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Rationalising Policy Directions for the Malaysian Palm Oil Industry: A New Approach

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Introduction

The palm oil industry has been, and is likely to remain, an important engine of growth for the Malaysian agricultural sector and economy. In year 2000, the industry contributed RM14.93 billion of export earnings and about 26% of total world edible oil and fats trade (Balasubramaniam, 2001). Based on the forecast made by the Third National Agricultural Policy (NAP3), the hectarage cultivated is expected to reach 3.6 million hectares in year 2010, palm oil production and exports to increase to 11.7 and 9.6 million tonnes, respectively. This optimism is based on the broad assumptions that the expansion in hectarage will be accompanied by improvement in productivity which includes yield of fresh fruit bunches (FFB) per hectare as well as oil extraction rates.

One of the main characteristics of the Malaysian palm oil industry is its long agro-processing chain consisting of five distinct subsectors, namely oil palm cultivation, palm oil milling, refining and the manufacture of oleochemicals for downstream consumer products. Various associations care for the welfare of the subsectors. The Malaysian

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Palm Oil Council or MPOC (plantation), Malaysian Edible Oil Manufacturer's Association (millers) and the Palm Oil Refiners' Association of Malaysia (PORAM) are examples of the strong associations, which back their group interests. Despite the dominance of the Permodalan Nasional Berhad (PNB)-owned corporations in the plantation sector, downstream integration by the PNB group is limited generally to the milling stage. Thus, the subsectors along the vertical chain have to compete aggressively among themselves for a greater share of the industry's profits. The ability of the Associations to influence government policies will certainly lead to regulations that favour their course. On the other hand, the Malaysian Palm Oil Board (MPOB) represents the key public agency responsible for the overall development of the industry.

At the global scenario, Indonesia is the only credible competitor to Malaysian palm oil exports while, in the consumers' market, soybean oil is the main substitute. The ASEAN financial melt down in 1997, and the political unrest that followed, has weakened Indonesia's threat to some extent.

Theoretical Framework

Government policies and regulations are generally purposive and goal-oriented. These can be specific or broad to cover industry or national issues. The identification of problems of public concern, be it economic, social, or political triggers the policy formulation process. This involves a clear statement of the objective(s) to be met and the consequent acts of policy adoption, implementation, monitoring, and evaluation of the course of actions taken.

In the case of primary commodities, government policies are often intended to correct market failures as well as equity imbalances among stakeholders, so as to enhance market performance and societal welfare. Generally, a dichotomy exists in assessing market performance between economic and management studies for which policy issues and prescriptions are sought. The former tends to emphasize market competitiveness while the latter on firm and industry profitability.

In the 1960's, most economic research on market competitiveness focuses on the industrial organization framework. Bain's (1968) seminal work on the market structure-conduct-performance paradigm provided the basis for much of the documented empirical work in this direction (Clarke, 1985, Ishak, 1994). Studies on the efficiency of information flow or price transmission were also popular, again to capture market imperfections (Granger, 1969, Fama, 1970, Gupta, 1982). These include lead and lag price structures, causal and asymmetric price relationships, market integration and so forth.

Another area that was popular among economists was on cost minimization strategies addressing issues on resource allocation and productive efficiency including applications of spatial programming models to minimize shipment costs (Bressler, 1970, Nik, 1976). The underlying rationale is that minimization of unit costs of production and distribution improves the competitiveness of the products sold, thus enhancing profits.

Whilst economists tend to focus on cost minimization solutions and market imperfections, the management approach in industry analysis begins from the firm perspective. The firm evaluates its strength - weakness - opportunities - threats (SWOT analysis) in rationalizing its strategic plan with the intention of achieving superior profits than before, or at least equal to the industry average. In recent years, the SWOT framework has been extended to cover industry and sector evaluation and in the formulation of policies and strategic directions. This approach was adopted in the formulation of Malaysia's Third National Agricultural Policy (NAP3).

An extension made to the SWOT analysis is the Porter's Framework (1979, 1994), which identified five forces that he claimed must be evaluated in the formulation of a strategic plan. These forces are the degree of rivalry among competitors, threat of new entry and substitutes, and the bargaining power of buyers and sellers. Porter further claimed, "Most issues in strategy are the same for domestic and global companies" (Porter, 1994, pg.109).

Because of the overwhelming popularity of Porter's approach, other management 'gurus' have developed other considerations or theories in order to add more meat to Porter's industry analysis. These include Collis and Ghemawat (1994) who incorporate some dynamics to the approach; Narayanan and Fahey (1994) on how environmental analysis affects firm decisions and profitability; and that of linking social and political environment to corporate strategy (Mahon, Bigelow and Fahey, 1994).

