CHAPTER 3: AFTA AND THE AUTOMOBILE INDUSTRY

3.1 ASEAN Free Trade Area (AFTA)

AFTA is a collective effort by ASEAN member countries to reduce/eliminate tariffs on intra-ASEAN trade in the goods sectors. The target is to achieve tariff between 0%-5% by 2003 for the six original member countries i.e. Malaysia, Thailand, Indonesia, Singapore, Philippines and Brunei; Vietnam by 2006, Lao PDR and Myanmar by 2008 and Cambodia by 2010, as well as eliminate quantitative restrictions on other non-tariff barriers. The reduction/elimination of tariff is undertaken through the Common Effective Preferential Tariff (CEPT).

The primary objective of AFTA is to enhance ASEAN's position as a competitive production base producing for both the regional and global markets. This can be achieved through promotion of intra-ASEAN trade and industrial linkages, specialisation and economies of scale as well as promoting the region as an efficient and competitive production base for investment. Malaysian companies will be able to gain many benefits offered by AFTA such as preferential access into the larger market of ASEAN with a population of 530 million, a wider base for competitive sourcing of raw materials from countries in the region, and opportunity to cooperate and collaborate with ASEAN partners to tap both the regional and global markets.

Tariff reduction/elimination under AFTA is granted on a reciprocal basis. Member countries can enjoy the lower tariff under AFTA only if they also offer tariff reduction for the same product and comply with local content requirement.

A product would be eligible for tariff concession if at least 40% of its contents originate from any ASEAN member state. The 40% local content refers to both single and cumulative content.

3.1.1 Tariff Reduction under AFTA

There are four categories of products listed under AFTA namely:

i) Inclusion List;
ii) Temporary Exclusion List;
iii) Sensitive and Highly Sensitive List;
iv) General Exception List.

3.1.1.1 Inclusion List

Malaysia has progressively transferred 10,116 products into the Inclusion List since 1993. These products constitute 97.32% of Malaysia's total tariff lines of which:

i) 99.26% have import duties of not more than 5%

ii) 60.3% of these products attract no import duties; and

iii) 0.74% has specific duties that will be reduced to 0-5% in 2010.

These include Unprocessed Agricultural Products in the Sensitive and Highly Sensitive List, which will be transferred into the Inclusion List beginning 2003.

3.1.1.2 Temporary Exclusion List

There are 218 tariff lines related to Completely Knocked Down (CKD) and Completely Built Unit (CBU) passenger cars, commercial vehicles and motorcycles that will be included in the Inclusion List in 2005. The delay in inclusion was to allow the domestic auto industry more time to recover from the impact of the 1997 regional financial crisis.

3.1.1.3 Sensitive and Highly Sensitive Lists

There are 75 tariff lines in the Sensitive List covering swine and poultry, tropical fruits, tobacco products and sugar. These products were transferred into the Inclusion List in 2003.

The 8 tariff lines in the Highly Sensitive List for rice and rice products will be transferred into the Inclusion List in 2005. The current applied rate for rice is 0%. Malaysia reserves the right to impose 20% import duty on rice in 2010 to protect the local industry.

3.1.1.4 General Exception List

There are 53 tariff lines in the General Exception List, out of which 32 tariff lines are related to alcoholic beverages and 21 tariff lines on arms and ammunition.

3.1.2 Conclusion

The creation of the ASEAN market comprising of 530 million people through AFTA provides enormous potential for market expansion of Malaysian companies. Malaysia's industries and businesses must strategise to take advantage of this potential to tap the ASEAN market by establishing linkages and strategic alliances, not only in other ASEAN countries, but also globally, so as to derive maximum benefits from sharing of resources, technology and research & development activities.

With the larger market size and the elimination of intra-regional tariffs and non-tariff barriers through AFTA, local investors can enjoy economies of scale in production. In addition, AFTA can attract more foreign direct investments, which in turn can stimulate the growth of supporting industries.

