JSPS (Kyoto University)-NRCT (Thamassat University)
Core University Program Conference 2006
"Emerging Developments in East Asia FTA/EPAs"
October 27-28, 2006
Kanbaikan Hall
Doshisha University

Can Its FTA Strategy Boost Malaysia's Growth and Competitiveness?

By

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1. Introduction

The proliferation of bilateral free trade agreements (FTAs) in East Asian is a recent and new phenomenon. Before the late 1990s, the focus of economic liberalisation for East Asian countries, including Malaysia, was the multilateral trade process. It was not until 1992 when ASEAN reached a milestone agreement to establish a free trade area that finally regionalism in the form of FTAs came into prominence in the region. However, since the onset of the Asian financial crisis in 1998, many countries in the region have embarked on bilateral FTAs. Most significant is Singapore's decision to become pro-active in pursuing bilateral trade pacts with its major strategic partners. The main reasons for choosing this form of economic integration are for regaining their growth momentum (their economies suffered a severe downturn during the crisis), expanding export market, attracting foreign investment and overcoming the slow progress of liberalisation in WTO. Besides these economic reasons, political economic perspectives were also an important motivation. The preference for FTAs was also hinted at by the US and EU, key actors in the WTO process, following the failure of the WTO Ministerial talk in Cancun in 2003.

With FTAs, countries can have a faster economic integration by forming strategic and preferential relationships among a smaller group of countries that permit deeper market access, give an edge over rivals in penetrating export market and allow faster liberalisation in new and sensitive areas. In addition to lowering tariff rates and removing trade barriers in traditional sectors, the concluded FTAs by East Asian countries have included liberalisation in the services sector, government procurement, investment rules, environmental issues, labour standards and electronic commerce.

Malaysia views its FTA policy in terms of the structure of its economy, namely it is a small, very open economy but with a relatively reasonable size domestic market. Its reliance on trade cannot be over-emphasized and thus it needs to be competitive. At the same time, Malaysia has sensitive sectors which carry important social considerations. The rapidly changing global and regional conditions require Malaysia to response in a timely and strategic manner if it were to remain competitive. FTAs, if used strategically, can be a tool to enhance Malaysia's competitiveness and economic growth.

FTA is also a part of the bigger agenda - multilateral, regional and bilateral agreements are all part of the mosaic of the global trading system and cumulatively must be consistent and can lead to higher trade growth and bring economic and social benefits to all participants. Choosing the right path is important because the impact of FTAs is wide-ranging and long lasting. Therefore, FTAs must be custom made to suit the situation and objectives of the partners and is a product of negotiation between the parties involved.

