturing	CPI	Unemp- loyment rate	Per capita income	
	Private	Public	Private	Public							Ringgit	Dollars
1980	12.7	25.1	17.9	38.1	3.2	20.5	7.4	9.2	6.7	5.7	3,751	1,723
1985	0.5	-0.9	-8.6	-10.4	0.4	-9.8	-1.0	-3.8	0.4	7.6	4,594	1,850
1986	-10.0	1.3	-16.6	-20.4	11.8	-6.5	1.2	7.5	0.6	8.7	4,147	1,607
1987	2.1	1.5	6.2	-17.0	14.6	8.5	5.4	13.4	0.8	8.2	4,518	1,793
1988	16.1	4.9	22.0	5.0	11.8	24.5	8.9	17.6	2.7	8.1	5,064	1,934
1989	14.3	7.6	30.5	34.3	18.1	29.1	9.2	12.0	2.8	6.3	5,573	2,057
1990	13.6	6.5	24.8	17.1	18.3	27.0	9.8	15.7	3.1	5.1	6,236	2,306
1991	9.9	12.4	27.2	9.2	15.0	23.7	8.7	13.9	4.4	4.3	6,752	2,496
1992	4.4	4.0	6.6	11.1	5.2	-1.0	7.8	10.5	4.7	3.7	7,511	2,948
1993	5.3	10.7	8.9	18.0	14.6	15.8	8.3	12.9	3.6	3.0	8,041	3,124
1994	7.0	9.9	25.5	10.6	20.6	25.1	9.2	14.7	3.7	2.9	8,970	3,418
1995	12.0	10.6	16.0	25.5	16.1	21.2	9.5	14.5	3.4	2.8	10,075	4,137

Note: 1978 price index

Source: Produced from *Economic Report and Annual Report*

Table 5-2 Products as a Share of Total Exports

(unit:%)

	1970	1975	1980	1985	1990	1991	1992	1993	1994	1995
Manufactured goods	11.9	21.9	22.4	32.7	58.8	64.8	69.8	74.0	78.2	79.6
Foods	15.0	13.5	7.8	6.1	4.2	3.4	3.1	2.7	2.5	2.2
Drinks, tobacco	3.3	1.3	0.4	0.2	0.2	0.3	0.3	0.2	0.2	0.3
Textiles, apparel, footwear	5.2	10.8	12.8	10.4	8.3	7.7	7.2	6.0	5.0	4.4
Wood products	14.6	10.2	7.4	2.9	2.9	2.8	3.2	4.5	4.0	3.4
Rubber products	2.7	2.1	1.3	0.9	2.9	2.8	2.9	2.7	2.3	2.2
Paper, paper products	0.9	0.4	0.6	0.6	0.9	0.7	0.8	0.6	0.5	0.5
Petroleum products	26.2	5.2	3.0	7.9	2.7	1.9	2.2	1.9	1.8	2.1
Chemicals, chemical products	5.7	4.3	3.0	4.9	3.1	2.9	3.2	3.2	3.8	4.3
Non-ferrous metal products	3.3	1.2	1.0	1.2	1.6	1.4	1.2	1.2	1.2	1.1
Metal products	5.6	3.1	3.9	2.9	3.4	3.0	3.0	3.4	3.0	3.1
Optical, scientific instruments	0.6	16.6	2.2	1.8	2.3	2.6	2.4	2.2	2.1	2.0
Toys, sporting goods	0.3	0.7	0.9	1.4	2.1	2.1	2.1	1.8	1.5	1.5
Other manufactured goods	2.9	0.7	4.4	1.9	4.6	4.8	4.7	4.2	3.9	3.6
Electronics/electrical machinery	8.5	25.0	47.7	52.3	56.6	58.0	58.0	61.4	63.5	65.7
Electronic components	-	-	36.3	35.8	24.9	21.3	19.8	20.9	20.7	22.5
Electrical equipment	-	-	4.4	3.7	5.3	5.9	5.5	5.7	5.3	5.2
Other electrical machinery	-	-	7.1	12.9	26.3	30.9	32.7	34.9	37.5	38.0
Transport equipment	5.3	3.3	3.5	4.6	4.1	5.4	5.8	4.1	4.8	3.6

 Source: Produced from *Economic Report and Annual Report*
Table 5-3 Influx of Foreign Capital

(unit: 1 million ringgit)

