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The Second Phase of Malaysia's "Look East Policy"

By G. Sivalingam

EXECUTIVE SUMMARY

- Japanese Prime Minister Shinzo Abe's recent visit to Malaysia has been hailed as marking the beginning of the second phase of Malaysia's Look East Policy. The original policy was initially propagated by Tun Dr Mahathir Mohamed in 1982, in anticipation of greater inflows of Japanese FDI into Malaysia's labour intensive manufacturing industries.
- Japanese FDI inflows into Malaysia following the Plaza Accord of 1985 failed to provide a way out of the country's middle income trap as it was focused on utilizing relatively low cost unskilled and semi-skilled labour. The heralded 'new wave' of Japanese investments, thirty years later, is expected to maintain that same focus.
- New Japanese investments raise the possibility that Malaysia may be able to attain the ratio of gross fixed capital formation to gross national income that it attained at the heyday of Japanese FDI into the country.
- Japanese infrastructure projects, such as the high-speed rail from Kuala Lumpur to Singapore will create investment opportunities for small and medium enterprises and are also expected to generate more local investments.
- The second phase of the Look East Policy would not on its own get Malaysia out of the middle income trap unless there is a concerted effort to attract technology-intensive industries by making available highly skilled labour and an environment conducive for technology-intensive industrialization.

INTRODUCTION

The recent visit of Japanese Prime Minister Shinzo Abe to Malaysia has been hailed as marking the beginning of the second phase of Malaysia's Look East Policy. This was initially propagated by the country's fourth Prime Minister, Tun Dr Mahathir Mohamed, in 1982 in anticipation of greater inflows of Japanese foreign direct investments (FDI) into Malaysia's labour intensive manufacturing industries (New Straits Times, 26 July 2013). Japanese FDI into Malaysia gathered momentum after the Plaza Accord of 1985 (IMF 2011). The politically determined or administered appreciation of the yen against the US dollar forced Japanese manufacturing multinationals to seek lower cost production platforms in Southeast Asian countries including Malaysia.

The trade war between Japan and the USA was at that time resolved by a meeting at the Hotel Plaza in New York in 1985. The outcome was to make the Japanese yen more expensive vis-à-vis the US dollar so as to reduce Japanese imports into the USA and lessen its trade deficit with Japan. The rising cost of production in Japan as a result of the appreciation of the yen, as decreed by the Plaza Accord, made Japanese exports more expensive in the United States with whom Japan had a large and spiralling trade surplus. One of the beneficiaries of the Plaza Accord was Malaysia as it received unprecedented inflows of Japanese FDI over most of the decade beginning in 1986.

However, the benefits pouring out of the Plaza Accord did not last long as Japanese FDI into Malaysia after 1994 began to shift towards China (as well as other Southeast Asian countries) where labour costs were relatively low, the supply of cheap labour almost unlimited, and the domestic market was huge. Many in Malaysia did not expect Japanese FDI to act in such a footloose manner. In fact from the mid-1980s to the early 1990s, there was apprehension that the country was going through a period of Japanization (or Nipponization), where Japanese penetration of the retail and services sector gained momentum and depth, as a result of the need to service the Japanese multinationals in the electronics and electrical industry. During those early years, billboards were visible everywhere advertising Japanese products and corporations. The publication of "The Asia That Can Say No" by Tun Dr Mahathir and Shintaro Ishihara in 1995 also gave the impression that Japan and Malaysia were united against the threat posed by the West, especially the United States.

The Look East Policy was greeted with enthusiasm in Malaysia as a nationalistic programme since it shifted the developmental focus away from the West. Similarities in the culture and value system between Malaysia and Japan were also emphasised, such as respect for elders and for the monarchy, and general practices of filial piety. The Japanese were also known for their thrift which was a value appreciated by Malaysians. No doubt, images of the Japanese Occupation of Malaya were still troubling but opportunities for business contracts and employment blurred some of the past images, along with news of Japanese remorse and repatriation for the atrocities committed during the Occupation period, which lasted from 1941 to 1945.

The Look East Policy was more than a slogan. It contained ideological preferences being pushed by the Tun Dr Mahathir who was the first prime minister not to have spent years domiciled in the West. Mahathir's "Buy British Last" policy came just a few years before the Plaza Accord and the passage of the Promotion of Investment Act (PIA 1986). The PIA 1986 was also a radical departure from the Investment Incentive Act of 1971 which it replaced, because it relaxed equity requirements and considerably liberalized the investment environment. This created a conducive environment for Japanese multinational corporations to operate in Malaysia. At that time, few would have suspected that the PIA 1986, the Plaza Accord of 1985, and the Look East Policy could be serendipitous for Tun Mahathir – the FDI inflows and the resultant increase in exports increased economic growth and strengthened Mahathir's political position. They all came together and kept him in power for the next 16 years, especially after his harrowingly narrow 40 vote victory over Tengku Razaleigh for the UMNO presidency in 1987.