New Wealth Creating Strategy (NWCS)

Admittedly, Porter's and related paradigms are useful in industry analysis and strategic planning but to say the same principles apply to domestic and international rivalry is rather simplistic and presumptuous. This is where our philosophy in determining policy directions and in strategising efforts to maximise profits for the palm oil industry differs from that of Porter.

The new approach requires a change in mindset or a paradigm shift. Its focus is on national rather than the firm perspective. The New Wealth Creating Strategy requires firms and government to work closely with each other, with the expectation that the synergy in effort can generate higher levels of profitability and wealth for the firms and the country respectively, than if firms operate independently and in rivalry. Here, national interest prevails over private or individual interest without compromising profit levels. In the case of Malaysia's palm oil industry, this collaboration is made easier as the government, through equity held by the PNB, indirectly owns most of the big companies. The rationale behind our approach is based on the premises that: -

a. The palm oil industry is of strategic interest to the economy and about 88.7 per cent of market competition (proportion of total output) is in the international arena and not the domestic market.

b. The global market represents a large enough cake for everyone; unlike domestic markets that are typically limited in size and firms have to compete aggressively to gain a greater share of profits or for survival.

c. Strategic alliances among firms and government can ensure that all systems (i.e. policies, strategies and actions of stakeholders) move in the same direction (for national interest) so that Malaysia's dominance in the global palm oil market can be built from strength to strength over time, and enhance her comparative advantage over product and competitor threats.

d. There will be considerable savings in firm and government resources if common activities such as research and development expenditures, information gathering, promotion and trading can be streamlined and responsibilities shared. Cross-fertilisation of ideas, information, research findings, and experience all work towards better performance in the industry.

What is advocated here is that stakeholders including government agencies operate as a team so as to give them strength and comparative advantage over foreign competitors. Government assistance in international marketing can provide firms easier and speedier linkage to foreign markets and in assuring that contracts are honoured than if firms were to venture on their own. Also, this amalgamation of forces will improve the industry's resilience in meeting challenges from increasingly competitive market conditions arising from e-commerce and borderless trade.

The application of NWCS requires us to define our primary development objective, either in broad terms (e.g. maximisation of national wealth) or measurable terms (e.g. targeted foreign exchange earnings), and other anchor or supportive objectives to achieve the former. Within each anchor objective, we nest the strategies or action plans we need to adopt, recognising that these actions may also have positive or negative effects on other supportive objectives.

The identification and adoption of good strategies and action plans is complicated and often clouded by institutional rivalries and influences of vested interest groups, especially by those who dominate and orchestrate the industry. Thus, in search for effective strategic directions and action plans, compromises and sacrifices have to be made among key industry players for sake of national interest and the benefit of all stakeholders in the long run.

With transparent policies as well as a cooperative business environment, the NWCS will send clear signals of the expected roles of stakeholders and government agencies in order to meet national aspirations. Thus, in search of policy directions for the palm oil industry, we pay special attention to collaborative behaviour, instead of one that is traditionally based on firm rivalry and greed.

Evaluation of Present Objectives

The Malaysian government's policy objectives and strategies for the palm oil industry are embodied in the Third National Agricultural Plan (NAP3) and the Second Industrial Master plan (IMP2). We will attempt to evaluate these and see if the efforts taken are synergistic and conducive for the creation of national wealth.

The mission statement or ultimate goal for the palm oil industry, as stipulated by both the NAP3 and IMP2, is that the palm oil sector should enable Malaysia to develop into: -

* An International Centre for Oils and Fats

In order to achieve this, the supporting development objectives (NAP3) are: -

i. To ensure sustainable supply of raw material for the continuous development of the palm oil industry, especially in the downstream value-added sector,

ii. To further enhance Malaysia's position as a centre of excellence for R&D and technology in palm oil and palm oil products,

iii. To position Malaysia as an international oils and fats centre, and

iv. To enhance contribution to revenue and growth for the overall economy.

With Malaysia's universal reputation for quality palm oil production and her competitive edge over other oils as well as her dominance in the world palm oil trade, the mission statement is achievable. The issue is the duration it will take to achieve this position but, even then, there is no guarantee that we will be maximising national earnings from palm oil products.

Skipping objective (i) for the moment, we find that objective (ii) is important as better technology contributes to the competitiveness of our palm oil exports in the global market. Objective (iii) is similar to the mission statement and is therefore redundant. As for objective (iv), the causal link to the mission statement, as mentioned earlier, may not be necessarily true.