	Capital investment			Domestic capital	Foreign capital share of domestic investment	No. of investments approved	
	Paid	Invested	Ratio (%)			Total	Foreign capital
1980	729.5	247.7	34.0	1373.3	34.7	459	97
1981	1309.3	475.9	36.3	3139.1	29.4	596	111
1982	1626.6	519.0	31.9	3808.2	29.9	468	63
1983	629.1	296.3	47.1	1729.0	26.7	490	69
1984	718.0	275.4	38.4	3083.1	18.9	749	85
1985	959.2	324.9	33.8	4727.6	16.9	625	78
1986	1687.9	524.5	31.1	3475.3	32.7	447	99
1987	2060.6	750.0	36.4	1873.9	52.4	333	132
1988	4878.0	2010.5	41.2	4215.9	53.6	732	301
1989	8652.7	3401.2	39.3	3562.7	70.8	792	439
1990	17629.1	6228.0	35.3	10539.0	62.5	906	533
1991	17055.3	6073.4	35.6	13763.1	55.3	973	561
1992	17772.1	5854.3	32.9	10003.0	64.0	874	425
1993	6287.2	2443.3	38.9	7465.5	45.7	686	328
1994	11339.1	4109.9	36.2	11612.2	49.4	870	432
1995	9143.5	3192.8	34.9	11725.5	43.8	898	403

Note 1: Domestic capital refers to paid capital

Note 2: Foreign capital share of domestic investment is on a paid basis (including loans).

Source: Produced from MIDA data

The Government of Malaysia has confidence in the impressive growth it has registered in the last decade and has set an ambitious goal it calls "Vision 2020" to propel Malaysia to become a fully developed industrial country by 2020. This goal is reflected in the Seventh Malaysia Plan (1996-2000; hereafter "7MP") released in May 1996 as well as the Second Industrial Master Plan (IMP2; 1996-2005) launched in November 1996.

This rapid growth from the latter half of the 1980s has been supported by the foreign enterprises which have made inroads into the country at record speed and scope since deregulatory measures taken in October 1986 permitted wholly owned subsidiaries (Table 5-3). This has brought a sudden rise in the foreign enterprise share of manufacturing assets, production, employment, exports and imports. The foreign enterprise share is large in non-resource-based industries, particularly machinery industries (electrical/electronics industries, among others). Japan has led the foreign investment boom, while newly industrializing economies also account for a large share of the investment.

To say the Malaysian economy is doing well is an understatement; rather, there is a sense that it is overheating. In response, the Government of Malaysia has set its 1996 target for economic growth at a low 8.3%, while trying to fight the upward pressure on the CPI by controlling demand. Public consumption rose a mere 0.8% from 7.3% in 1995 to 8.1% in 1996. This is due to a downward shift in public expenditure per annum from 17.0% under the Sixth Malaysia Plan (1991-1995, hereafter "6MP") to 2.4% under the 7MP started in 1996. Under this policy of restraint, economic growth in 1996 is thought to have reached 8.2%, slightly above the initial targets.

Another important reason that growth in the overheating Malaysian economy was contained at this level is that there has been a continuous decline in the growth of exports. In 1996, export growth slowed to single-digit levels, with growth in September actually lower than in the same month of the previous year. The Government of Malaysia projects that overall export growth in 1996 will plunge to 4.1% from 20.2% in the previous year.

There are two reasons for this slowdown in export growth. First, export growth of manufactured goods dropped from 22.9% in 1995 to 5.8% in 1996, due to a slowdown in exports of electrical machinery and electronics to the United States and a price collapse in the semiconductor market. The

wholesale spot price for one semiconductor fell from its peak at US\$54 in September 1995 to US\$6-10 one year later. Second, the export of agricultural produce actually underwent a reversal from plus 11.4% in 1995 to minus 15.3% in 1996, against a backdrop of lower export prices of palm oil, rubber, and wood materials.

2. *The Asian Economy's Deterioration and the Malaysian Economy*

The prospects for further "Go-Go Growth" (Business Week, February 19, 1996) in the Asian economy are starting to look bleak. Productivity growth rate is not keeping up with that of wages and stock prices are sluggish. The Far Eastern Economic Review (FEER) considers "Trees don't grow forever" and predicts that "The go-go years of near-double-digit growth are over, probably for good." The journal cites cyclical factors and structural problems as the two reasons for the slowdown in exports (FEER, October 31, 1996).