Consumers in ASEAN are now offered a wider variety of quality products manufactured regionally at lower prices. However, this also means that there is

increasing competition for domestic industries for certain products, due to the liberalised ASEAN market.

Malaysian and Malaysian-based companies must enhance their resilience to remain competitive domestically and identify new potential for exploiting the ASEAN market, as well as the global market at large.

3.2 The ASEAN Automobile Industry

ASEAN has been regarded as one of the growth centres for the world's automobile industry. Among the ASEAN members, Thailand and Malaysia have the largest and most developed automobile sectors. ASEAN countries have a combined annual vehicle sales of 1.5 million units in 1996 (pre-financial crises.)

Before the beginning of the economic crisis in 1997, Thailand was the largest automobile market within the ten-nation ASEAN, with Indonesia ranking second in the group, followed by Malaysia, and then the Philippines. For 1997 and 1998, Malaysia was the largest vehicle market, followed by Thailand, then the Philippines and Indonesia (vehicle sales in 1998 for the entire ASEAN market were down 73 percent compared to the pre crisis levels of 1996.) For the year 1998 the sales was 500,000 vehicles. In 1999 car sales were 740,000 vehicles. For the year 2002, the sales reached 1 million vehicles and 1.5 million units in the year 2003.

The leading supplier in the ASEAN region is Proton. It has 22% of the market. This is mainly due to its monopoly in the Malaysian market. Toyota is second in the list with a 20% share. According to Mr. Jerry Kania of Ford Motor Company, the ASEAN market integrated sales could be fifth largest in the world by the year 2005.

Many foreign giants from Japan and US have already invested in this region, since the market is very attractive. From 1995-1999, US giants like Ford, General Motors, and Daimler Chrysler have invested US$1.6 billion dollars in the ASEAN

region. 75 percent of this has been invested in Thailand. General Motors itself has invested 750 million in Thailand to open up a base. Their investment in other ASEAN countries, is however, low. Flexibility and trade regulations that are not so tight is the reason Thailand has attracted more investment compared to other ASEAN countries. Thailand has, thus, been pointed out as a strategic base for investment in this region. A few more giants like Volvo are already negotiating with Thai companies to open a base in Thailand.

3.3 The Automobile Industry in Malaysia

Proton's entry into the local automobile market in 1985 has resulted in massive structural changes in the industry. The domestic car market has shifted from being dependent on imported cars, especially Japanese makes, to one that is dominated by locally made cars. Proton cars distributed by EON and Proton Edar constituted 59.4% of the Malaysian passenger car market as at end 2002. For non-Proton distributors, the entry of Proton has resulted in a much smaller slice of the car market. Nissan and Toyota, which dominated the local passenger car market in the pre-Proton era, have lost their popularity among local car buyers. For example, Nissan and Toyota only managed to sell in the range of one to two percent of total passenger cars sold in 1999 – 2002. However, the sales of Toyota have increased tremendously to 6% of total passenger cars sold in 2003, due to the introduction of a new model, Vios.

The second national car producer, Perodua, whose plant was set up in Serendah, Selangor in October 1992, made its debut in 1994. Perodua is now the second best-selling passenger car in Peninsular Malaysia capturing a market share of 31.9% as at end 2002. This was achieved after being in the market for only four months. Today, Perodua has the second largest share of the passenger car market in the country.

Honda, Toyota and Nissan, which dominated the Malaysian car market prior to 1985, remain among the best sellers in the non-national car market although their market shares have declined substantially.

Volvo, Ford and Mercedes are the other strong players in the non-national car segment. The market for the non-national cars remains very competitive. In 2002, there were about 20 foreign car distributors competing to get a fair share in about 31,296 units or 8.7% of the market.