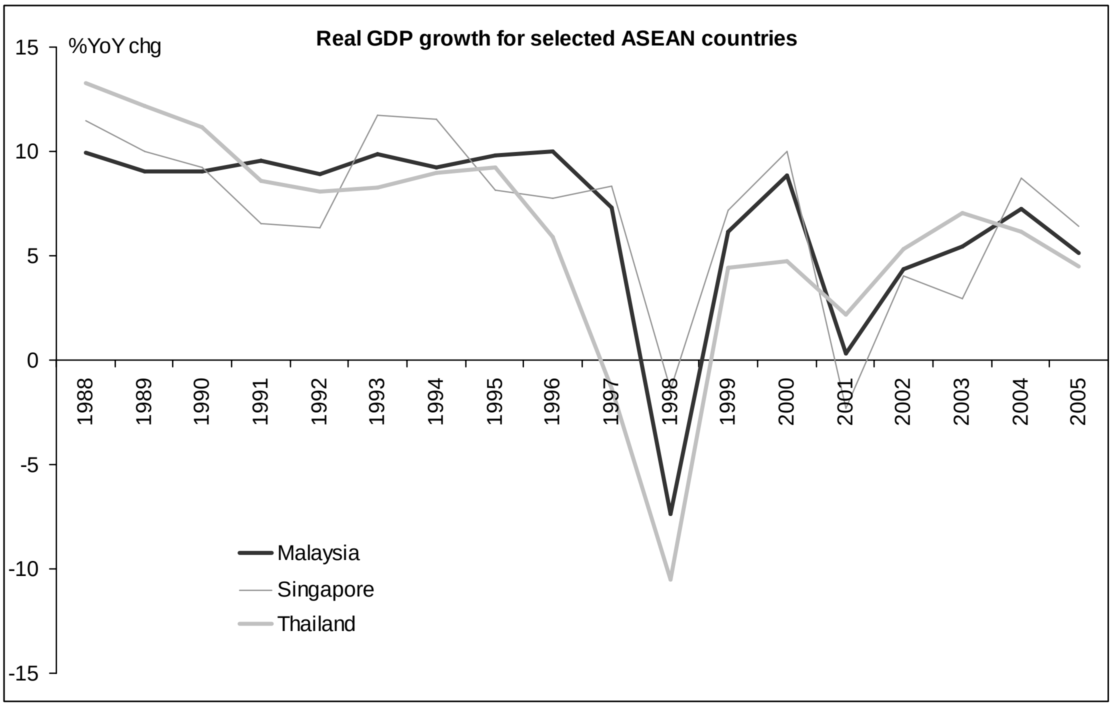
The Malaysian economy has transformed from one that is based on agriculture activities to one that is driven by industrialization. In these two phases, the economic growth and transformation process were driven by outward-oriented policies and promotion of exports. The transformation was achieved mainly because the Malaysian economy was liberalized and adjusted to market demand. Malaysia is now entering its third stage of transformation in order for it to sustain a high economic growth rate. This third stage of transformation is going to be based on services and competitiveness is founded on higher productivity. Will this transformation be achieved through liberalization like the other two phases? Can the liberalization undertaken in the Malaysian FTA initiatives assist in the transformation process? Unlike the previous two stages of transformation, the liberalization of the services sector is more difficult to carry out because of the state of readiness of the domestic services industries.

The objective of this paper is to analyze the impact of Malaysia's FTAs on its growth and competitiveness. Section 2 discusses the changing structure of the Malaysian economy and examines the factors that influence its competitiveness. Section 3 studies Malaysia’s FTA initiatives and the areas liberalized while Section 4 analyses the impact of FTAs on Malaysia’s competitiveness and growth. The conclusion is given in Section 5.

2. The Changing Structure of the Malaysian Economy and the challenge to its competitiveness

Since the Asian Crisis in 1998, Malaysia’s growth performance has been mixed (Figure 1). As with other countries in the Southeast Asian region, Malaysia has suffered two recessions during the past seven years. Malaysia enjoyed a decade of consistently high growth driven by manufacturing investment and exports until the Asian financial crisis in 1997-1998, which saw Malaysia experiencing real GDP contraction by 7.4% in 1998. In 2001, Malaysia was yet hit again by a downturn in global demand resulting in a plunge in exports and a sharp fall in GDP growth – GDP only grew by 0.3%. Growth resumed in 2002 and picked up significant momentum in 2004, when the economy expanded by 7.1% but 2005 data highlighted a more modest pace being achieved at 5.3%. Hence, Malaysia’s 2001-2005 growth performance at 4.5% was far below both its potential growth rate of 6.7% and target growth rate of 7% if Malaysia was to reach a developed nation status in 2020.

Figure 1：Real GDP Growth for Selected ASEAN Countries



Source: CEIC

The reasons for the lower than targeted performance in 2001-2005 were both external and internal. Malaysia's dependence on exports, particularly electronics and electrical (E&E) goods (64% of manufactured exports in 2005), means that economic growth was vulnerable to both global fluctuations in the demand for these products as well as the economic conditions of countries such as the U.S. and Japan, which were major buyers for E&E goods. Unfortunately, this dependence cannot be reduced quickly, and a shift to other sources of economic growth, which the government is now promoting in its new phase of development plans, could take a long time.

Malaysia's growth over the past 20 years has also been financed and sustained by high domestic savings and large inflows of foreign direct investment (FDI), attracted by Malaysia's well-developed "hardware" infrastructure and educated workforce. Indeed these inflows reached a peak of 8.7% of GDP in 1992-1993. However, they never fully recovered after the Asian financial crisis – for example, FDI inflows were barely positive in 2001 but had risen to 3.9% of GDP in 2004. While Malaysia benefits from the trend among multinational companies (MNCs) in developed countries that relocate some of their operations to lower-cost centers, it also faces constant threats from other countries in the region that offer attractive investment conditions, notably India for services and Vietnam and China for manufacturing goods.