The same symptoms can be found in the Malaysian economy. Reflecting this situation, targets for growth in 1997 were lowered further, this time to 7.8%. Of course, this is still high in global terms. One might even call it "still too high."

Exports are projected to recover in the latter half of 1997, but the problems faced by the countries of Asia have become manifest during the slowdown process. The Malaysian government's goal for macroeconomic management is to achieve non-inflationary, sustainable growth over the medium to long term, by containing inflation (CPI) at home and maintaining a balance of payments with the outside world. However, because the Malaysian economy achieved high growth over an extremely short period, it faces two problems that threaten to shatter the balance. One is that the rise in wages has far surpassed the growth in labor productivity. The other is that the current balance has worsened.

The tight labor market has brought a large influx of foreign workers, but wages continue to rise. In the 1990s, they have risen at double-digit rates, increasing as much as 11.7% in 1995 and 12.3% in 1996. In the manufacturing sector, wages are rising faster than the average. Under the 6MP, average GDP growth in Malaysia was 8.7%, while employment grew 3.4%, resulting in labor productivity

of 5.3%. This means that wages rose at double the rate of labor productivity. In the manufacturing sector, average growth during the period of the 6MP was 12.2%, while employment grew at 9.0%, resulting in labor productivity of 3.2%, a figure far below that for the economy as a whole.

With wages outstripping labor productivity levels, the National Labor Advisory Council (NLAC) proposed a wage reform bill in August 1996. Now the government, businesses and labor unions use this wage reform bill as a guideline for wage negotiations. Enterprises, in general, are responding to the situation by introducing new machinery and automation, while foreign enterprises are shifting their production lines to other countries where wages are lower, or simply shutting down their plants.

The current balance has worsened as a result of high growth (Table 5-4). Looking at balance of current account from 1982 through 1996, Malaysia has recorded a deficit every year except for 1987 and 1988. In 1995, the size of that deficit was 19.4 billion ringgit, making Malaysia second only to Vietnam (over 10%). In 1997, this deficit is expected to expand even further (approximately 21.6 billion ringgit).

The worsening current balance is due to two factors. One is the widening deficit in the service

sector, as investment earnings and freight/insurance sectors go deeper into the red. The net outflow of investment incomes reflects the repatriation of profits and dividends from the rapid influx of foreign capital shown in Table 5-4. Through about 1990, foreign capital entered the country at an average rate of some 5 billion ringgit per annum. Since then, this figure has risen steadily, reaching 11.4 billion ringgit in 1996. The worsening of the freight and insurance balance reflects problems related to intermediate services.

The second factor is the precipitous decline in the trade surplus. Malaysia's trade balance, while consistently remaining in the black, dropped from 4,561 million ringgit in 1994 to 233 million ringgit in 1995, due to a sharp increase in imports. Imports relative to GNP increased steadily from 1980 (41.1%) through the first half of the 1980s, then shot upward in the latter half of the decade, climbing all the way to 86.1% in 1995. The boost in imports is primarily due to a sharp rise in capital and intermediate goods. These goods had always occupied a large share of total imports (60.1% in 1970), but rose to 77.6% in 1985 and 85.2% in 1995. The capital goods' share underwent a particularly steep rise from the middle of the 1980s, while the intermediate goods' share remained steady at around 40-41%.

Table 5-4 International Balance

(1 million ringgit)

	1985	1990	1991	1992	1993	1994	1995	1996
Merchandise account balance	8,883	7,093	1,449	8,609	2,831	4,561	233	4,643
Exports (fob)	37,576	77,458	92,220	100,910	118,383	148,506	179,491	187,020
Imports (fob)	28,693	70,365	90,771	92,301	110,152	143,945	179,258	182,377
Services account balance	-10,391	-9,723	-13,195	-14,568	-16,670	-17,025	-19,041	-19,423
Freight and insurance	-1,852	-3,837	-4,847	-4,265	-4,890	-7,367	-9,028	-9,129
Travel	-1,332	-632	547	657	906	3,603	4,143	4,776
Investment income	-5,434	-5,072	-6,735	-7,920	-8,174	-9,469	-10,562	-11,430
Other services	-1,806	-1,418	-2,095	-2,739	-4,244	-4,197	-4,317	-4,525
Transfer balance	-14	147	102	337	513	388	118	9
Current balance	-1,522	-2,483	-11,644	-5,622	-7,926	-12,076	-18,690	-14,771
Long-term capital balance	4,229	3,473	10,331	10,328	13,864	11,874	16,181	12,402
Long-term public capital	2,504	-2,836	-665	-2,876	979	480	5,834	1,574
Corporate capital	1,725	6,309	10,996	13,204	12,885	11,394	10,347	10,828
Basic balance	2,707	990	-1,313	4,706	5,938	-202	-2,509	-2,369
Total balance	3,209	5,365	3,427	16,744	29,239	-8,262	-4,403	1,230