The Malaysian automobile industry is thus currently dominated by Proton (EON and Proton Edar) and Perodua, followed by UMW (which assembles and sells Toyota), Oriental (Honda & Hyundai) and Tan Chong Motor (Nissan). A narrowing of the price gap between Proton cars and non-national models such as Toyota's Vios and Honda's City as well as other South Korean makes also led to many motorists switching to foreign brands

3.3.1 The National Automobile Industry

Malaysia's first national car, the Proton Saga, represents more than a motor-vehicle. It symbolizes the determination of the nation to shake off its traditional status as a producer of primary commodities and to emerge as a member of the community of industrialized nations. Today, Malaysia is the proud producer of many more models, such as the Proton Perdana, Proton Wira, Proton Iswara, Proton Satria, Proton Tiara, Kancil, Rusa and the Kenari and the newly launched GEN.2. So it can be seen that automobile industry is very important for Malaysia not only as one of the major industrial sectors but also as national pride.

The national cars (Proton and Perodua) are exempt from import duties and are granted a 50 percent reduction in excise taxes (not available to foreign manufacturers). Protons typically sell for half the price of imported equivalents. In addition, national cars (Proton and Perodua) are assessed an import duty of 13 percent for CKDs versus 42 percent for other CKDs. Under the World Trade

Organization's Trade Related Investment Measures (WTO TRIMs) Agreement, Malaysia is required to eliminate its National Car preferences by 2000.

3.3.1.1 PROTON

Malaysia's then Prime Minister, Dato Seri Dr. Mahathir Mohammed commercially launched the first national car, Proton SAGA, on July 9, 1985. It was a joint venture between Mitsubishi Motor Corporation (MMC), Mitsubishi Corporation and Heavy Industries Corporation of Malaysia (Hicom). Within approximately two decades, Proton's model line up embraces ISWARA, WIRA, SATRIA, SATRIA GTi, PERDANA, PERDANA V6, TIARA, PUTRA and the most recently launched, GEN.2. The models come in various body sizes and ranging from 1.1 to 2.0 litre engines.

Proton did not have a successful start due to the 1985-86 recessions which caused a decrease in demand and increase in vehicle prices as a result of the Japanese yen appreciation against the national currency. The recovery of the Malaysian economy in later years, however, has contributed to the increase in Proton's production and market share, making it the best selling passenger car in Malaysia. Proton captured 65 percent of the car sales in 1987. Ever since, their market share has always been above 60 percent. Their sales in the domestic market have been improving ever since until 1997, when it declined drastically because of the economic turmoil caused by the Asian Financial Crisis.

Proton took a major step in advancing its engineering abilities with the acquisition of the Lotus Group International Limited, a British automobile engineering company and a manufacturer of luxury sports car, in October 1996. With this Proton gained greater engineering expertise, which will enhance it to improvise and come up with new models that are globally competitive and innovative.

In the same year, the Malaysian government sold its equity in Proton to a private company-- HICOM-DRB. As of August 1999, reports indicated that Petronas, the

national oil company, has purchased controlling interest in the financially troubled Proton, to give it a much needed cash infusion.

In May 2000, Proton introduced Proton WAJA, the first Malaysian designed car. By 2002, Proton's factory had achieved a capability of producing 230,000 units per year.

3.3.1.1.1 Measures taken by Proton to remain competitive

In order to remain competitive, Proton has developed its own engine, the Campro, which is expected to reduce production cost by 10-15%, as no royalty need to be paid by Proton to any party, as done at present for the other engines. The engine will be fitted into the new model, the GEN.2, which was launched on 6 February 2004. In addition, they have also invested in Research & Development (R&D) for product development and improvement. Currently, PROTON has invested RM350 million for this purpose.

A modular type of production to help reduce assembly time and inventory cost is currently in practice. Presently, there are 29 first-tier vendors with R&D and design capabilities serving PROTON, producing modular parts, such as instrument panel, door module and brake system. On top of that, PROTON has 105 second-tier vendors who are involved in some designing activities.

In addition, in order to boost their design capability, Proton now have invested in a much faster and cost-effective alternative with the initiation of RAPID PROTOTYPING, a relatively new class of computerized technology used for building physical prototype parts and tools directly from 3D-CAD data. In a short period of time and with excellent detail, finish and accuracy, RAPID PROTOTYPING prototype is able to provide solutions for new design concepts.

Other measures include establishment of a dedicated cost improvement unit to focus on cost reduction measures. Other functions of this unit are multi-sourcing of components and parts (currently, PROTON sources RM2.2 billion worth of

components and parts locally, and RM1.4 billion through multi-sourcing), compliance with international standards on emission and fuel efficiency (PROTON currently meets Euro III standards) and establishment of plants in other countries such as Iraq and Indonesia, to make inroads into these countries, development of human resources through upgrading core competencies of workers such as in R&D, engineering design and styling. PROTON has 350 engineers involved in R&D activities in its local plant.

3.3.1.2 PERODUA

Perusahaan Otomobil Kedua Sdn Bhd (PERODUA) was established in 1993. The joint venture partners/shareholders of Perodua and their respective shareholdings are UMW Corporation Sdn Bhd (38%), Daihatsu Motor Co. Ltd. (20%), MBM Resources Berhad (20%), PNB Equity Resources Corporation Sdn Bhd (10%), Mitsui & Co. Ltd (7%) and Daihatsu (Malaysia) Sdn Bhd (5%).

The company's operations commenced in early 1994 and the first vehicle, Perodua Kancil was introduced to the Malaysian market in August 1994. To date, the following vehicles have rolled out of the Perodua plant:

i) The Perodua Rusa, a multi utility vehicle, in March, 1996
ii) The Perodua Kembara, a 4x4 vehicle, in August, 1998
iii) The Perodua Kenari, a mini MPV, in June 2000
iv) The Perodua Kelisa, a sporty fun car, in August 2001

Up to end of October 2003, Perodua has successfully sold approximately 738,000 units of vehicles of various models both locally and abroad. In December 2001, Perodua announced the completion of a Group restructuring exercise undertaken earlier in the same year. The restructuring, which is part of a long-term strategy, was carried out mainly to prepare Perodua for the challenges of a more liberalised market under the AFTA conditions. With the restructuring, Perodua Auto Corporation Sdn Bhd (PCSB) was formed. Besides Perodua, the

two other joint venture partners of PCSB are both Japanese companies, namely Daihatsu Motor Co. Ltd., and Mitsui & Co. Ltd. To date, the manufacturing operations of the Perodua Group are being managed by PCSB.

The three active entities within the Group are:

i) Perodua Sales Sdn Bhd, which is responsible for the sales, marketing and distribution of all Perodua vehicles, and also to operate the nationwide after sales service and spare parts operations.

ii) Perodua Manufacturing Sdn Bhd, the company responsible for the manufacturing of the Perodua vehicles and selected vehicle component parts.

iii) Perodua Engine Manufacturing Sdn Bhd which undertakes the assembling of the vehicle engines and also to manufacture selected engine component parts.

Save for the sales and service operations, which exist in all the states nationwide, Perodua operates from its headquarters in Sungai Choh, Rawang, Selangor Darul Ehsan. The 200-acre site of land houses amongst others the Perodua Corporate Building, the R&D testing labs and styling studio, the vehicle test track, the manufacturing plant, the engine plant, the pre delivery inspection area, the vehicle distribution stockyard and the parts warehouse. To date, Perodua has a workforce of approximately 6,600 employees nationwide.

Perodua plant has a factory area of 64,000 square metres and has a production capacity of 120,000 units per annum, working on a 2-shift cycle. The facilities available in the plant include press shop, body shop, casting, machining, engine assembly (cmk), paint shop, logistic, assembly shop, training centre / quality audit, pre-delivery inspection (pdi), stockyard and parts warehousing.

Perodua, the second national car project, has supplied the Malaysian population with compact, affordable and reliable vehicles. Since the establishment in 1994,

the domestic market share of Perodua has reached approximately 35% of the passenger cars market in Malaysia in year 2003.

3.3.2 The Government's Role in the Industry

To show its commitment in promoting the national car production (NCP), the government adopted a policy known as intervention, i.e. providing support in the form of financial investment and tariff protection as well as sourcing of management expertise (Mahani, 1997).

In particular, the following measures were adopted:

i) Direct investment in setting up the manufacturing facilities, financing the high developmental cost and obtaining foreign technology expertise.
ii) High import tariffs and import quotas on CBUs and CKDs to protect the NCPs from direct imports and non-national assemblers.
iii) NCPs were given preferential import duties on CKD parts and exemption on excise duty.
iv) Imports of CBUs were restricted through import licensing requirement.

Selling prices of national cars are being controlled to ensure reasonable and justified increases. This measure is also used to regulate competition among automobile producers. Direct local marketing outlets for NCPs were established to provide efficient distribution.

3.3.3 The Impact of Government Policies on the Automobile Industry

The "protectionist" policies adopted by Malaysia, in particular those that promote the national car producers, have drastically transformed the automobile industry. Though the policies strengthened the position of national assemblers, they nonetheless weakened the non-national automobile assemblers. Several

assemblers were forced to exit the industry, while some had to diversify their activities.

3.3.3.1 The Positive Impact

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 (as a direct result of the high tariffs imposed on imported vehicles) is the main reason for the trend, although due credit should also be given to improvements in the quality and performance of both PROTON and PERODUA models.

Besides nurturing the NCPs, Malaysia's protectionist policies have also accelerated the development of automobile components and parts manufacturing. The Vendor Development Program, with the intention to provide NCPs a better control of their inputs, has created many new players in the manufacturing of component parts. In addition, some of the vendors have also ventured into original equipment manufacturing (OEM) activities and started exporting their products. A multiplier effect of the expansion of component parts supplier is the creation of second-tier subcontractors and suppliers. This is an essential step towards developing the automobile parts manufacturing industry.

3.3.3.2 The Negative Impact

Although high tariffs have succeeded in developing the local automobile industry, they are barriers to international trade as they distort markets and represent real welfare losses to consumers. They promote inefficiencies among local producers and deprive consumers of affordable imports of higher quality and better products. The local content requirements and high import tariffs on CBU and CKD units inevitably lead to high production costs, and these are passed on to consumers in the form of higher prices.

Prices of motor vehicles have increased steadily since the first national cars were introduced in 1984 and are now beyond the reach of a sizeable proportion of the population. For example, a fresh graduate earning RM1,500 per month would utilize half of 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 RM30,000). From the consumers' point of view, the loss in static welfare outweighs the dynamic gains in the industry.

3.3.4 The Impact of Liberalisation on the Automobile Industry in Malaysia

In May 2000, Malaysia received approval from its ASEAN partners for an extension of its commitment under AFTA to reduce 218 tariff lines in the automobile sector until 2005. Malaysia has also requested an extension of its commitments under the World Trade Organisation (WTO) Agreement on Trade-Related Investment Measures (TRIMs) to eliminate local content requirement in the automobile sector.

The inclusion of motor vehicles in CEPT beginning 1 January 2005 will have implications on the domestic automobile industry. Local manufacturers and assemblers of motor vehicles will face increased competition from foreign motor vehicles assembled in the ASEAN countries.

The potential in respect of foreign competition as a result of liberalisation may pose a serious threat to the future development of the local automobile industry. Market opening measures are expected to have far reaching implications on the national cars ability to retain their lucrative domestic market shares and would thus compel them to increase their exports in a highly competitive environment. Even if liberalisation efforts are delayed, the local industry must strive to be more internationally competitive. Efficiency should also be enhanced so that the domestic car can match, if not undercut imported prices, even in the absence of government support and protection. Otherwise, Malaysia would not optimally

utilize the economic resources, and domestic consumers will continue to shoulder the burden of the industry's inefficiencies

To enable the domestic automobile industry to meet the challenges of market opening (AFTA), the government has implemented several measures to increase the competitiveness of the local automobile industry, i.e. through cost reduction, enhancement of R&D activities, product design and improvement in productivity of workers. Measures will also be undertaken to make Malaysia as a regional hub for production and distribution of motor vehicles.