Lower FDI coupled with weak private domestic investment have resulted in declining capital investment for Malaysia. Gross fixed investment dropped from 43.1% of nominal GDP in 1997 to 20% in 2005. Indeed a lack of enthusiasm among domestic companies to increase investment remains a concern for the government, who is expecting the private sector to contribute towards national development as highlighted in the 9th Malaysia Plan.

For the past 30 years, Malaysia has industrialized rapidly, transforming itself from a commodity-based economy relying primarily on palm oil, natural rubber and timber to an industrial-based economy dominated by the manufacturing sector. In 1987, the agriculture sector's share of GDP was 20% and this has since declined to 8.2% in 2005. Share of manufacturing output to GDP has been gradually rising from 18.6% to 31.6% while share of services output has been increasing from 45.3% to 58.2% in the same period.

Table１：Share contribution to GDP by industry (%) （1987 to 2005）

Year	Agriculture	Manufacturing	Construction	Services
1987	20.0%	19.8%	3.5%	45.3%
1988	18.6%	21.1%	3.2%	45.1%
1989	17.9%	23.3%	3.3%	46.0%
1990	16.3%	24.6%	3.5%	46.8%
1991	14.9%	25.6%	3.7%	47.6%
1992	14.6%	25.1%	3.8%	48.8%
1993	12.9%	26.2%	3.8%	50.6%
1994	11.6%	26.7%	4.0%	51.0%
1995	10.3%	27.1%	4.4%	51.2%
1996	9.8%	29.1%	4.7%	50.7%
1997	9.2%	29.9%	4.8%	51.9%
1998	9.6%	27.9%	4.0%	55.8%
1999	9.1%	29.4%	3.6%	55.0%
2000	8.9%	31.9%	3.3%	53.9%
2001	8.8%	30.0%	3.4%	56.9%
2002	8.6%	30.0%	3.3%	58.1%
2003	8.6%	30.8%	3.2%	57.6%
2004	8.5%	31.6%	2.9%	57.5%
2005	8.2%	31.6%	2.7%	58.2%

Source: Bank Negara Malaysia

In terms of value added in the agriculture sector, the crude palm oil (CPO) is the most important crop contributing 37% to total agriculture sector. In 2005, CPO output expanded by 7% to reach a record high of 14.96million tonnes due to bumper harvest. For the manufacturing sector, production of transport equipment continued to expand strongly – 2005 saw rapid growth car assembly activities and the spillover effects on production of parts and accessories for motor vehicles reflecting robust domestic consumer demand aided by attractive financial packages offered by financial institutions.

Meanwhile labor-intensive manufacturing activities, in particular the textile, wearing apparels and footwear industry are affected by actions of industrial countries shifting their orders to lower cost countries such as China.

The services sector benefited from strong growth in private consumption and higher tourism and business activities. Furthermore, efforts by government in recent years in promoting new areas of growth in the services sector were beginning to show results in terms of a more robust sectoral growth. These are high value added activities such as IT services, shared services and outsourcing, Islamic finance, investment banking, education services and health and medical tourism.

Trade statistics highlighted the fact that Malaysia is still largely dependent on "traditional partners" such as the U.S., Japan and the EU for its trade activities. Also, Malaysia is still heavily dependent on exports of E&E goods which comprised 53% of total manufactured goods exports in 2005 (in the late 1970s E&E goods share was around 30%). This means that total exports rise and fall is dictated by the global demand for the E&E products. To reduce this vulnerability, the government is actively encouraging manufacturers and exporters to move up the value chain and improve product quality to maintain international competitiveness.

The U.S. remains the largest export market with a share of 19.7% of total exports in 2005. While the Japanese share of total exports for Malaysia has been slowly declining from 38% in 1986 to 11.7% in 2005, the Chinese share has been increasing from 1.2% to 6.6% in the same period hinting to increasing importance of China as a trade partner for Malaysia.

Intermediate goods import dominated share of gross imports at 71% in 2005. Increased sourcing of intermediate inputs from China, Singapore and Thailand was underpinned by the manufacturing supply chain as well as extensive production network and linkages in the region. However, Japan remained the principal source of imports for Malaysia, accounting for 14.5% of total imports.