Source: Produced from *Economic Report* of the Ministry of Finance, etc.

Malaysia's export dependence paralleled the rise in import dependence as the nation began to export more sophisticated products, rising from the 50-51% range in the first half of the 1980s to 55.2% in 1985, then to 86.3% in 1995. In other words, Malaysia needed to import an increasingly higher share of components to manufacture the higher value-added goods for export. This trend has strengthened another notch with the rapid influx of foreign capital from the latter half of the 1980s.

Due to the above factors, imports increased and the trade surplus, in turn, decreased. This is qualitatively different from the deficit trends in the countries of Central and South America. Moreover, savings and investment have both remained strong, so foreign currency is not being consumed. In other words, the sharp increase in Malaysia's imports, while stemming from investments by foreign enterprises, will in the end lead to a future increase in productivity and a further expansion of exports, so it has not raised concerns. However, the government has cut back on public investment and called upon the people of Malaysia to increase their savings.

3. Current Performance of and Future Prospects for Malaysian Economy

The characteristics of Malaysia's economic boom, as explained in Section 1, can be summarized into the following five points: (1) high long-term economic growth rates above the world average were maintained; (2) economic achievement was achieved through industrialization; (3) wage and per capita income levels rose fairly constantly; (4) unemployment rates dropped steadily from 1986 and currently stand at less than 3%, indicating a successful transition from a labor surplus to a labor shortage economy; and (5) an export oriented industrialization strategy was successfully put into action, which many developing countries seek in the pursuit of industrialization through expanded exports.

Malaysia's economic situation can be assessed as follows, looking at the goals and means under the development strategy started around 1970, and focusing on the labor shortage and large increase in wages. Malaysia can no longer exploit its natural resources, which are its basic endowments. In other

words, the industrialization strategy that pursues labor-intensive manufacturing has reached its end. The current labor shortage is a sign of this. This brings the Malaysian economy to a new stage of industrialization.

It is clear where Malaysia want to head — toward the sophistication of its industrial structure and the creation and development of new leading industries. The Malaysian government is therefore implementing the following policies.

First is the creation of high-tech industry. The Malaysian government designated 10 high-tech sectors: advanced electronics, equipment/instrumentation, biotechnology, automation and flexible manufacturing systems, electro-optics and non-linear optics, optoelectronics, advanced materials, software engineering, alternative energy sources, and aerospace. To promote development in these sectors, the government is offering incentives to stimulate high-tech enterprises and establishing seven high-tech industrial complexes, including the Kulim Hi-Tech Park in Kedah, which already houses 16 high-technology-oriented companies. In August 1996, the government announced its plan for the creation of an info-communication industry, referred to as the Multimedia Super Corridor (MSC). This is an attempt to create leading sectors by integrating the above-mentioned high-tech industries with advanced service industries, e.g. high value-added goods and information services and software.

Second is the control of labor-intensive investment. Since August 1995, MIDA has strengthened guidelines not to approve, in principle, investment when capital investment per employee falls below a lower limit of 55 thousand ringgit. The aim is to further attract capital-intensive investment.

Third is promotion and support for reverse investment, i.e. investment in labor-intensive and lower value-added industries overseas. The positive attitude toward overseas investment is also a response to the globalization of the world economy. In the words of Prime Minister Mahathir, "We have to go global" in order to survive (FEER, December 12, 1996). Another aim is to support the countries south of Malaysia that aim to diversify their export markets (Malaysia International Trade and Industry 1995/1996, pp. 115-121).

7MP and the IMP2 offer a clear vision and schedule for the sophistication of the industrial structure and the realization of Vision 2020. The two

were announced at about the same time, with the former lending more substance to the first half of the plan for the latter.

