

## Chapter 4

### Critical Appraisal of Proton

---

---

As the first moves toward recovery are being taken, it is worth taking a step back and looking at the Industry as a whole. This is necessary to understand how the auto industry will fare in the long term. Malaysia has an outside chance of developing into a passenger car export base. Prior to the crisis, Proton was planning to increase capacity to 500,000 units per annum. This scale has been postponed, perhaps permanently. It is difficult to overestimate the national pride invested in the car and this is perhaps the dominant factor when considering alternatives. This will be discussed in this Chapter.

#### **4.1 Industry Structure and Performance: Crisis Period**

The regional financial and economic crisis that started in mid-1997 had a profound effect on the Malaysian automotive sector. Unlike the export-oriented industries in the manufacturing sector, the automotive industry was badly affected by the crisis. Not only did the crisis severely bruise the NCPs and other vehicle assemblers and importers, it did not spare the automotive dealers and component parts suppliers. Being largely domestic-oriented and still dependent on imported inputs, the industry was severely hit by the weak ringgit. Demand patterns were also affected as a result of the lower purchasing power and cautious attitude of consumers. Affordability remained a key factor as buyers opted for lower priced alternatives — a fact evident from the increase in market share of the national cars from 82.8 percent in

---

1997 to 92.4 percent in 1998.<sup>1</sup> Credit tightening measures for hire purchase financing combined with higher interest rates dampened automotive sales towards the end of 1997 until early 1998.

#### **4.2 Impact on Automotive Manufacturers and Assemblers**

The production of motor vehicles declined 67 percent from 443,000 units in 1997 to 147,000 units in 1998. Proton only produced 92,000 units in 1998, compared to 213,000 in 1997, registering a 57 percent drop. Of this amount, 19,000 units or 20 percent of production was exported. Even worse hit than the NCPs were the non-national assemblers. Their production of passenger and commercial vehicles fell by 85 percent, from 175,000 units in 1997 to about 27,000 units in 1998. Production of commercial vehicles, in particular, was severely affected by the slowdown in economic activity.

According to figures released by the Malaysian Motor Traders Association (MMTA), total industry volume (TIV) of motor sales plunged drastically by 60 per cent from 405,000 units in 1997 to 164,000 units in 1998. While sales of the national cars declined by about 50 per cent during that period, that of non-national cars suffered a staggering 80 per cent drop. Sales were down to a nine-year low in February 1998 (at 6,872 units) before trending upwards. Hari Raya and Chinese New Year orders helped curb sales in the ensuing months and the government's relaxation of hire purchase margins (in May 1998) from 70 percent to 85 percent for automobiles priced below RM40,000 helped push

---

<sup>1</sup> A study on the national car industry Proton and its impact on Malaysia economy 1995, Chee Keem Chan

sales of the national cars upwards. The introduction of "no-frills" models by Proton and Perodua slashed car prices further, making them more affordable in adverse circumstances. The market share of Perodua, in particular, increased from 19 percent in 1997 to 26.3 percent in 1998.

NCPs and the other assemblers were forced to reassess or delay their plans for plant and capacity expansion. Proton deferred the construction of a RM4 billion plant in Tanjung Malim, which would have boosted its capacity by another 150,000 units per annum from the current 230,000. Perodua has also to put on hold the building of its second plant. The national car makers and other automotive assemblers have to rationalize their operating costs by embarking on "cost down" programmes, rescheduling the introduction of new models, adopting innovative business and marketing strategies, and sacrificing profits to minimize inventory levels in order to survive the economic downturn.

Table below shows the non-national vehicles from year 1997 to 1998.

**Table 4.1 Production of Non-National Vehicles, 1997-1998**

Vehicle Type	1997	1998	% Change
Passenger Cars	86,240	15,040	-82.6%
Commercial Vehicles	89,043	11,572	-87.0%
Total	175,283	26,612	-84.8%
Source: MMVAA			

---

While both Proton and Perodua managed to retain their employees, they had to cut down their working hours. Most assemblers of non-national cars were forced to shut down their assembly plants for several months to counter increasing stock levels. Unlike the NCPs, the assemblers had to lay off employees, especially foreign contract workers who made up about 15 percent of the workforce. Some even offered voluntary retrenchment schemes to workers as part of their cost-cutting strategy.