THE QUESTION OF GROWTH

The high growth that Japanese FDI created in Malaysia was dubbed as part of the East Asian miracle by the World Bank. In a very prestigious study of East Asian development entitled "The East Asian Miracle" funded by the Japanese government, the World Bank (1993) was more willing to attribute the sources of growth to market and institutional forces than to Japanese investments. At the same time, American economist William Easterly (2001) attributed the phenomenon as being home grown rather than externally generated. It was obvious that high growth was more sustainable if it was internally generated than if it were not. However, the momentum of growth dropped sharply after Japanese FDI into Malaysia dropped in the mid-1990s. Paul Krugman (1994), benefitting from Young's 1992 study, similarly attributed the growth to perspiration rather than inspiration – a stark reminder of the eight-hour shifts that female rural migrants had to undergo in assembling the electronics components with their nimble fingers in the factories of multinational corporations that constantly reminded them to attain "zero defects" in their output.

It bears remembering that Japanese FDI inflows into Malaysia following the Plaza Accord of 1985 failed to provide a way out of the country's middle income trap as it was focused on utilizing relatively low cost unskilled and semi-skilled labour. This is important since the heralded 'new wave' of Japanese investments–pledged by both governments following Prime Minister Abe's recent visit to Malaysia–is also expected to focus on Malaysia's comparative advantage in relatively cheap and unskilled and semi-skilled labour rather than on labour that has high technical skills.

For an upper middle income industrialized country like Malaysia, further development requires strengthening of domestic capability and moving into more value-creating activities. However, a pressing problem for the country is education in particular and the quality of human resources in general. Malaysia has been a bit relaxed about upgrading the skills of its labour force as the educational institutions are unable to absorb all the capable and bright students. There has also been a considerable amount of brain drain from Malaysia as educational and career mobility paths are blocked or made difficult by an administrative and political system that is peculiar and unique to Malaysia.

TRENDS AND PROSPECTS

The second wave of the Look East Policy raises the possibility that Malaysia may be able to achieve the ratio of gross fixed capital formation (GFCF) to gross national income that it attained at the heyday of Japanese FDI into Malaysia from 1987 to 1994 and that lingered on till 1997. Total investments or Gross Fixed Capital Formation have fallen from about 40 per cent of Gross National Income in the period before the Asian Financial Crisis (AFC) in 1997 to about 20 per cent of Gross National Income in the period after the crisis. There were no signs prior to Prime Minister Abe's visit to Malaysia that this ratio can be attained in the near future despite the fact that Malaysia has one of the highest savings rate in the world and that the absolute amount of total investments has been rising every year.

The shortfall in investments has resulted in a savings-investment gap as Malaysia has a savings rate of more than 34 per cent of Gross National Income and total investments measure up to only about 20 per cent of Gross National Income. The surplus of savings over investments has been utilized, in part, by Malaysian corporations and banks in direct investments abroad, which raises the question whether investments in the country may have reached their potential and whether risk-adjusted returns to investments abroad are higher overseas than in Malaysia. In the absence of data, it is hard to assess the rationale for Malaysia's direct investments abroad except to note the multinational objective of firms and banks in Malaysia, and their need to maintain a regional presence and compete in the regional market. The banks may also be interested in benefitting from being a part of the financing of the growing intra-regional production and trade network in the ASEAN countries. Part of the rationale for direct investments overseas may be to benefit from "carry trade" as interest rates in Malaysia are much lower than in some neighbouring Southeast Asian countries.

Total investments in Malaysia comprise of public investment, private investment and foreign direct investments by multinational corporations. The inflow of foreign direct investments has dried up in Malaysia since the 1997 AFC. In fact, there have been divestments from Malaysia to China in the early years of the new millennium. However, the trend seems to have shifted recently as Japanese Multinational Corporations are moving their production bases and export platforms from China to the ASEAN countries—hence the second phase of the Look East Policy. Although the recent increase in foreign direct investment flows have not increased the ratio of Gross Fixed Capital Formation to Gross National Income to beyond the 20 per cent level, it is probable that with continued increases in foreign direct investment inflows, domestic public and private investments will also rise because of the need to provide new and additional infrastructure facilities to accommodate, facilitate and service the multinational corporations.

Prime Minister Abe has already promised to provide the technology for the construction of the high-speed rail from Kuala Lumpur to Singapore. The technology and soft loans from Japanese banks and the government of Japan will generate business contracts for entrepreneurs in Malaysia and higher paid jobs for the local population. As a result, there is a prospect of pushing the growth rate in Malaysia to more than 8% as it used to be in the 1990s before the AFC of 1997-98. The initiation of infrastructure projects by the Japanese will create investment opportunities for the small and medium enterprises that will be eligible for an expected myriad of low interest loans offered by Malaysian banks. The Japanese investments are also expected to generate more local investments as Japanese multinational corporations will not be able to complete all the infrastructure projects that are necessary to create the conditions for their effective operations in Malaysia. The infrastructure projects that can be completed by local corporations and small and medium enterprises include the building of road and power generating plants, laying of optic fibre cables, augmenting of port facilities and a host of other activities and projects.

