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ECONOMIC DIVERSIFICATION AND PRIMARY COMMODITY PROCESSING IN THE SECOND-TIER SOUTH-EAST ASIAN NEWLY INDUSTRIALIZING COUNTRIES

Jomo K.S. and Michael Rock

Instead of simply relying on static comparative advantage considerations, the governments of the three second-tier South-East Asian newly industrializing countries of Indonesia, Malaysia and Thailand have all intervened to diversify their economies. Such diversification has included the promotion of new crops (e.g. oil palm) and natural resource exploitation, i.e. diversification of primary production, as well as the promotion of manufacturing. Besides import-substituting and export-oriented manufacturing, primary commodity processing and resource-based manufacturing more broadly have been very important for the industrialization of these countries. Malaysia's palm-oil refining, Thailand's agro-processing and Indonesia's plywood manufacturing have figured significantly in their development of internationally competitive industrial capabilities.

INTRODUCTION

The second-tier or second-generation South-East Asian newly industrializing countries (NICs) of Indonesia, Malaysia and Thailand have been distinguished from the first-tier East Asian economies (NIEs) of Hong Kong, the Republic of Korea, Singapore and Taiwan Province of China as well as Japan on a number of grounds, including the resource wealth of the former in contrast to the resource poverty of the latter. South-East Asian resource wealth, it has been argued, made possible rapid economic growth on the basis of primary production, and thus weakened the imperative to industrialize. As much of this primary production was for export, such resource wealth also weakened the imperative to manufacture for export. Thus, resource wealth is seen by some as a "resource curse", weakening the imperative to industrialize, especially for export. This argument is invoked to explain the second-tier South-East Asian NICs later and slower industrialization (compared to Japan and the first-tier NIEs), as well as the allegedly lower emphasis on exports.

Thus, many observers - most recently Jeffrey Sachs and his colleagues in the *Emerging Asia* study published by the Asian Development Bank (ADB, 1997) - now suggest that being a natural resource-rich country is bad for growth. Curiously, the ADB study defines natural resource abundance in terms of the ratio of net primary product exports to GDP in 1971, without distinguishing between extractive natural resources (especially minerals) from agricultural products. The so-called "Dutch disease" mainly involves the former, which tends to be very capital-intensive and only involves a small proportion of the population in the extraction of the resource. Consequently, the added income accrues to a few, while the appreciation of the country's currency affects the entire population.

Agricultural exports generally involve much more of the population, and increased income usually accrues to all producers, diffusing the adverse consequences of currency appreciation. The South-East Asian high performing economies have been major agricultural exporters, thus offsetting the problems associated with the mineral exports of Malaysia and Indonesia, in sharp contrast to, say, Nigeria. Generally, good macroeconomic management has also helped, especially in offsetting the tendency to indulge in expenditure on non-tradables.

Citing Lindauer and Valenchik (1994, pp. 288-9), Intal (1997) has argued that the marginal labour productivity, and hence the opportunity cost of farm labour for manufacturing, is higher in land-abundant African economies compared to land-scarce Asian ones, even though average labour productivity is usually higher in the latter. Thus it is unlikely that the former will be able to compete with the latter in labour-intensive manufactures. The Malaysian experience suggests that such labour-scarce, land-abundant economies can only be competitive in skill-intensive, rather than unskilled, labour-intensive manufactures, requiring considerable investments in human resource development.

Comparing wage rates to labour productivity in manufacturing for 1992, Intal (1997, table 4) shows the high proportion of wages and salaries to value addition per worker in economies such as Hong Kong (0.51), India (0.39) and Singapore (0.34) compared to Malaysia (0.28), the Republic of Korea (0.26), the Philippines (0.23), Sri Lanka (0.19), Thailand (0.15 in 1990) and Indonesia (0.14). This suggests that the low wages received by Indian workers do not automatically translate into labour- cost competitiveness. The situation in much of Africa suggests that, not unlike Indian labour, African labour may also not be competitive in wage/productivity terms.

The "tropical curse" thesis has also been resurrected by the Asian Development Bank (ADB, 1997). Surprisingly, the study seems to be oblivious to Lewis's (1969, 1978) pioneering work on the economic condition of the tropics. Lewis (1978) showed that tropical exports grew faster than temperate zone exports during the last period of global liberalization from the end of the last century. While the tropics generally had more modest export bases than the temperate zone, it implies that the tropics were able to respond to export demand despite the disadvantages they faced. Lewis emphasized, however, that not all tropical countries were able to seize the opportunities from increased export demand. He suggests that the exports in greater demand were largely water-intensive; hence, only those areas with enough water to substantially increase their exports were able to take advantage of the new opportunities. The more arid tropical grassland areas thus could not benefit from the increased demand for tropical products. It is also important to note that Lewis observed that the terms of trade for tropical exports had deteriorated badly against temperate exports. This suggests that productivity gains in the tropics were largely lost to the worsening terms of trade, and the situation would have been even worse where few productivity gains were made.

As the South-East Asian NICs and some other tropical countries have grown rapidly since the 1960s, it is necessary to explain why countries in the tropics have fared so badly in the last few decades. It is not enough to simply attribute the tropical growth shortfall to “pests, diseases, typhoons and other natural calamities”, as the ADB study does, although such factors may not have been unimportant.