To deplete inventory levels, which had piled up from 4 to 10 times the normal three-month advance orders, non-national vehicle assemblers offered attractive price discounts, free accessories and various flexible financing schemes to potential customers. Despite this, the selling prices for models of similar engine capacities were still higher than those of the national cars which, apart from lowering their prices, also benefited from various government incentives such as the relaxation of hire purchase guidelines from 70 to 85 percent of loans for cars not exceeding RM40,000 and the extension of loan repayment period from 5 to 7 years.

Proton, in particular, was also granted higher exemption from excise duty, from 50 to 70 percent. In addition, the 13 percent import duty on Proton Tiara — the 1100 c.c. car jointly developed by Proton and Citroen of France — was temporarily suspended and a further six-month exemption on excise duty was given. The excess stock and cheaper cars resulted inadvertently to shorter waiting periods for customers in a "buyer's market". Such a situation contrasted sharply from that several years ago when buyers of certain marques and models had to wait for up to six months for their car orders.

---

### **4.3 Impact on Automotive Parts and Components Manufacturers**

Like the manufacturers and assemblers, automotive parts and components suppliers were as badly, if not more affected by the crisis. Vendors to the national car producers (Proton has 180, and Perodua, 125 vendors) suffered from lower orders from their principal buyers and higher prices for imports of raw materials and intermediate parts, following the depreciation of the ringgit vis-à-vis the yen. In some cases, the costs of such raw materials as steel, resins, chemical compounds and other intermediate components have increased between 30 to 60 percent, forcing vendors to appeal for a hike in the price of their products from their buyers.<sup>2</sup> The squeeze on credit and higher interest rates on loans further compounded their problems.

The significant drop in production and sales of motor vehicles translated to lower orders for parts and component manufacturers. Consequently, the import of motor vehicle parts fell 56 percent from RM1.4 billion in 1997 to RM616 million in 1998 (Table 9). The weak demand for parts and accessories in the local OEM and replacement market also forced manufacturers to seek export markets for their products. The result was a 19 percent increase in the export of motor vehicle parts, from RM263 million in 1997 to RM314 million in 1998.

---

<sup>2</sup> The potential impact of the national car project on the Malaysia economy (FJ LG173.1 U83.8)

---

#### **4.4 Impact of Government Policies on the Automotive Industry**

The "protectionist" policies adopted by Malaysia, in particular those used to promote the NCPs, have drastically transformed the automotive industry. While the policies strengthened the position of the national assemblers, they have nonetheless weakened the non-national automotive assemblers. Several of these assemblers were forced to exit the industry, while some have to diversify their activities.

##### ***The Positive Side***

Since their inception, the national cars have captured a major share of the domestic market for passenger cars, and more recently, for commercial vehicles. Price advantage<sup>3</sup> is the main reason for this trend, although due credit should also be given to improvements in the quality and performance of both Proton and Perodua models.

High import tariffs have contributed significantly to developing Malaysia's NCPs. By relying less on imported automobiles, Malaysia has, to some extent, reduced its balance of payment (BOP) deficit. The impact of high tariffs on imported vehicles have resulted in the following:

- Protection of the domestic automotive industry: local producers of national cars earn higher profits due to their higher prices and increase in production.

---

<sup>3</sup> Price advantage: as a direct result of the high tariffs imposed on imported vehicles

- 
- Reduced foreign exchange outlays: tariffs reduce demand of imports as the price differential make imported automobiles unaffordable for many people.
  - Higher government revenue: unlike quotas, which benefit the importer or exporting country, revenues from tariffs are collected by the government of the importing country.

Besides nurturing the NCPs, Malaysia's protectionist policies have also accelerated the development of automotive components and parts manufacturing. The VDP for national cars has not only created new players but more importantly has given component parts manufacturers the scale of production necessary to become viable. Some of these vendors have also ventured into OEM<sup>4</sup> activities for other automotive makers and started exporting their products. A multiplier effect from the expansion of component parts suppliers is the creation of second- and third-tier subcontractors and suppliers. This is an essential step towards developing an automotive parts manufacturing industry.

