Chapter Two

The Background of Automotive Industry

2.1 Introduction

Automobile has become an in-separable part of today's modern life. The automotive industry provides employment, bringing about industrialization and contributing substantially to the national growth. Today, the country is faced with economic recession and the automotive industry is one of the most affected industry. The survival of the industry as a whole has been threatened. Individual automobile company needs to be flexible to respond to all these immediate challenges. In other words, companies must always be prepared to anticipate the unexpected.

Different strategies maybe adopted by different companies to overcome this economic downturn. The implementation of different strategies greatly depend on the position of the company in the industry and its ability to build strategic competitiveness. The ability to build a strategic competitiveness in turn, depends on the resources, capabilities and core competencies of a company.

2.2 The History of the Industry

Prior to 1966, the automobile industry in Malaysia involved mainly distribution and sales activities. In the 60's, the government conceived the vision of systematically securing Malaysia's future as an industrialized nation. Although the motor trade at that time remained profitable, neither the established brand owners nor their local distributors seriously considered establishing production facilities, perpetuating the industry's continuing dependence on fully imported units.
However, the government's introduction of protective tariffs on all imported vehicles in 1967 had compelled local distributors to invest in assembling facilities and, at the same time, enabled the foreign auto brand owners to transfer their assembling technology to Malaysia. In addition, the adoption of a lower tax structure for CKD (Completely Knocked Down) vehicles compared to CBU (Completely Built Up) vehicles provided further incentive for the establishment of CKD assembly operation in the country to allow for lower vehicle pricing. The lower import duties imposed on CKD vehicles vis-a-vis CBU vehicles of different models for the years 1996 and 1997 are shown in Tables 2.1, 2.2 and 2.3.

In 1979, the government intensified its pursuit for the industrialization of the industry by issuing a local content policy. This directive called for the progressive mandatory deletion of specified items from the CKD vehicle kits, requiring the local assemblers to produce or source them locally.

Despite government protection of the industry, the auto components and parts market continued to be very fragmented. This was largely due to the variety of models and makes of automobiles available in this country which inhibited the upgrading and integration of these manufacturers in the industry.

Although the drive towards localization by the government had achieved a certain amount of success in creating many local parts and components suppliers, some of these suppliers were just assemblers of imported parts rather than manufacturers. Furthermore, most of these local parts suppliers were involved mainly in manufacturing components and parts that used relatively low level of technology, simple design, and production specifications. Consequently, the actual objective of the localization programmed to achieve transfer of technology and upgrading of capabilities and know-how could not be realized fully.

Table 2.1 : Import Duty On Cars

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<tbody>
<tr>
<td>Less Than 1,800cc</td>
<td>140%</td>
<td>140%</td>
<td>42%</td>
<td>42%</td>
</tr>
<tr>
<td>1,800cc &lt; X &lt; 2,000cc</td>
<td>170%</td>
<td>170%</td>
<td>42%</td>
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<tr>
<td>2,000cc &lt; X &lt; 2,500cc</td>
<td>170%</td>
<td>200%</td>
<td>42%</td>
<td>60%</td>
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<tr>
<td>2,500cc &lt; X &lt; 3,000cc</td>
<td>200%</td>
<td>250%</td>
<td>42%</td>
<td>70%</td>
</tr>
<tr>
<td>3,000cc and above</td>
<td>200%</td>
<td>300%</td>
<td>42%</td>
<td>80%</td>
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For new diesel cars (CBU) the rate of import duty is 120% whereas for used / old diesel cars the import duty rates are similar to petrol driven cars.

Table 2.2 : Import Duty On 4WD and MPV

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<tr>
<td>Less Than 1,800cc</td>
<td>50%</td>
<td>60%</td>
<td>5%</td>
<td>10%</td>
</tr>
<tr>
<td>1,800cc &lt; X &lt; 2,000cc</td>
<td>50%</td>
<td>80%</td>
<td>5%</td>
<td>20%</td>
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<tr>
<td>2,000cc &lt; X &lt; 2,500 cc</td>
<td>50%</td>
<td>150%</td>
<td>5%</td>
<td>30%</td>
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<tr>
<td>2,500cc &lt; X &lt; 3,000cc</td>
<td>50%</td>
<td>180%</td>
<td>5%</td>
<td>40%</td>
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<tr>
<td>3,000cc and above</td>
<td>50%</td>
<td>200%</td>
<td>5%</td>
<td>40%</td>
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Table 2.3 : Import Duty On Van