Objective (i) requires some deliberation as both the IMP2 and NAP3 stress on the need to ensure adequate and sustainable supply of raw material for continued downstream development of the industry. As with other previous development plans, this fear of lack of raw materials was mooted due to the existence of excess capacity in the milling, refining, and oleochemical industries (PORLA Annual Reports), which is assumed to limit the availability of raw materials for downstream activities. In other words, excess capacity has been equated with inefficiency in the milling, refining and oleochemical manufacturing sub-sectors, thus stifling their growth.

Evaluation of Strategies Adopted

Thus to ensure adequate and sustainable supply of raw material for downstream value added activities, the main strategies adopted by NAP3 were:

(a) Prevent new entry by freezing licenses or by imposing highly restrictive entry conditions (e.g. any new refinery license is only for refining other oils except palm oil),

(b) Impose high export taxes on crude palm oil (CPO), and

(c) Promote offshore investments.

Although on paper the value-added theme appears a logical and sequential development process for the sector, the adoption of the above strategies created serious structural problems to the industry. The freezing of licenses led to high market concentration and foreign ownership in downstream activities, especially in the refining sub-sector. Here, the market concentration for the top 8 firms was reported to be 79% (Table 1) as against 54 % in the 1980's, with foreign and non-Bumiputra ownerships at 57% and 28% respectively. This distribution of ownership is lop-sided as the PNB group of companies owned more than 70% of the plantations and yet owned less than 10% of the refineries, in terms of both number and capacity.

With about 10% of palm oil products being exported through local shippers, this meant that the marketing infrastructure, from refining to shipping of palm oil products, was dominated by foreign participants. Needless to say, the ability of these firms to artificially depress CPO

Table 1: Malaysian Palm Oil Industry: Concentration Ratio (4 and 8 Firms) by Sub-sector, 1998

Sub-sector	4 Firms	8 Firms
Plantation	32.7	40.0
Mill	39.6	49.8
Refinery	61.0	79.0
Oleochemical	63.5	87.4

prices will enhance their profits; all of which are at the expense of primary producers and national wealth generation. Market indicators of the lucrative profits that are enjoyed by refiners were expansion in refining capacities, full capacity operation of plants, stickiness in retail cooking oil prices relative to falls in CPO prices, and their ability to acquire public-listed companies that were caught by the ASEAN financial crisis. An example of the massive profits of downstream players was the recent acquisition of two public-listed companies (Pantai and Tongkah Holdings) by a newly listed palm oil processing company (Paos Holdings).

The imposition of high taxes on a progressive scale on CPO exports (Table 2) further favoured downstream players, again at the expense of primary producers. With the present production cost of CPO at around RM800/ton, the tax structure creates an absurd situation in which exports of processed palm oil (PPO) are cheaper than CPO. For CPO prices of RM700/ton and above, the processing cost per ton CPO (about RM50/ton) is lower than the export tax (RM 70/ton), thus forcing CPO producers to sell in the domestic market.

In a buyers' market, it is not surprising that CPO prices were suppressed and transacted for sometime below the cost of production. For the first six months of 2001, the average price of CPO was only RM 750/ton. With a loss of RM 50/ton and production level close to a million

Table 2: CPO Prices and Export Tariffs (%)

CPO Prices	Tariff Rate %
On 1st RM650/ton	0
Plus on the next RM50/ton	10
Plus on the next RM50/ton	15
Plus on the next RM50/ton	20
Plus on the next RM50/ton	25
Plus on the balance	30

tons per month, palm oil plantations incurred a massive loss of about RM 50 million per month. On the other hand, and based on retail cooking oil prices at RM 2/kg, refiners were making a whopping profit of about RM 1 billion per month- what a loss to the national economy!

Following the strategic directions of NAP3, reverse investment in plantations were actively pursued in Indonesia and Philippines, in particular, by the PNB Plantation-based Corporations. In Indonesia alone the exposure was about RM8.42 billion, consisting of new investments in plantations (RM3.87 billion) and acquisitions of auctioned plantations (RM4.55 billion), excluding Gutheries' recent acquisition of Indonesia's Salim Group for RM1.3 billion.

Despite expectations of cheap labour and low operational cost, most of the Malaysian companies incurred heavy losses and are presently struggling to salvage their investments. In the Philippines, one prominent company wound up its operation while the existence of another is symbolic. Experiences in Kalimantan and Sumatra, Indonesia, too were far adrift of expectations. Government inefficiencies, corruption, thefts in both office equipment and oil palm fruits, uncertain tenure arrangements, excessive employment demands on estates, security problems and expenses on "social obligations" constitute the large "hidden costs" Malaysian companies had to bear.