### ***The Negative Side***

Although high tariffs have succeeded in developing the local automotive industry, they are barriers to international trade as they distort markets and result in welfare losses to consumers. They promote inefficiencies among local producers and deprive consumers of affordable imports of higher quality

---

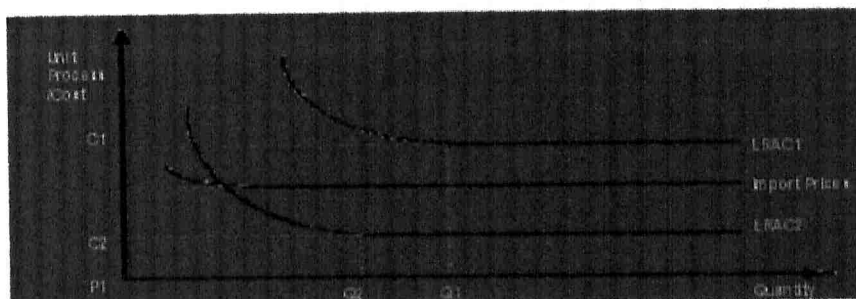
<sup>4</sup> OEM - original equipment manufacturing



Prices of motor vehicles have increased steadily since the first NCP was introduced in 1984 and are now beyond the reach of a sizeable proportion of the population. For example, a fresh graduate earning RM1,500 monthly would need about half his annual salary as down payment for the lowest priced new car in the market (i.e., a Perodua Kancil which is marketed at around RM 30,000). Thus, from the consumers' viewpoint, the loss in static welfare outweighs the dynamic gains to the industry.<sup>5</sup>

### National Economic Gains Versus Consumer Welfare Losses<sup>6</sup>

**Figure 4.1 The Long Run Average Cost Curve for a Protected Industry**



While the protectionist policies of the government augur well with the "infant industry" argument, high import tariffs and the local content programmes have inevitably translated to higher prices of cars for domestic consumers. High production costs and generous rents from tariffs have seen prices of cars increased steadily over the years. Since the long-term viability of the NCPs depends on the eventual reduction, if not elimination, of tariffs and subsidies, these projects have to be sustainable and internationally competitive as they mature. Only then would an infant industry realise the

<sup>5</sup> Lessons from the Malaysia Financial crisis & through road ahead for Proton. (HF1008 UM 2000 KHO)

<sup>6</sup> Theory of National Economic Gains Versus Consumer Welfare Losses, *Rasiah* 1996

---

prices of cars increased steadily over the years. Since the long-term viability of the NCPs depends on the eventual reduction, if not elimination, of tariffs and subsidies, these projects have to be sustainable and internationally competitive as they mature. Only then would an infant industry realise the benefits of consumer welfare through import substitution strategies that eventually lead to the development of productive capacities in the longer term (Rasiah 1996).

A graphical representation of the NCPs' performance in terms of the gains generated for the national economy versus the welfare loss borne by Malaysian consumers is shown in Figure 4.1. In general, tariffs and subsidies for a capital-intensive infant industry, such as the automotive industry, are gradually lowered as it becomes viable and competitive. It is expected that in the absence of competition, the industry will attain scale economies and efficiency improvements which will result in the downward shift of the long-run average cost (LRAC) curve from LRAC1 to LRAC2.

Without dynamic efficiency improvements, however, the infant industry curve will only move down the LRAC1 path and achieve minimum efficient scale (MES) at quantity  $Q_1$  and unit cost  $C_1$ . This cost level is higher than the import price  $P_1$ . The LRAC curve will only shift downwards from LRAC1 to LRAC2 if the infant industry achieves real gains through rapid technological change and innovation. Effective management of rents from tariffs and subsidies should enable the firm to achieve its MES level at  $Q_2$ , at which point the industry does not require rents to be competitive since the corresponding cost  $C_2$  on the LRAC2 curve is below the import price  $P_1$ . The industry is

considered to have matured and will be able to offer domestic consumers a price lower than that of imports.

For as long as the average cost is above import price, consumer welfare losses are incurred. Continued protection can only be justified by foreign exchange savings. It should be noted however that various disciplinary measures<sup>7</sup> and effective state-business coordination enabled countries like Japan, Korea and Taiwan to develop a viable automotive industry that even overtook many international incumbents<sup>8</sup>.

