

# Do not neglect the manufacturing sector

THEEDGE MALAYSIA | JANUARY 16, 2012

The common tendency is that in rich countries, the manufacturing sector — once the driving force during the take-off stage — now plays a less important role than services. The relative size of services rises with prosperity as there is more need for high-productivity, knowledge-based services such as financial services and information and communication technology.

More people will also be working in banks, hotels and shops than in factories. So, it is logical that most countries are promoting the services sector to create growth and employment for their well-educated population.

However, during this turbulent global economic period, it is the countries with a strong manufacturing sector that have done better, partly through robust export performance. In other words, can a country base its growth solely on services and neglect the manufacturing sector?

Recently, the Institute of Strategic and International Studies Malaysia and the United Nations Development Programme representative office in Malaysia hosted a talk by noted economist Professor Ha-Joon Chang of Cambridge University, who argued that the manufacturing sector is a key foundation for a vibrant economy.

He gave three reasons for reaching this conclusion:

1. The manufacturing sector creates demand for the growth of high-productivity services sub-sectors such as finance, telecommunication and transport;
2. Some knowledge-intensive services are spin-offs from manufacturing production; and
3. The manufacturing sector generates export surpluses which can finance imports.

Many would not entirely agree with this opinion



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because they cite very successful economies, such as Switzerland and Singapore, which have become rich on the basis of services. In addition, Britain, which was once an industrial giant, has de-industrialised.

It is worth examining the Malaysian case because we have declared the services sector to be the main source of growth to achieve a high-income and developed country status. The acid test is whether Malaysia can transform and grow its economy to catch up with the likes of South Korea, Taiwan and Singapore. Will the manufacturing sector experience de-industrialisation?

The share of the manufacturing sector rose from 24.6% of GDP in 1990 to 30.9% in 2000, and then fell to 27.4% by 2011. Since the end of the 1990s, we have been lamenting the eroding competitiveness of our manufacturing sector, especially when compared with the rise of China and Vietnam. Efforts to move up the value-added chain, develop indigenous technology and build national champions have produced limited success.

Most of the advanced technology in use here still comes from foreign companies. The manufacturing sector is struggling to restructure and is stuck with many low value-added, labour-intensive activities. So, are we right to focus on the services sector as the engine of our future growth?

Let us return to the example of Switzerland and Singapore. Contrary to popular perception, the success of these countries is not only due to services. In fact, both are highly industrialised. Switzerland specialises in very high-value machinery and industrial chemicals while Singapore focuses on electronics, chemicals and precision engineering.

In 2005, Switzerland's manufacturing value-added per capita was US\$6,874, second only to Japan, while Singapore was third with US\$6,708. Germany is another

example of a rich country with a successful industrial sector, and is the world's second largest manufacturing exporter after China.

Germany's small and medium enterprises (SMEs) or *Mittelstand* focus on producing sophisticated machine tools that other countries cannot easily replicate, for example, for specialised manufacturing. Germany's prowess in the auto industry, with marques such as BMW, Daimler, Porsche and Audi, is world famous and this industry represents about 20% of GDP.

This brings into question the future direction of the Malaysian manufacturing sector and the measures to be taken. It is clear that to achieve sustained high growth and high income, Malaysia needs a strong and vibrant manufacturing sector as relying on services alone to drive growth may not be possible. Not all services sub-sectors generate high productivity or high wages. In reality, quite a number of them pay low wages and have little room to improve productivity.

To better understand the importance of the manufacturing sector, we should not just look at the total value of its output but analyse the level of productivity and technology. The share of manufacturing can appear to shrink when its productivity rises faster than other sectors and thus leads to a fall in relative prices.

Take the example of computers — productivity improvements have slashed the unit price of output. Likewise, productivity and mechanisation have slowed the rate of employment creation. This positive de-industrialisation (when the manufacturing sector becomes smaller) does not mean the sector is contributing less. It is alright provided productivity and trade improve.

A vibrant and strong manufacturing sector is a necessary complement to the services sector. The

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popular perception is that a move to a knowledge-based economy is synonymous with services activities. But many knowledge-intensive services such as research, engineering and design started and grew inside the manufacturing sector. As they become successful, they were outsourced or spun off to be standalone service activities.

Traditionally, manufacturing has been the main source of new productive knowledge and innovation. The sector produces many innovations in response to demands for practical solutions. If manufacturing is weakened, we will lose knowledge.

Services growth is closely linked with the manufacturing sector because the former serves the needs of the latter. Knowledge-intensive activities such as finance, design, research and telecommunications sell their services to the manufacturing sector. Likewise, transport and logistics are closely linked to, and their prosperity depends on, manufacturing operations.

The ability to produce export surpluses is another reason why a strong manufacturing sector is vital. Without export surpluses, imports — some of which are critical for economic activities and growth — cannot be financed.

With the exception of a few areas

such as tourism and education, it is more challenging to export services than to export manufactured goods, because of the methods of services provision and the many indirect barriers, including domestic regulations. Moreover, it is also more difficult to quantify the services trade, thus we cannot easily tell how it is performing. For many years, Malaysia had deficits in the services trade and even the surpluses made recently have been small relative to the goods trade.

Manufacturing labour productivity has slowed down in key industries such as electronics, textile and transport equipment while export performance is moderating. The need to compete in high value-added activities and have leading edge technology and strong domestic companies is obvious. So, what is next for the Malaysian manufacturing sector? Should we have a new industrial policy?

Malaysia has introduced a series of plans (Industrial Masterplans 1, 2 and 3), a host of measures and many institutions for the development of the manufacturing sector. Perhaps these require a fresh look.

The manufacturing sector should be at the heart of the national innovation effort. The focus should be on increasing productivity by developing national technology capability, supporting R&D, providing incentives for investment and nurturing productive

human capital in technology, production and management.

Using the experience of other countries, Malaysia should review how policies regarding government procurement and government research support can significantly and cleverly promote the manufacturing sector. At the same time, we should be prepared to restructure and close down some unviable industries if necessary.

We should step up efforts to connect existing knowledge-creating organisations with firms for technology development and then impose performance standards. Equally important, the manufacturing sector, including the SMEs, should have an international perspective and linkages, and be part of a globally integrated production and technology network.

Although the focus on the services sector is the right call, the manufacturing sector should not be overlooked. A productive, competitive and high-growth manufacturing sector is a necessary complement to the services sector. Developing and promoting synergies between high-end manufacturing and services can bring more solid growth to Malaysia. ■

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