Table 2：Destination of Malaysian Exports

Selected partners	1985	1990	1995	2000	2005
The U.S.	12.8%	16.9%	20.8%	20.5%	19.5%
Japan	24.6%	15.3%	12.5%	13.0%	8.3%
Singapore	19.6%	23.0%	20.3%	18.4%	15.4%
China	1.0%	2.1%	2.6%	3.1%	11.3%

Source: Asian Development Bank

Table 3 : Sources of Malaysian Imports

Selected partners	1985	1990	1995	2000	2005
The U.S.	15.3%	17.0%	15.3%	15.9%	9.1%
Japan	23.0%	24.2%	26.1%	26.0%	11.0%
Singapore	15.8%	14.8%	15.5%	15.7%	26.4%
China	2.0%	1.9%	2.2%	2.4%	9.2%

Source: Asian Development Bank

In an effort to diversity its sources of exports, Malaysia has been actively promoting services exports. While continues to be the largest contributor to services exports, accounting for 44.8% of gross services receipt in 2005, tourism has also become a major component of Malaysia's total exports. Tourist arrivals in Malaysia grew by 4.4% to 16.4 million visitors with gross foreign exchange earnings amounting to RM31bn.

Realizing that the global economic and trade environment will become more challenging in the future and Malaysia is losing competitiveness in activities using unskilled labor, the government has announced ambitious plans to restructure the economy. Its latest economic development plan, the 9th Malaysia Plan (9MP) and the Third Industrial Master Plan (2006-2020) set targets and promote initiatives to develop new sources of growth and increase exports competitiveness. The 9th Malaysia Plan 2006-2010 (9MP) projected spending of RM200 billion (US$54.6 billion) with an additional RM20 billion under Private Funding Initiative for national development. The 9MP has five key thrusts:

a) Moving the economy up the value chain.
b) Raising capacity for knowledge and innovation, nurturing "first class mentality".
c) Addressing socio-economic inequalities.
d) Improving the standard and quality of living.
e) Strengthening institutional and implementation capacity.

The government has targeted higher average real GDP growth at 6% for the 9MP period and the Plan's key targets are as follows:

- Growth is expected to be achieved through higher Total Factor Productivity (TFP) at 2.2% from both capital (2% vs. 1.7% in 8th Malaysia Plan) and labor (1.8% vs. 1.5% in 8th Malaysia Plan) as the economy becomes more knowledge-based.
- The services sector is expected to remain robust growing 6.5% with contributions coming mainly from finance, insurance, real estate and business services.

- The manufacturing sector is expected to benefit from new sources of growth including biotechnology and ICT sectors identified in the IMP3. The manufacturing sector is targeted to grow by 6.7% in the 9MP.
- Private investment is projected to grow at average 11.2% as government takes greater measures in enhancing the investment climate through improvement in human capital development and provision of support services.

The IMP3 complements the 9MP and covers 15 year period to 2020. It has ten strategic thrusts:

i. Enhance Malaysia's position as a major trading nation by intensifying exports of products in targeted growth areas such as E&E goods, chemicals and chemical products, ICT and multimedia products, biotechnology products, agro-based products and medical devices.
ii. Generate investments in targeted growth areas.
iii. Integrate Malaysian companies into regional and global networks including promotion of outward investments to gain market access and improving competitiveness and developing Malaysia into a regional hub for selected products including halal products and services, biotechnology and automotive products.
iv. Ensure balanced equity and regional developments by drawing policies which consider progressive liberalization in an open economy.
v. Sustain contribution of manufacturing sector to growth by having measures that accelerate the shift towards higher value-added products and services and encouraging and developing growth areas.
vi. Promote services as a major source of growth by ensuring that Malaysia be a regional centre for selected services such as business and professional services, integrated logistic services, construction, education and training, health and tourism. The government intends to facilitate progressive liberalization of the services sector, create greater linkages between manufacturing and related support services and promote collaborations with foreign services providers.
vii. Facilitate the development and application of knowledge intensive technologies by promoting research-based industrial cluster development and encouraging R&D.
viii. Develop innovative and creative human capital by rationalizing laws and regulations to provide greater flexibility and mobility in employment.
ix. Create a more competitive business-operating environment by reviewing rules and regulations to facilitate growth and expansion of existing and potential industries and services.
x. Strengthen the role of private sector by encouraging companies to become members of trade and industry associations and spurring private sector to undertake capacity building, trade and investment promotions.