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<tbody>
<tr>
<td>Less Than 1,800cc</td>
<td>35%</td>
<td>42%</td>
<td>5%</td>
<td>5%</td>
</tr>
<tr>
<td>1,800cc &lt; X &lt; 2,000cc</td>
<td>35%</td>
<td>55%</td>
<td>5%</td>
<td>10%</td>
</tr>
<tr>
<td>2,000cc &lt; X &lt; 2,500 cc</td>
<td>35%</td>
<td>100%</td>
<td>5%</td>
<td>30%</td>
</tr>
<tr>
<td>2,500cc &lt; X &lt; 3,000cc</td>
<td>35%</td>
<td>125%</td>
<td>5%</td>
<td>40%</td>
</tr>
<tr>
<td>3,000cc and above</td>
<td>35%</td>
<td>140%</td>
<td>5%</td>
<td>40%</td>
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Source : National Budget, October 1997
Given the countervailing interests that prevailed, the government decided on a concerted state-led heavy industrialization programme to be spearheaded by the national car project (in the mid 1980s) for the local market. The objectives were to provide optimal incentives for ancillary and component manufacturing and precipitate integrated linkages within the automotive industry. The national car project also served as a launching pad for the transfer of technologies through the joint-venture between the Heavy Industries Corporation of Malaysia (HICOM) and Mitsubishi Corporation, Japan, in the automotive industry. In 1980, the cabinet approved the establishment of HICOM to undertake the task and the first Proton Saga was launched in 1985.

Subsequent to the establishment of HICOM, the government approved the setting up of Perodua (Perusahaan Otomobil Kedua) Sdn Bhd in 1993 to undertake the production and marketing of the 600cc Kancil range of passenger cars and later the Rusa range of vans. Backed by its expertise in automobile manufacturing, HICOM produced its first commercial truck- the Hicom Truck in 1995. Today, the national cars are represented in the 600cc segment up to the 2000cc segment and enjoyed market share as high as 85% in 1997.

The development of the automotive industry was well on track as envisaged by the government until the recent economic crisis. Jointly, the national and non-national automobile firms were progressing towards maximizing production facilities and capabilities to achieve the economies of scales and strengthening the linkages among the related industries. Parallel to the progressive development of the industry itself, the local content policy (which required the automobile assemblers to source for local components and parts) was well adhered to and had developed component parts supplier network that supported the industry.
Supporting service industries such as insurance and finance services benefited from the increased number of vehicles put on the roads which had brought about increased profits for the automobile companies as well as revenue from vehicles sales tax for the government. This was reflected in the average annual growth rate of 14.5% in the Malaysian automotive industry during the period between 1985 and 1997. However, in the third quarter of 1997, the industry began to register a rapidly declining trend in sales until today as a result of the regional economic slowdown. The performance in terms of unit sales for the Malaysian automobile industry for the years from 1983 to 1998 is presented in Figure 2.1.

In absolute figure, the average sales in the passenger car industry for the last five years were 218,400 units. There had been a steady increase in sales since 1987, after the mid-80s economic crisis, peaking at 307,907 units in 1997. The robust performance in the earlier part of 1997 enabled the industry to record a modest growth of 11% for the year. In percentage terms, the sales of new cars had reportedly fallen by more than 60% whereas the used car value had declined by more than 30% as at May 1998.

The Malaysian Motor Traders Association (MMTA) projected a sharp decline in the sales for all automobile sub-sectors (which includes the commercial vehicles and passenger cars) with total industry sales falling by about 60%. Total sales in 1998 is estimated to be in the region of 130,000 units as compared to more than 300,000 units sold in 1997. The breakdown on the expected vehicle demand by segment for 1998 is shown in Table 2.4.

To manage this crisis, the immediate steps that were taken by some of the automobile companies include the temporary closure of production plants, termination of contracts and promotional workers, closure of some sales branches, re-deployment of employees, pay cut and many other measures. Taking into consideration the social impacts and the necessity of retaining workers, few industry members such as Cycle Carriage & Bintang
and Tan Chong assembly plant have embarked on temporary shut down. Instead of opting for downsizing, employees are paid 75% of their salaries and given RM120 allowance.

Table 2.4
Vehicle Demand (units) in 1997 and the projection for 1998

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<thead>
<tr>
<th></th>
<th>1997</th>
<th>1998(Projection)</th>
<th>% Contraction</th>
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<tbody>
<tr>
<td>Passenger</td>
<td>310,077</td>
<td>99,415</td>
<td>-68%</td>
</tr>
<tr>
<td>Commercial</td>
<td>71,970</td>
<td>23,330</td>
<td>-68%</td>
</tr>
<tr>
<td>4x4</td>
<td>22,423</td>
<td>7,255</td>
<td>-68%</td>
</tr>
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Source: Data compiled from MMTA

Amidst this market slowdown, the automobile companies are keeping a close watch on the changing needs and expectation of consumers in the hope to provide value that meet their financial capability. Many automotive companies adopt price-down strategy as consumers are found to be highly price sensitive. Proton and Kancil have led the "no-frills" strategy by providing customers the flexibility of removing accessories or to purchase these at discounted prices. With this strategy, EON, — the marketing arm of Proton, succeeded in carving a bigger market share of 42.25% and 53.88% market share for March and April 1998 respectively.
Figure 2.1

The Malaysian Automotive Industry

* Estimation
* Sources of information:
TIV (Total Industrial Volume) = Malaysia Motor Traders Association
2.3 Factors Contributing to the Slowdown in the Automotive Industry

Dato' Micheal Lim, the CEO of UMW Toyota, pointed out that what the industry is facing today is a scenario presenting a different set of problems as compared to the last recession. In the last recession, demand dropped slowly and that allowed the industry to prepare itself better. However, for this economic recession, demand for the automobiles has plunged drastically, catching the industry by surprise with overstocking and over-capacity.

