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Asean Industry: The Quest For Depth
ASEAN INDUSTRY: THE QUEST FOR DEPTH

Almost two-fifths of ASEAN imports consist of manufactures. The cost to the five countries of buying these was as much as US$43 billion in 1980. Can some of this huge and increasing outflow of cash be retained within the countries by adopting a "do it yourself" approach? This is the key issue ASEAN decision-makers have to resolve as they look for a new framework of policies to cope with a worsened international environment.

The industrial countries, the market for a very large proportion of the exports in each of the five countries, are faced with a prolonged showdown in the 1980s. This may mean, on the one hand, a softness in ASEAN commodity prices and, on the other, persistence of protectionist barriers. Moreover, capital inflows are on the decline.

Given this context, does prudence require the ASEAN five to give renewed emphasis to import-substituting industries? Is this why Malaysia, for instance, has launched a steel project while Thailand is drawing up plans for a petrochemicals complex? Is this also the rationale for Indonesia's expansion of oil refineries and the Philippines' bid to produce fertilisers and diesel engines?

The answer in all cases is that a reduction of imports is part of the motivation. This is so despite the bad odour that now attaches to policies of import substitution because of the costs they have involved - spectacularly so in the case of India and less so in South Korea. Many international institutions, notably the World Bank, have developed an array of arguments based on impressive statistical evidence to show that the price of substitution has been a slowing down of overall economic growth.

Singapore's Deputy Prime Minister, Dr. Goh Keng Swee, a distinguished economist and an even more distinguished administrator, has brought up the weighty argument that import substitution leads to major evils, among them corruption. This is because substitution requires industrial licensing as well as protection of domestic markets, leading to import and foreign exchange controls. Those administering these curbs come under the temptation to share the windfall rewards accruing to the lucky recipients of permits and quotas.

Since import curbs also lead, in most cases, to the overvaluation of the currency, devaluation remains a constant danger - prompting capital flight as has undoubtedly taken place in Indonesia from time to time. Overvalued currencies have an adverse impact also on agricultural and mining activities, and on export-oriented industries by raising the prices of substituted goods they
have to buy and reducing the domestic currency proceeds of what they have to sell. In view of these costs, is import substitution a viable approach to industrialisation?

It is, provided protection is not excessive and does not become permanent. It is not easy to determine what is excessive but a study of Brazilian and South Korea experience suggests that wise policy-makers can devise a pragmatic policy package which makes domestic production profitable without condoning inefficiency. Over time, the promoted industries become internationally competitive as in the case of automobiles and ancillaries in Brazil, steel, machinery and heavy chemicals in South Korea. Protection for them is withdrawn but it is extended to other industries a country may wish to develop - as for example computers and industrial electronics in South Korea in the present phase.

There are inherent dangers in pursuing the approach that worked for South Korea and Brazil, despite the evidence that they combined this with vigorous and successful export expansion. The biggest risk is that the choice of industry picked under the import substituting strategy tends to be made by governments in the light of their judgements of future viability. They can make very costly mistakes as evident from the white elephants strewn across the Third World landscape.

It can be argued for instance that even as discerning and hard-headed a government as Singapore's has made a monumental blunder in promoting a mammoth petrochemical project, although the intention in this case was not import substitution but export promotion. The repeated delays in starting up the completed units, and the Japanese investors' insistence on additional Singapore investments, reinforce the doubts.

This underlines the need for exceptionally vigorous scrutiny of all sponsored projects because there is no room for costly mistakes now in tight Asean budgets. Generally speaking, there is more scope for import substitution projects where effective protection of industries competing with imports is currently low.

Leaving out Singapore which, because of its size and character must necessarily follow an open door policy, all Asean countries protect final products far more than immediate goods; and consumer durables far more than machinery and equipment. This has skewed the choice of industries and prevented a deepening of the industrial base. A correction of this bias is desirable for any new round of import substitution.

Wherever feasible, an import substituting industry should aim eventually to have a surplus of output available for export. The benefits from this will be two, one being a
contribution towards meeting the initial and recurring foreign exchange costs of the plant and the other being exposure to international price and quality norms. Even if the exports are made on the basis of marginal costing - with domestic sales carrying all or most of the overhead costs - the discipline of international trade is worth the price.

The Employment Perspective

Saving or earning foreign exchange is only one policy objective to keep in mind. As important, if not more, is the pressing need for off-farm employment. Although the labour force in agriculture has suffered a proportionate decline, the absolute numbers are still large and in some cases increasing. If Asean countries are to sustain the rapid growth in per capita incomes they have witnessed, they will need (except in Singapore where this does not apply) to give their industrial strategy a strong employment orientation to facilitate the transfer of work as from low-income farming or petty trading to the higher incomes industry offers.

In other words, they should promote, within the limits set by the technological characteristics of the products and the quest for international competitiveness, the use of labour-intensive methods. By and large, they have failed to do this and have in fact been inadvertently encouraging substitution of capital for labour. This is because of the incentives they give to the investor by way of special depreciation allowances, tax holidays and import duty exemptions.

A study of the effect of such incentives given in the Philippines showed that the government was paying in this manner from 15 to 45 per cent of the capital costs. Against this, the encouragement of the use of labour, such as the tax deductibility of training expenses in the Philippines, is marginal. Malaysian experience provides further confirmation: only 4 per cent of the 770 projects granted incentives qualified for a concession called "labour utilisation relief". The country has only recently extended its incentive schemes to cover such rural enterprises as fishing and market gardening.