Reverse investment in plantations is a clear case of a strategy that was not thoroughly evaluated. If such investments were made locally especially in East Malaysia, the Malaysian economy would have benefited substantially, through strengthening her position as the dominant supplier for world palm oil as well as gaining, directly and indirectly, from the multiplier effects arising out of the economic activities generated from the business.

Discussion

From the above discussion, it is apparent that extreme caution must be exercised in rationalising policy objectives and directions for an industry, as these can lead to the formulation of strategies that are detrimental to overall development of the industry itself and to national wealth creation. In the case of the Malaysian palm oil industry, ignorance of the term 'excess capacity' among policy makers led to poor licensing and fiscal policies, the dominance of foreign firms downstream, and financial losses in offshore investments. These ills were eventually shown in form of reduced profits or losses in the annual accounts of primary producers, including the PNB corporations (Golden Hope, 2000, Guthries, 2000, Sime Darby,2000).

Excess capacity for all intent and purpose is a norm rather than an anomaly for most industries. Motives for excess capacity are many and these could be due to anticipated growth in market demand or even to pose a threat to new entry. In the case of West Coast fisheries, the problem of excess capacity (too many boats catching limited stocks of fish) has been in existence for decades (Ishak, 1994). However, the Malaysian government does not impose a ban or high tariffs on fish exports in order to solve the problem. Obviously, these steps will not work but instead create new problems, which penalise innocent fish exporters for poor decisions made by the boat owners.

A similar situation prevails in the palm oil industry. The existence of excess capacity in the industry could be due to bad investment decisions by some stakeholders in relation to the anticipated market demand, or even fictitious as refiners were making exorbitant profits. High tariffs on CPO and palm kernel oil (PKO) exports and the promotion of offshore investments in oil palm plantations (NAP3 and IMP2) in order to ensure an adequate supply of raw materials to refineries and oleochemical plants will not solve the problem of over capitalisation. It only compounds the problem as investments are trapped in foreign land which is in turmoil.

In the former situation, it means that producers are pressured to sell their products in the domestic market because of the export duty, thus subsidising operators of refineries and oleochemical plants who had the global world market at their disposal. Furthermore, the perpetual surpluses of palm oil in the industry's physical inventories and those held by companies in their plantations clearly indicate that the raw material is plentiful. As the leading supplier of palm oil to the world market and with domestic consumption at about 11.3 %, it is ironical that ensuring adequate supply of raw materials is a policy objective. As such, reported surpluses of the raw material will obviously depress palm oil prices and national earnings.

When priorities are not in place, issues not properly identified, and problems not clearly understood, policy prescriptions often run conflict with each other. Another example is the recent fixing of minimum wages to the estate sector. Without due consideration of the target groups (foreign and local labour) to benefit or the cost of labour in plantation operations, the policy will be counterproductive to efforts in increasing labour productivity. There is a dire need for issues or problems to be thoroughly investigated before effective policies can be crystallised, otherwise policy prescriptions will misguide public and private investors, penalise innocent parties, and result in a misallocation of national resources.

Using the NWCS as a guide, and recognising the liberalisation of trade under AFTA, AIA and WTO, national development policies for the palm oil industry must be proactive, outward looking, coherent and, more importantly, unbiased to all stakeholders in order to inculcate cooperative behaviour. Also, the policies must be clearly understood by all stakeholders so that they can play their expected roles to meet national aspirations, besides providing good service to global buyers so as to gain market confidence for the products that we sell. With these considerations in mind, we propose the national objective or mission statement for the palm oil industry as: "to enhance contribution to foreign exchange earnings and growth for the overall economy" while the anchor objectives are as follows: -

1. To create a friendly and transparent business environment, locally and internationally, for enhancing market confidence and sustainable development of the palm oil industry,
2. To enhance the competitiveness of Malaysian palm oil in the global oils and fats market,
3. To encourage the development and growth of downstream value-added activities,
4. To augment Malaysia's position as the world's centre of excellence for R&D and technology development in palm oil and palm oil products, and
5. To develop Malaysia as an international oils and fats centre.

To augment each of the anchor objectives, we need to nest the appropriate strategies or action plans to adopt. Here, institutions play an important role in the formulation of appropriate action plans as well as in the development of regulations, practices, and relationships that emphasize transparency, trust, cooperation, and accountability. In these respects, we suggest the rationalisation of industry agencies to just two globally oriented institutions

(a) MPOB to represent the government sector, and

(b) MPOC to represent the private sector, two core umbrellas for the industry, whereby all other public and private agencies or associations can channel their views so that debates and resolutions are made in the context of national rather than group interest.

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