The government sets even more ambitious targets for the IMP3 period:

- GDP is expected to expand 6.3% annually with manufacturing sector projected to expand 5.6% per annum during the 2006-2020 period, contributing 28.5% to the economy by 2020.

- Non-government services sector is expected to play a major role in growth expanding 7.5% per annum to contribute 59.7% to GDP by 2020.
- Total trade is targeted to grow three-fold from RM967.8 billion in 2005 to RM2.8 trillion in 2020 with exports targeted to rise 2.7 times to RM1.4 trillion.
- The agriculture sector is to be more commercialized and technology intensive.
- The services sector is expected to be the largest provider of employment at 52.2% by 2010, while the manufacturing sector will account for 30%.
- To achieve the IMP3 targets, total investment in manufacturing and services should grow by 7.7% per annum. The total investment requirement is projected at RM1.3 trillion for the entire period, with RM412.2 billion invested in the manufacturing sector alone. The required investment in services sector is even larger at RM687.7bn for the period 2006-2020.

Both the 9MP and IMP3 are meant to address challenges in upgrading Malaysia's competitiveness vis-à-vis its regional competitors and this can only be achieved through the transformation and increasing the efficiency of the entire economy as well as introducing innovation for the targeted industries. Challenges in enhancing Malaysia's competitiveness are focused in two areas:

a) How to have sustainable high economic growth as per the targets announced in the face of fluid external environment?
b) How to maintain robust exports activities to support economic agenda?

There are specific issues to be addressed in each of the economic sector if Malaysia is to achieve a high growth rate in a challenging global environment. Agriculture sector needs strong R&D capability and protection of intellectual property rights if it were to be successful in high technology agricultural activities in particularly those linked to biotechnology. Palm oil, the most important agriculture exports needs to cap its production costs in view of the emerging competition from Indonesia.

Domestic manufacturing industries must be efficient, operating at a competitive real costs and have high productivity if it were to maintain its share in the GDP contribution. Certainly the issue of inefficient industries that enjoy high protection will have to be tackled because these industries, operation must meet international standards and cost competitiveness. Drawing FDI and encouraging domestic investment will be the major challenge as Malaysia has to ensure that its investment climate remain attractive. Resource based industries utilizing palm oil and petroleum should be promoted rigorously because Malaysia has the raw materials and research capability.

Maximizing the potential of services sector is perhaps the key factor to Malaysia's competitiveness because it is an intermediate input for all activities as well as some services industries can be significant contributor to growth. Productivity and costs of other economic activities depend on the efficiency of the intermediate services. At the same time, tourism, construction, telecommunication, computer-related services, education and health services are recognized as leading industries in terms of employment, generating export income and producing economic spillovers.

As can be seen in the various thrusts of both 9MP and IMP3, the government is striving to create more a conducive business environment to facilitate business activities as well as to identify new markets and encourage capital investments especially for export-oriented businesses. This needs to be balanced with current industry capacity and capabilities as there are still pockets of the economy that are considered either strategic or sensitive such as distributive trade and professional services sectors.

Above and beyond the national plans, Malaysia should also look into how its recent FTA initiatives can help its competitiveness, produce higher growth, attract investment, restructuring its exports and expand export markets.

3. Malaysia's FTA Initiatives

On 11 December 2003, Malaysian and Japanese leaders agreed to commence formal negotiations on a bilateral economic partnership between the two countries. The Malaysian-Japan Economic Partnership Agreement was signed in mid 2005 containing the following main elements:

- Liberalization, facilitation and cooperation measures;
- Flexibility in dealing with sensitive sectors;
- The FTA component includes industrial and agricultural goods, services trade, investment, rules of origin, standards and conformance, small and medium scale industries, customs procedures, safeguards, enhancement of business environment and dispute settlement; and
- Cooperation in education, human resources development, ICT, R&D, and science and technology.