### **4.6 Prognosis on Medium-Term Development**

There are now positive signs that the Malaysian economy is on the road to recovery and that the worst could be over. Business and consumer sentiments are on the rise as evidenced by the recent MIER quarterly surveys, and borne by actual economic indicators. The industrial production index for February 1999 posted a 3.9 percent growth over the same month last year. Monthly retrenchment figures are also down and most major economic forecasting agencies project a positive growth for 1999 between 0.2 to 2.5 percent. The forecasts for the year 2000 range from 2.0 to 5.0 percent. Even the International Monetary Fund (IMF) predicts that Malaysia's economy will grow by 0.9 per cent this year. The figure is close to Bank Negara's forecast of 1.0 percent growth.

---

<sup>7</sup> Disciplinary measures: export targets, gradual withdrawal of rents and constant appraisals of real technical gains

<sup>8</sup> Amsden 1989; Shinohara 1982; Fransman 1986; Wade 1990

#### T 4.2 New Vehicle Registration/Sales, 1997-1999

Vehicle Type	1997	1998		1999*	
	Actual	Actual	% Growth	Forecast	% Growth
<b>Passenger Cars</b>	307,907	137,691	-55.0	168,000	22.0
<b>Proton (EON &amp; DRB)</b>	196,806	87,489	-55.5		
<b>Perodua</b>	58,255	38,921	-33.2		
<b>National</b>	255,061	126,410	-50.4		
<b>Non-National</b>	52,846	11,281	-78.7		
<b>Commercial Vehicles</b>	70,334	17,641	-75.0	21,000	19.0
<b>Perodua (Rusa)</b>	10,476	2,452	-76.6		
<b>Hicom (MTB)</b>	625	1,232	111.7		
<b>National</b>	11,101	3,775	-76.6		
<b>Non-National</b>	59,233	13,866	-76.6		
<b>4x4 Vehicles</b>	26,596	8,519	-68.0	11,000	29.0
<b>Perodua (Kembara)</b>	-	3,564	-		
<b>Non-National</b>	26,596	4,955	-81.4		
<b>Grand Total</b>	404,837	163,851	-60.0	200,000	22.0
<b>National</b>	266,162	133,749	-49.7		
<b>Non-National</b>	138,675	30,102	-78.3		

Source: MMTA; \*Forecast

As for the automotive industry, sales were up in the first two months of 1999 compared to the corresponding period last year. Motor vehicle sales in January rose by 51 percent to 18,400 units while those for February went up by more than 200 percent to 21,200 units. Based on the renewed confidence, MMTA expects some 200,000 motor vehicles to be sold in the domestic market this year. The figure represents a 22 percent increase from the 1998 level. Passenger cars are expected to make up 168,000 or 84 percent of the forecasted sales for 1999<sup>9</sup>. The rest would be made up of commercial vehicles (10.5 percent) and 4x4 vehicles (5.5 percent). MMTA attributes the projected increase in domestic sales to an improved economic climate, better consumer sentiments, easier access to credit facilities and lower interest rates on hire purchase loans. The possibility of car prices being raised in the near future by 5 to 20 per cent has also boosted sales this year.

Sales of national cars are already on the rise. Proton sold 35,000 units in the first quarter of 1999. Of this amount, 30,000 were sold in the local market and 5,000 exported. Currently, Proton, which is operating at a capacity slightly below 70 percent of its 230,000 units installed capacity, is averaging 14,000 units per month in sales. The company has indicated that it may raise the prices of its cars as the Malaysian economy picks up. Despite an anticipated increase in price, it is likely that automotive sales would be driven by the more affordable national cars as their price hikes are often lower than those of imported models and those produced by non-national assemblers.

---

<sup>9</sup> Table T4.1

The combined installed capacity of manufacturers and assemblers is presently about 570,000 units per annum. The national cars account for about 300,000 units per year or 53 percent of the total. Non-national assemblers account for the rest. The anticipated 200,000 domestic sales figure for 1999 translates to an industry operating capacity of only 35 percent. If the industry were to function at an operating capacity of 70 percent, this would translate to a production figure of 400,000 vehicles. It is unlikely that the limited Malaysian market would be able to absorb anything more than 350,000 new vehicles in the next couple of years. It would definitely take several more years before the sales volume of 400,000 units that was registered in 1997 can be reached. The local automotive industry, and in particular Proton, would have to proactively seek export opportunities in both the existing and new international markets.