IMP2 was released in November 1996. This long-term plan, the successor to IMP1 (1986-1995), sets forth five strategic thrusts: (1) global orientation; (2) enhancing competitiveness; (3) improving requisite economic foundation; (4) Malaysian-owned manufacturing companies; and (5) information-intensive and knowledge-driven process. In short, IMP2 aims to take the Malaysian economy beyond its traditional labor-intensive manufacturing and turn it into a true industrial nation, by "strengthening industrial linkages and enhancing value-added through full integration of activities along the value chain to include R&D and design capabilities, development of integrated supporting industries on one side and packaging, distribution and marketing activities on the other," and achieving the earlier mentioned five strategic thrusts. In IMP2, this is referred to as the "manufacturing ++ orientation." As a base for the achievement of "manufacturing ++" and as conditions for strengthening this base, the plan calls for human resources, technology, financial incentives, a strong service sector, and physical infrastructure.

IMP2 cites eight industrial clusters and twenty-two sub-sectors to promote: (1) electrical and electronics industry; (2) transportation industry (automobiles, motorcycles, marine transportation and aerospace); (3) chemical industry (pharmaceuticals, petrochemicals); (4) textiles and apparel industry; (5) resource-based industry (wood-based products, rubber-based products, palm oil-based food/non-food products, palm oil-based food/non-food prod-

ucts, and cocoa-based products); (6) materials and advanced materials industry (polymers, metals, composites and ceramics); (7) agro-based and food products industry (fish and fish products, livestock and livestock products, fruits and vegetables, floriculture and (8) machinery and equipment.

IMP2 sets economic growth rate targets at 8.0% for the first five years, and 7.7% for the second five years, or an average of 7.9% for the decade. IMP2 projects the manufacturing share of GNP to climb from 33.1% in 1995 to 38.4% in 2005 (growth rate per annum of 10.7% from 1995 to 2000, and of 8.3% from 2000 to 2005), the final year, and also projects a rise in the service share from 44.3% to 48.4% (8.8% and 8.9%, respectively). The two industries are the driving force behind the Malaysian economy (Table 5-5).

The 7MP, announced ahead of IMP2 in May 1996, lends further substance to the IMP2. While average economic growth under the plan was revised downward to 8.0% from 8.7% under the 6MP, the figure still envisions high economic growth. Looking at targets for economic growth by sector, the highest targets are set for manufacturing, utilities (electricity, gas, water), and transportation, storage and communications, each at 10.7% (13.3%, 13.1%, and 9.9%, respectively, under the 6MP). The next highest targets are set for finance, insurance and real estate (10.2%). If these targets are achieved, manufactured goods as a share of exports will climb from 79.6% in 1995 to 88.6% in 2000.

Prime Minister Mahathir is emphasizing the special importance that must be placed on the expansion of manufacturing in order for Malaysia to truly become an industrialized country. The

Table 5-5 Projected Share of GDP by Sector

(unit: 1 million ringgit,%)

	1978 prices			Average growth		GDP share		
	1995	2000	2005	1995-2000	2000-2005	1995	2000	2005
Agriculture	16,230	18,542	21,081	2.6	2.5	13.5	10.5	8.2
Mining	8,979	10,062	10,824	2.3	1.5	7.4	5.7	4.2
Manufacturing	39,825	66,323	98,672	10.7	8.3	33.1	37.5	38.4
Construction	5,385	8,557	12,159	9.7	7.3	4.5	4.8	4.7
Service	53,303	81,117	124,245	8.8	8.9	44.3	45.8	48.4
Bank handling fees (+), import tax (-)	Δ3,413	Δ7,502	Δ10,358	-	-	Δ2.8	Δ4.2	Δ4.0
GDP	120,309	177,099	256,623	8.0	7.7	100.0	100.0	100.0

Source: *Business Times*, November 29, 1996.

Prime Minister points out that if Malaysia is to reach the goals it has set under IMP2, domestic and foreign investment must amount to 2,500 billion ringgit. He further stresses that for Malaysia, the next ten years will be decisively important. This is because the next ten years will tell whether or not Malaysia can change from a rubber and palm tree landscape to a truly industrialized landscape (Business Times, November 29, 1996).