Besides the Malaysian-Japan Economic Partnership Agreement, Malaysia is engaging in a number of bilateral and ASEAN level FTA negotiations. In terms of bilateral FTA, Malaysia is currently negotiating with the US, Australia, New Zealand and Pakistan. The bilateral FTA talks with the US is entering the third round and although it is expected to be concluded by 2007, there are major issues such as government procurement and negative listing for services liberalization that have to be ironed out before more progress can be made. The negotiation with Australia is at an advance stage and an agreement is expected to be reached soon. The negotiation with Pakistan is at the final stage as most of the major issues have been agreed. Unfortunately, the negotiation with New Zealand has stalled because of disagreement of the approach for services sector liberalization.

In addition to the bilateral FTA negotiations, Malaysia is also involved in liberalization initiatives at the ASEAN level. These are the ASEAN - China FTA, ASEAN - Japan FTA, Trans Regional EU-ASEAN Trade Initiative (TREATI), ASEAN - South Korea FTA and ASEAN-India FTA. The summary of the initiatives are as follows:

i. **ASEAN - China FTA:**

The Framework Agreement on Comprehensive Economic Cooperation between ASEAN and China was signed in November 2002. The agreement is to be implemented within the next 10 years and ASEAN domestic industries are expected to be able to take advantage of the massive Chinese market. Some key features of this agreement are:

- It entered into force on 1 July 2003.
- Includes an early harvest package covering Chapters 1-8 (agriculture products such as live animals, meat and meat products, fish, dairy produce, other animal products, live trees, edible vegetables and edible fruits and nuts) of the Customs Harmonized System and selected specific products beyond those chapters (palm kernel oil, vegetable fats and oils, margarine, cocoa products, coffee, soap, stearic acid, erasers and glass envelopes)
- Contains guidelines for negotiating an FTA in goods, services and investment
- Identifies other areas for economic cooperation
- Sets the timeframes and deadlines to negotiate specific arrangements to implement the Framework Agreement including provisions on dispute settlement

ii. **ASEAN - Japan FTA**

Japan has entered into the Framework for Comprehensive Economic Partnership (CEP) with ASEAN (as a group), which was signed in October 2003, in Bali Indonesia. The Work Programme includes:

- Trade and investment facilitation and liberalization
- Cooperation in other areas, such as science and technology; human resources development, small and medium scale industries, ICT, tourism and hospitality; transportation and logistics; and energy.
- CEP to start in areas where implementation is feasible such as technical assistance and capacity building, trade policy and business sector dialogue, and facilitation of business mobility.
- Two track process is envisaged for FTA negotiations: first, the bilateral FTAs between Japan and selected ASEAN countries with a common set of rules of origin and second, a region-wide CEP to be implemented by 2012

iii. **Trans Regional EU-ASEAN Trade Initiative (TREATI)**

In April 2003, ASEAN and EU Ministers had agreed to work towards the establishment of TREATI to enhance ASEAN-EU economic partnership. The main areas of cooperation include trade and investment facilitation and promotion, technical barriers to trade, sanitary and phytosanitary (SPS) measures, customs, and tourism. The implementation of TREATI could pave the way for a future preferential trading agreement between ASEAN-EU

iv. ASEAN - South Korea FTA

Negotiation on this initiative is at the final stage.

v. ASEAN-India FTA

Framework Agreement on Comprehensive Economic Cooperation between ASEAN and India was signed in October 2003. Main elements of Framework Agreement provides for negotiations to establish FTA in goods, services and investment, contains an early harvest package on goods and trade facilitation measures, and identifies areas for cooperation activities aimed at capacity building. Negotiation is at the final stage.

Since the Malaysian-Japan Economic Partnership Agreement (MJEPA) is the only bilateral FTA agreement that has been signed by Malaysia, it will be used as the template to analyze the potential impact of such liberalization commitments on Malaysia's competitiveness. The key commitments in this agreement are:

- Manufacturing - Malaysia is committed to a progressive elimination of tariffs on industrial goods. However, flexibility is given on sensitivity of products such as automotive and steel where the reduction of tariff will be stretched out over a period of time.
  Malaysia has offered a substantial liberalization for automotive industry where cars with large engine capacity can enter the Malaysian market with low import duties. In addition, import duties for other categories of cars were also reduced substantially while components parts can enter without duty. Other major imports from Japan that can enter Malaysia duty free are electrical and electronics; machinery and equipments; and chemical and petrochemicals.
  Malaysian products entering the Japanese market will enjoy duty free treatment for 6,613 industrial products, tropical fruits and forestry products. The major products of interest are rubber products; electrical and electronic products; footwear; chemical and petrochemicals; plastic products; furniture and automotive and parts and components.