Against this background, this paper will show how the second-tier NICs successfully diversified the range of their primary exports and also developed processing capacities to increase retained value-added. As this paper will show, such diversification and development of resource-based industrialization did not always come easily, usually requiring government intervention to facilitate the process. Such a discussion implies that the South-East Asian NICs went beyond static comparative advantages derived from natural resource endowments to develop new capabilities through learning, productivity growth, externalities and scale economies. Some South-East Asian governments have captured and deployed resource rents to support policies enhancing new productive capabilities and capacities as well as international competitiveness, while some firms have invested their resource wealth to develop new internationally competitive capacities.

The story in South-East Asia is quite varied, emphasizing the importance of careful and judicious targeting and organization to ensure the efficacy of public policy as well as private initiatives. Hence, we provide some detailed description of policy initiatives – including firm and industry-level measures – used to encourage primary product diversification and processing. These include “functional” interventions, such as physical and social infrastructure support, as well as research and development (R&D) and training, policies aimed at boosting private domestic investment (including foreign direct investment), fiscal measures, subsidies, preferential credit, procurement policies, etc. We shall also show how export promotion and other policies were used to diversify exports, i.e. to promote non-traditional exports. Finally, some attention will be given to the role of primary sector institutional reform, particularly in designing, implementing and monitoring policies.

This paper proceeds in two stages. Because conventional wisdom exerts substantial influence on the way economic policy-making is viewed, our discussion departs from the conventional interpretation by offering an industrial policy interpretation of the three South-East Asian governments’ economic diversification policies. The focus here is on demonstrating how natural resource riches were used as part of an overall development strategy to diversify the economies away from dependence on primary products. The contention will be that if these South-East Asian governments had not intervened selectively and effectively to do this, they would not be second-tier NICs today.

MALAYSIA

The colonial Malayan economy grew rapidly from the late 19th century to become the single most profitable British colony. Access to agricultural land as well as to forest, mineral and other natural resources increasingly came under the control of the State during and after the colonial period. Peasant agricultural settlement from neighbouring islands was encouraged by offering easy access to cultivable agricultural land. The colonial authorities generally allocated land and other natural resources to favour British investors, ostensibly because they were better financed. Favouring big British capital could have been efficient in so far as there may have been significant scale economies. However, this was certainly not the case in the tin industry during the 19th and early 20th centuries before the advent of the dredge, or of the rubber economy during the colonial era (Jomo, 1986).

Infrastructural development – in the form of roads, ports, railways, telecommunications, electricity and water supply – favoured British interests. Malaysia’s economic infrastructure (e.g. railways, roads, ports, utilities, etc.) – so crucial for profitable investment – was generally more developed than in almost any other British colony. Ethnic Malays remained largely marginal to the growing capitalist sector, with the elite integrated into the colonial State apparatus, and the masses remaining in the countryside as peasants. Instead, emerging business opportunities were mainly taken by some of the more urbanized and commercially better-connected Chinese. However, local businesses often found it more profitable to engage in production for export, commerce and usury.

The tin boom after the decline of Cornwall in the second half of the 19th century, and then, the decisive dominance of British dredging as well as the rubber boom with the growth of the motor car industry from early on in this century secured this position. In the half-decade after the end of the Second World War, colonial Malaya contributed more export earnings to the British Empire than any other part of the empire, including Britain itself. However, tin mining, rubber plantations and international trade continued to be dominated by British-owned agencies after independence until they were bought back, mainly by Malaysian State-owned enterprises, in London between the mid-1970s and the mid-1980s. Some have since diversified considerably into real property development, financial services, and resource-based as well as import-substituting manufacturing, and also abroad.

Although the Malaysian economy has changed significantly since independence, the many existing differences reflecting uneven development can be traced to the crucial formative decades under colonial rule that shaped Malaysia’s economic structure. Helped by favourable commodity prices and some early success in import-substituting industrialization, the Malaysian economy sustained a high growth rate with low inflation until the early 1970s. Malaysia’s export-led growth record in the last century has been quite impressive. During colonial times, Malaya was, by far, Britain’s most profitable colony, credited with providing much of the export earnings that financed British post-war reconstruction. Only a few industries were allowed to develop by the colonial authorities, which generally considered the colonies as suppliers of raw materials and importers of manufactured goods. Most industries then were set up to reduce transport costs of exported or imported goods, such as factories for refining tin-ore and bottling imported drinks. Local industries developed most when economic relations with the colonial powers were weak, e.g. during the Great Depression and the Japanese Occupation.

Tables 1 and 2 illustrate some macroeconomic trends in the Malaysian economy in the post-colonial period, showing rapid growth as well as structural change (table 1) and the rapidly changing composition of exports (table 2). After independence in 1957 and especially during the 1960s, the Malaysian economy diversified from the twin pillars of the colonial economy, i.e. rubber and tin. The Malaysian economy continued to experience rapid economic growth following independence. The average annual growth rate of the gross domestic product (GDP) in Peninsular Malaysia was 5.8 per cent during 1957-1970 (Rao, 1980). Later, the GDP for the whole of Malaysia rose by an average of 6.9 per cent per year between 1971 and 1990 (Malaysia, 1991) and by over 8 per cent annually from 1988. Malaysia's considerable export earnings ensured that it did not suffer from shortages of either savings or foreign exchange, contributing to investments, growth and structural change.

Table 1

Malaysia: gross domestic product by sector, 1960-1995
(percentage)

	1960[a]	*1970*	*1980*	*1990*	*1995*