4. *Vulnerability of and Prospects for the Malaysian Economy*

(1) Rise of China and Structural Reform

The labor shortage and concomitant rise in wages relative to productivity are not Malaysia's only motives for upgrading its industrial structure. External factors also come into play. The biggest factor is the rise of China and other neighboring rivals. The remarkable progress of the Chinese economy looms particularly large. Malaysia expects China to become Asia's final production and export base for labor-intensive goods and low value-added goods, given its massive population and low wages. Malaysia cannot have, and does not intend to have, the competitive edge for such products, so it must upgrade its industrial structure before China starts full-scale export of labor-intensive goods. Malaysia is not the only country feeling this Chinese threat. Thailand is thinking the same way. Other countries, including China itself, are also aiming to foster many of the same industries as Malaysia. When the export slowdown and supply side bottlenecks of 1996 became more visible, every country awakened to the reality that the industrialization strategy aimed at growth through traditional labor-intensive manufacturing industries would eventually be exhausted. In other words, countries throughout Asia have started to "climb up the value-added economic ladder" to survive. Malaysia must climb this ladder, whether it wants to or not. Indeed, it is already headed forward on its own volition. As already shown here, the industrialization pursued under 7MP and IMP2 reflects a transition from the traditional labor-intensive manufacturing to technology- or capital-intensive manufacturing. Another transition under this industrialization process is the one from input-driven growth to productivity-driven

growth. It is no longer socially or politically tenable for Malaysia to deal with its labor shortage by bringing in more foreign laborers than it already has. It must change its tack from the input of more labor to the improvement of productivity.

The Malaysian economy has achieved spectacular growth, but a closer analysis reveals a number of issues that must be addressed. Malaysian policy makers are well aware of their economy's vulnerability and where the problems lie. The Malaysian Institute of Economic Research (MIER), a government think tank, cites the three main weaknesses of the Malaysian economy: (1) narrow-based industrial sectors; (2) a high dependence on imports; and (3) weak economic linkages. To address these weaknesses all at once, a national automobile project was launched. The IMP1 review report released in 1995 cites the same three weaknesses in a list of 11 issues to be addressed, which also include tasks related to indigenous enterprises, such as the labor shortage, low skill levels, insufficient industrial research and development, as well as the need to modernize and improve international competitiveness (Table 5-6). None of these issues can be resolved over the short term. They are structural issues that must be tackled over the long term. While they are issues that must be addressed by all developing countries, they can become much more serious bottlenecks for Malaysia as it pursues its ambitious goals, given its remarkable development so far.

Table 5-6 Key Issues

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1. Labor Shortage
 2. Low Level of Technology
 3. Inter- and Intra-industry Linkages
 4. Local Content
 5. Domestic Investment
 6. Modernization of Industry
 7. Market Access and International Competition
 8. Excess Capacity
 9. Low Value-Added Activity
 10. Heavy Dependence on Imports
 11. Lack of Industrial R&D
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Source: *Review of the International Master Plan 1986-1995*, Ministry of International Trade and Industry, pp. XV-XVIII (1995).

(2) Development of Industry through Foreign Capital and its Dangers

The factors that threaten to restrict Malaysia's economic development in the future are human resources, financial resources and a peculiar industrial structure.

The shortage of skilled workers, R&D personnel and other such human resources is decisive. For example, there are more than 7000 information technicians (IT) fewer than needed for the establishment of MSC. In response, the government has lifted virtually all restrictions on the introduction of foreign experts necessary for MSC (employment terms limited to 10 years). Malaysia is also boosting expenditure for R&D. These measures aim to raise the productivity of workers, especially total factor productivity (TFP). Malaysia's TFP growth increased 1.2% per annum from 1971 to 1990, then jumped up to 2.5% under the 6MP. Now, the aim is to boost this up another notch to 3.3% under the 7MP. This requires huge financial resources. The development budget under the 7MP is 162.5 billion ringgit and ordinary expenditure is 289.8 billion ringgit, so Malaysia is trying to cover the balance with foreign loans. IMP2 requires financial resources amounting to 2,500 billion ringgit. Malaysia would have to depend on foreign capital more than half of this.