The slowdown in the automotive sector may be attributed to the loss of consumer confidence and uncertainty caused by some macroeconomic factors. These macroeconomic factors include the weakening of the Ringgit, which shed 43% against the US dollar and 36% against the Yen, compared to July 1997. In addition, the fall of the Kuala Lumpur Stock Exchange (KLSE) together with the downward revision of the 1998 gross domestic product (GDP) from 7% to -3% also contributed to the slowdown in the automotive industry.

Apart from the macroeconomic factors mentioned above, a series of new government guidelines such as limiting credit availability to car buyers and increasing the duties on foreign luxury cars also played a part in the slowdown in the automotive industry. For example, funds for end-financing has been reduced as a result of the credit squeeze on credit growth from 25% in 1997 to 15% in 1998. Credit screening became extremely stringent for used car purchase as used car buyers are considered to be customers with higher risk of defaulting payment. As a result, the used car market was affected seriously and that created a bottle neck to new car sales. As reported by MMTA, the value for the used car market shaved drastically by a good 30%.

Rising interest rate has affected the automotive industry badly, making it more expensive for consumers to buy cars. For example, the hire-purchase interest rates were raised on several occasions in 1997. From an initial 7% hire-purchase rate as at August 1995, the rates were increased to 8% in
November 1997 and climbed to a high of 8.5% in November 1997. In December 1997, the hire-purchase rates were hiked up to 10% and the rates have risen to more than 10% at present. Furthermore, with many companies going for pay cut, laying off workers, and being on the verge of collapsing for some, consumers are very careful in making new financial commitments when continuous employment is uncertain.

Foreign car sales have also been badly affected following the announcement of the National Budget in October 1997 whereby steeper duties were imposed for bigger capacity passenger cars, especially for completely-built-up (CBU) models. Import duties on CBU cars were raised from between 140% and 200% to between 140% and 300%. On the other hand, duty on CKD (Completely Knocked Down) cars grew from 42% to maximum of 80%.

2.4 Future Market Orientation

Malaysia is bound by the AFTA (Asean Free Trade Area) and GATT (General Agreement on Tariffs and Trade) agreements legally, to liberalize the currently protected automobile industry by the year 2007. The introduction of AFTA/CEPT (Common Economic Protection Tariffs) scheme (Figure 2.2) requires that the tariff for majority of manufactured items to be reduced to only 0% - 5% by year 2003. Nevertheless, the automotive sector is excluded from this ruling as it is categorized currently in the Temporary Exclusion List of CEPT (exempted from this ruling until year 2000). The inclusion to this Temporary Exclusion List was based on the necessity to protect the industry due to its economical importance to the nation. But by the year 2000, when this ruling is in full implementation, the automotive firms in the country need to position themselves to take advantage of the open market and at the same time face competition from fellow automotive firms from the ASEAN region.
From the global perspective, the local automotive sector will be confronted with challenges and opportunities posed by the liberalization under GATT by the year 2007. The relevant changes in the new trading environment recommended under GATT will include:

(a) Abolition of local content requirement, meaning that the local automobile companies are not required to source for local components and parts. They are free to source their requirements from other countries as well.

(b) Abolition of the voluntary export restraint programme, meaning that automobiles from any countries are free to be exported to any other countries so long as they are competitive to survive.

(c) Abolition of export subsidies, meaning that local and national automobile company like Proton will not be able to enjoy subsidies from the government to make them competitive in overseas markets.

(d) Removal of non-trade barriers, meaning any barriers apart from taxes will be disallowed.
## Figure 2.2
The Common Effective Preferential Tariff Scheme

### Objective
The Common Effective Preferential Tariff Scheme is a co-operative arrangement among Asean member states to reduce tariffs on all manufactured goods to 0-5% by the Year 2008. The CEPT scheme is the main instrument for making ASEAN a free trade area in 15 years (commencing from 1st Jan 1993).

### Products
- All manufactured products including capital goods & processed agricultural goods.
- Agricultural products are excluded under CEPT scheme.

### Exclusion List
The CEPT Exclusion list is on a temporary basis and would be reviewed in the 5th year and efforts would be made to remove products in Exclusion List and to subject them to a schedule of tariff reduction to 0-5% within the remaining 7 years. The automotive industry is in the exclusion list whereby no scheduled reduction of import duty is specified until Year 2000.

### Conditions for Eligibility
- Local Content:
  - It has to be an Asean product i.e. it has to satisfy the local content requirement of 40%.
  - Formula:
    - Value of Imported + Value of Undetermined
    - Non Asean materials + Origin materials, parts
    - Parts on Produce or produce X 100% = < 60%
    - FOB PRICE
- Country of Origin (CO)
  - The firm must apply in writing to the relevant government authorities in his company for pre-exportation verification of the origin of the product.

In order to promote the commonality of tariff rates in the subsequent years, member states have agreed to reduce the tariff rates in 3 tranches according to the following schedule:

| Year 2003 | 0-15% |

Source: