Services the next growth engine?
By Quah Boon Huat

It may be the way to go but…

The services sector is a miscellaneous rag-bag made up of, according to Adam Smith, "some both of the gravest and most important, and some of the most frivolous professions: churchmen, lawyers, physicians, men of letters of all kinds; players, buffoons, musicians, opera singers, opera dancers, etc." To the list, one could also add economic consultants.

A 2002 empirical study published in the *ASEAN Economic Bulletin* shows that services sector growth has had a positive effect on per capita income in ASEAN. That's to be expected because the sector not only provides economic growth momentum in its own right, it is also essential for the smooth running of the economy. Specifically, it facilitates economic transactions by enabling the efficient production and delivery of goods and other services. A well-functioning services sector is thus critically important to economic performance.

Up to until the Second Industrial Master Plan (1996-2005), Malaysia's policy focus had been primarily on the export-oriented manufacturing sector as the key driver of economic growth.

In the IMP2, for example, the manufacturing sector's contribution towards GDP was targeted to reach 38.4 per cent at the end of the plan's period, a 9.3 percentage point increase as compared to the beginning. The services sector's GDP contribution, on the other hand, was targeted at 48.4 per cent, a 2.3-percentage point decrease over the plan's period.

The performances of the two sectors during the IMP2 period did not go according to plan because of external shocks like, e.g. the Asian Financial Crisis of 1997-98 and the September 11 attacks in the US in 2001. The manufacturing sector only managed to increase its GDP share by just 2.3 percentage points, instead of the targeted increase of 9.3 percentage points. The services sector, instead of decreasing, managed to increase its share of GDP by 7.4 percentage points.

Malaysia's policy stance turned right around in the Third Industrial Master Plan (2006-2020). It had become clear that the growing weight of the services sector in the Malaysian economy meant that it became strategically important to build a stronger and more dynamic services sector. The IMP3 therefore laid out policies to start grooming services as the next engine of growth.

By the end of the IMP3 period, the services sector's contribution towards GDP is targeted to increase by 8.4 percentage points to 66.5 per cent, while that of the manufacturing sector to decrease by 2.9 percentage points to 28.5 per cent. The government's recent announcement lifting the 30 per cent bumiputra equity requirement in 27 services sub-sectors is a step forward towards making that happen.

This change in policy focus towards the services sector is not an unreasonable strategy shift considering that Malaysia will have trouble maintaining its growth momentum, going forward, if it were to continue relying on an export-led growth strategy that is primarily dependent on manufacturing. The strategy is after all already well past its sell-by date for Malaysia. This is because rising competition from the regional powerhouses, China and India, countries that have significant competitive advantages in manufacturing, will see to that.

Needless to say, an export-led growth strategy that can also depend on services would be ideal for Malaysia. But it can't currently, and IMP3's policy stance of positioning services as a major source of growth will also involve building up the sector's export competitiveness. But despite the fact that the services sector in Malaysia is presently anything but export-oriented, its domestic-oriented nature can help add a dimension of stability to Malaysia's growth process.

The director-general of the Economic Planning Unit, Tan Sri Dr Sulaiman Mahbob, in comments about the necessity of improving the services sector, has however admitted that the country's economy was not being restructured fast enough.

One can immediately think of a few reasons why that's so.

Historically, the emphasis of Malaysia's development policies has always been on manufacturing. And just like in other countries, the services sector was a neglected area of research until just recently.

As such, comprehensive policies and measures for services sector development are for the most part "missing" from Malaysia's development plans, and knowledge generally wanting among agencies responsible for matters related to services sector development. And regulators are not familiar with the business operations of modern services and the alternatives open to investors. The multiple agencies dealing with the services sector also adds to the general confusion; their activities overlap and they keep getting in each other's way because they have different objectives.

Another reason why restructuring is not happening fast enough is the lack of labour with the right skills needed in services. Most services involve direct customer contact, and human resources are critical to performance. The EPU's director-general himself had, when admitting that the country's economy was not being restructured fast enough, also commented "we must have more people with higher calibre".

There was and still is a lot of hue and cry about the inadequacy of the Malaysian education system to produce employable graduates. If the education system is already having problems meeting the human resource needs of a manufacturing economy, what more a services economy when there will be lots more new business models driving businesses?

These are just some of the impediments that need to be overcome, if economic restructuring is to happen fast enough or if the services sector is to achieve its full potential as a growth engine.

It should be noted here that while the shift in policy focus towards the services sector is economically rational, we should tread carefully here. One concern: What if the shift in policy stance results in "less attention" being paid to the other sectors, especially manufacturing?

See what happened to agriculture's share of GDP after Malaysia went full steam ahead to pursue an export-led growth strategy primarily dependent on manufacturing? Agriculture was and still is export-oriented, and agricultural exports have been critical to Malaysia's economic performance over the last decade or so despite its small share of GDP. One can only surmise what it would have been like if Malaysia had not "sidelined" agriculture in its big push for manufacturing but had instead worked at sustaining agriculture's contribution to economic growth.

Malaysia can ill afford that kind of policy mistake going forward. Why's that?

A growing services sector chugging nicely alongside a manufacturing sector that's losing its shine could, theoretically at least, eventually lead to an era of lower economic growth. That's because the scope for productivity gains is more limited in typically labour-intensive services when compared to manufacturing.

Imagine a Malaysia that's stuck in its middle-income country rut for like forever but whose era of high economic growth is already over and now "enjoys" annual GDP growth rates that are synonymous with high-income countries, say around 3 per cent (during normal times).

A scary thought. And that's why we need to tread carefully here.

The writer is a research fellow at the Malaysian Institute of Economic Research.