One of the problems with the industrial structure is weak inter- and intra-industry linkages. This problem is rooted in FTZ, which is the most clear symbol of the difference between the trade orientation and geographical field of activity evident in the performances of foreign and indigenous companies. Foreign companies enter FTZ with a mind to export and do not form linkages with indigenous companies. For this reason, FTZ are called "Export Enclaves." This situation is further aggravated by the immaturity of small and medium indigenous enterprises and the shortage of human resources. As such, the sophistication of the Malaysian industrial and export structures are really due entirely to the entry of foreign capital into FTZ. The Malaysian government has set up various schemes (e.g. Industrial Linkage Program, Vendor Development Program) to foster small and medium enterprises and train personnel so as to form the necessary linkages and resolve this export enclave problem, but these efforts have not been adequate.

Malaysia is currently leading climb up the

value-added economic ladder and aims to be the first to reach the finish line, but it continues to rely, even deepen its reliance, on foreign capital. This is typified in the MSC concept, which calls for a reliance on foreign capital in all areas from hardware and funding to technology and human resources. However, this wholesale reliance on foreign capital is dangerous. In January 1996, it appeared that Malaysia would succeed in bringing in a semiconductor joint venture between LG Semiconductor of Korea and Hitachi Manufacturing of Japan, but plans fell through by the end of the year. The semiconductor joint venture would have introduced technology related to the first half of the manufacturing process and thereby contributed to the achievement of higher technology, which is part of the plan for climb up the value-added economic ladder. With this, the plan suffered a setback. A foreign company need not, nor is under any obligation, to follow the host country's policies.

There is another danger. One of the factors behind the worsening of the current balance mentioned earlier is the export activity of foreign enterprises, which accounts for 82% of all Malaysian exports (*Review of the Industrial Master Plan 1986-1995*, p. 82). In 1996, Malaysian exports slowed drastically due in large part to plunging prices resulting from the overproduction of VTRs and ICs by foreign enterprises. The activities of foreign enterprises, which are not heavily affected by the Malaysian government, are exerting further influence on the macroeconomic balance. To counter this, the government will likely apply comparable pressure on local enterprises. In actuality, as mentioned earlier, the government vastly reduced its spending from 1995 through the start of 1996 as the Malaysian economy appeared to be overheating.

Economic development through foreign capital has its good and bad sides. For the Malaysian economy in its pursuit of sophistication, it is likely to present severe constraints. While the government fully recognizes this situation, it is forced to turn again to foreign capital as its only viable option. The future of the Malaysian economy depends on whether or not it can continue to attract this foreign capital and do something about the vulnerability mentioned above. If it cannot, the Malaysian economy may fall behind in climb up the value-added economic ladder.

(3) Two Turning Points

The "climb up the value-added economic ladder" in Asia will not continue forever. It will probably last through the latter half of the 1990s at the earliest, or through the beginning of the 21st century at the latest. Malaysia is actively taking part in climbing up the value-added economic ladder, but faces potential setbacks that could slow it down.

Malaysia's construction sector has consistently recorded double-digit growth since 1989. In 1995, it was as high as 17.3%, or nearly double the GDP growth rate. The construction sector was a powerful driving force behind the buoyant Malaysian economy. The engine behind the construction sector itself was mainly government investment in construction. Government projects included the KL City Centre, the world's tallest building, the KL New International Airport, Malaysia's first subway in the capital, and a sports stadium. These projects sparked the construction of hotels, office buildings and housing. All of the building is in preparation for the Commonwealth Conference, Commonwealth Games and Asia Pacific Economic Cooperation (APEC) forum, to be held in 1998. In 1999, the F1 car race is scheduled to be held in Malaysia. For this, the

Malaysian car maker Proton has purchased British car maker Lotus and will manufacture the Lotus sports car in Malaysia. Economies often face recessions immediately after major events, as did Japan and the Republic of Korea right after the Tokyo and Seoul Olympics, respectively. Putrajaya, the name of a project for the construction of an administrative city, got underway at the end of 1995 and is scheduled for completion in 2005. Prime Minister Mahathir was probably concerned that the other projects would not be enough to avoid recession. It is worth noting, however, that 1999 also happens to be the year that Mahathir leaves office. In this light, his interest may be more in Putrajaya as a "monument" than as an investment in technology (Business Week, February 19, 1996). Perhaps he feared a mounting recession in 1999. Even if the "monument" helps keep Malaysia afloat for the moment, however, it does not provide a long-term solution. This makes it urgent for Malaysia, while continuing to fully rely on foreign capital as mentioned earlier, to shed some of its vulnerability and steadily build the foundation that enables it to move to the next stage.