However, it is worth noting that Bank Negara Malaysia (BNM) was correct in asserting that the GFCF/GNI ratio of 40 per cent achieved before the AFC was “not sustainable in the long run” as the investments were “predominantly in infrastructure” (BNM, Annual Report, 2010: 25). In other words, there are limits to spending on infrastructure even though there are many areas in Malaysia that are still short of infrastructure. The impetus to spending on infrastructure has come from FDI inflows as Multinational Corporations that invest in plant and machinery and greenfield investments need infrastructure. So unless FDI inflows increase, there will be very little incentive for the public and private sectors to raise their investments in Malaysia; and unfortunately since the AFC of 1997 and until 2004, FDI inflows in Malaysia have not been high and are only a percentage of what they used to be in the boom time of FDI inflows from the mid-1980s to the mid-1990s. In view of what has happened in the recent past, the prospect of the second phase of the Look East Policy increasing domestic investments in Malaysia appear to be very bright.

Malaysia achieved the peak of FDI inflows in 1996, which was a year before the AFC, when total FDI inflows were US$7.297 billion. However, after that they declined to US$2.473 billion in 1998 or a third of what they were in 1997. Although they increased by 43 per cent in 1999, they were only about 53 per cent of the peak reached in 1996. After 1999, the decline in FDI inflows into Malaysia continued until 2004 and reached a trough in 2001 when FDI inflows was only about 7.5 per cent of what the case was in 1996. In 2004 and 2005, the FDI inflows were only about

63 per cent of their level in 1996. This led the WTO Trade Policy Review of Malaysia to comment that "the decline in private investment" in Malaysia was due to "weak external demand" (WTO, 2005: 6). The weakening of external demand may also be a cause and a consequence of the decline in FDI inflows into Malaysia. Most of the public and private investments during the AFC period were mainly in infrastructure projects to support multinational corporation activities in manufacturing.

Before the 1997 AFC, foreign governments and banks keen on foreign direct investments used to lend soft short term loans to Malaysian banks and corporations for infrastructure projects. The Japanese used to call these soft loans a form of aid and these loans were used to finance long term capital intensive infrastructure projects. These soft loans were also denominated in foreign currency. This was not perceived as a problem then because the Malaysian Ringgit was on a somewhat fixed exchange rate with the US dollar or what McKinnon (2005) prefers to call the US Dollar Standard. Malaysian corporations and banks had strong faith that the exchange rate would not vary much, and the exchange rate with the US dollar would be guaranteed by the Malaysian government. However, they were in for a surprise when, on the onset of the 1997 AFC, the Japanese and European banks were at their doorsteps demanding repayment of the loans and refusing a "roll over" of the short term foreign currency loans. The Malaysian government and the Central Bank of Malaysia could not help the corporations and banks. This was because the international reserves were not infinite and were fast dwindling as Malaysia had loaned money to Thailand to defend the baht, and used the foreign reserves to defend the exchange value of the Malaysian Ringgit which was in free fall.

The corporations and banks that borrowed in foreign currency and used short term external loans for long term investments were caught in two mismatches – that is, a currency and maturity mismatch. As a result, they got burnt very badly and are considerably more risk averse now. The banks are also risk averse as they do not want to bear the risk of borrowing short term from the depositors and lending it long term to investors and corporations for fear that they will face a liquidity crunch in the event of a repeat of the external shock that occurred in 1997. The firms are also deleveraging and, hence, may not want to incur too much long term or short term external debt in case they are unable to service their debt if there is an external shock.

CONCLUSION

With the lessons learnt from the AFC, Malaysia is perhaps more prepared to address the unanticipated consequences of increased FDI such as the temptation to raise foreign borrowings on the back of increased exports generated by increased FDI. The second phase of the Look East Policy will not on its own get Malaysia out of the middle income trap unless there is a concerted effort to attract technology-intensive industries by making available highly skilled labour and an environment conducive for technology-intensive industrialization. As Malaysia is short of highly-skilled labour, there may be a need to attract the Malaysian diaspora back to the country or to rely on foreign talent as America did and does. However, there may be political resistance to importing skilled labour or encouraging the Malaysian diaspora to return as it may have consequences for the political structure in Malaysia.

Increased FDI will increase economic growth and strengthen Prime Minister Najib Razak's grip on power as it did for Tun Dr Mahathir. He will have the ability to overcome nationalistic pressures not to rely on foreign labour to get out of the middle income trap. Regardless of whether or not Malaysia gets out of the middle income trap, the expected increase in FDI through the revival of the Look East Policy will put the ruling UMNO and the Barisan Nasional in a stronger position as there will be more contracts, jobs and avenues for upward mobility.

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G. Sivalingam *is a visiting senior fellow at ISEAS.*

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Institute of Southeast Asian Studies
30, Heng Mui Keng Terrace
Pasir Panjang, Singapore 119614
Main Tel: (65) 6778 0955
Main Fax: (65) 6778 1735

Homepage: www.iseas.edu.sg

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