The discouraging effect of the incentive structure is compounded by wage policies. As a staff paper published by the Asian Development Bank argues, policies which raise wage costs "put those branches of manufacturing at a disadvantage which primarily employ unskilled labour and hardly use (subsidised) physical capital".

Moreover, since minimum wage laws and the compulsory fringe benefits cannot be enforced in all economic sectors and regions, this deepens the divide between the formal manufacturing sector and the informal one - hindering the
upgrading of the latter that would otherwise take place in normal course.

One strange consequence of wage policies is the special dispensation Malaysia and the Philippines offer to investors in their free trade zones. In one way or another, trade union rights of the workers in the zones have been curtailed, in fact if not in law. This is an implicit acknowledgement that employment-intensive industries need favoured treatment but this is not alas available outside the small, specially designated enclaves. While the zone scheme may not have pushed wages down, the discrimination in their favour generates misgivings about working conditions and gives rise to resentment. However, there is no denying the benefit from the zones in terms of employment; 11 per cent of total employment in Malaysia’s manufacturing was accounted for by zone factories in 1980. The proportion was 38 per cent in Singapore’s pioneer industries with privileges similar to those available in the zones.

All the same, the relevance of export zones to Asean's industrial strategy is an issue that is open to debate. Academic critics have raised strong objections to the lack of linkages between industries located in these enclaves and the rest of the economy, and the absence of any worthwhile transfer of technology. As summed up in the 1982 report to the UN Economic and Social Commission for Asia and Pacific, the view is the zones "tend to generate inferior employment and provide minimal other benefits to the domestic economies at maximum cost", reckoned at over US$4,000 of government investment expenditures per job created in the first eight years of the Philippines export zone in Bataan set up in 1972.

The argument is not however conclusive. Singapore’s pioneer industries have developed to the point of integrating backwards from simple assembly operation to the manufacture of increasingly sophisticated components. A similar shift is beginning to take place in Penang in Malaysia as evident from the capital and skill-intensive new projects now being set up there. There is also evidence from both countries of technicians who cut their teeth in zone factories graduating to entrepreneurship in technologically-demanding fields. While the evidence is still too thin and recent for a definitive judgement, it seems that the zones can be steered towards greater relevance to the economies through suitable government initiatives and prodding.

Small Industry

The industries that are appropriate to export zones are few in number. A broader strategy for spreading industrial employment will be to promote geographical dispersal of industry by adopting policies which encourage the setting up
of new, technologically efficient, small-scale units or the modernisation of existing ones. But this too may involve unacceptably high costs. In all Asean countries with the exception of Singapore, small industry accounts for the bulk of manufacturing employment but its contribution to value added is quite small — one-third to one-fifth. This indicates very low productivity per worker, and also a low efficiency in the use of capital as measured by value added per unit of capital.

Small industry in Japan does not suffer from such handicaps. A study undertaken by the International Labour Organisation suggests that the difference stems not so much from the technological gap between Asean and Japanese small industries as from poor management, low worker skills, inadequate access to credit, and last but not least government policies which discriminate in favour of large units.

For example, the survey of Malaysian units showed that they were able to obtain only 8 per cent of their capital requirements from institutional sources. The proportion in Thailand was 12.5 per cent. The compulsion to rely on informal channels of credits must mean the cost was very high.

Even more important, the subsidies the governments provide for large capital outlays encourage the big units to undertake manufacture of spares and components to a much greater extent than they otherwise would. In contrast, Japanese industries seek to reduce their costs by delegating work to sub-contractors with lower overhead and wage costs. This creates a relationship which ensures that the smaller firms have access to capital, management and technological guidance, enabling them to meet demanding quality standards. Something like this must happen in Asean too through a carrots and stick policy to encourage large firms to move in this direction.

Any facet of an Asean country's industrial strategy — whether in relation to small industries, export zones or import substitution — has to subserve the overall goal of accelerating industrial development and promoting the enlargement of industry's share in the national cake.

The growth of manufacturing in the Asean five in the 1970's was higher than the average for all middle-income countries by a considerable margin. This was notwithstanding the fact that growth during the past decade was slower than in the previous one in Singapore (because a large base had been built up by 1970) and in Thailand (because simpler import substitution industries were close to the limits set by the domestic market).
Perhaps growth everywhere will now be slower because of the build-up that has already taken place. But this need not cause undue concern if the structure of manufacturing changes in a direction which would enhance each nation’s capability to sustain its growth. From this viewpoint, the development of machinery and transport equipment industries is particularly important.

In 1980, Singapore obtained more than half of the value added in the country from this group of industries. The country next best off was Malaysia where the share was one-sixth. Both figures may however be misleading because this group – as defined – also includes electronics assembly plants. These, as noted, provide employment, but they are not in a position to contribute to industrial development in the rest of the economy.

In the other ASEAN countries, the share of machinery and transport equipment was 11 per cent or less – compared with 28 per cent in Brazil, 20 per cent in India and 17 per cent in South Korea. Setting towards these levels will require judicious policies of import substitution, taking care to learn from the mistakes made by these countries in getting to where they stand today.