- Agriculture
  As well as tariff elimination for tropical fruits, Malaysia also received an expansion of quota for selected agriculture exports, namely banana.

- Investment
  The JMEPA provides the framework for the expansion and facilitation of freer cross-border investment between the two countries, through commitments on national treatment, most-favored-nation treatment (MFN), and enhanced protection of investors and investment. The agreement also seeks to establish a

more predictable and favorable environment for investors and investment such as a mechanism to resolve operational issues.
Japan requested for the elimination of investment performance requirement such as the right to impose export requirements on existing companies and on local equity requirements. Malaysia asserted that these requirements are needed for development purpose and for capacity development, in particular for technology transfer.

- Services
  Services is one of the major areas of interest for both parties. Japan requested for a faster liberalization of services industries but Malaysia insisted that it must be done progressively. For investment in services, Japan sought a more liberal policy on equity holdings in services industries that would allow larger foreign equity holding than the existing threshold. Another key area of negotiation is the approach that should be taken in terms of commitment of services industries. In the end, Malaysia's proposed approach of a positive listing for liberalized services industries was accepted by Japan.
  For trade in services, Malaysia will have market access in sectors of interest in Japan such as business and professional services; education services; communication services; tourism and travel related services; and health related and social services. Conversely, Japan will also enjoy market access in Malaysian professional services; computer and related services; communication services; educational services; hospital services; leasing services; and repair and maintenance services.
- Intellectual property and competition policy
  The commitments made by Malaysia in these two areas are in conformance with the WTO obligations and are focused on cooperation
- Government procurement is excluded from liberalization.
- The MJEPA is different from the normal FTA because it also includes cooperation. The cooperation projects identified for implementation include agriculture, fisheries, forestry and commodities; information and communication technology; education and human resource development; science and technology; small and medium enterprises; tourism; and environment.

4. Possible Impact of FTA on Malaysia's Competitiveness

Malaysia had shown reservations when Singapore announced that it were negotiating its first bilateral FTA, namely the Comprehensive Economic Partnership Agreement with Japan, due to concerns about the impact of such agreements on ASEAN Free Trade Agreement's progress. There was the concern about a "back-door" entry into ASEAN[i]. Furthermore, there was also the fear that ASEAN countries would place a lesser emphasis on the regional integration became stronger when Thailand embarked in many FTAs during a short span of time. Since 2000, Thailand has signed three FTAs, in negotiation with another three and is proposing three more. Malaysia's initial reservation ebbed when it realized that there is a possibility that its exports may become less competitive in markets where preferential treatment had been given to other competitors through FTAs. Thus, it can be inferred that the proliferation of Malaysia's bilateral FTAs is an effort to address the concerns about the impact of these agreements on competitiveness.

The impact of bilateral FTAs on Malaysia's competitiveness is analyzed in three aspects:

(i) Exports

Prospects for greater market access for Malaysian industrial goods differ between two types of market, namely between developed and developing countries. Although developed countries generally have very low tariff rates for industrial goods, there exist many tariff peaks. FTA would provide ways in which these high tariffs can be reduced. On the other hand, developing countries, on average, have higher tariff rates. Market access in the developing countries is further restricted due the common practice on imposing trade restrictive practices such quotas (e.g. for palm oil in India, Pakistan and China) and import licensing to protect domestic industries. Thus, an FTA would have an immediate impact of improving the competitiveness of Malaysian exports in both developed and developing countries when average or peak tariffs and non-tariff barriers are reduced. If Malaysia does not enter into an FTA arrangement, its export competitiveness would be adversely affected if instead a competitor receives a preferential treatment due to reduction of tariffs achieved through an FTA with a trade partner. Furthermore, a country may prepare to relax import quota to specific trade partner through a bilateral FTA rather than a multilateral liberalization commitment under WTO. Hence, the ability to expand import quota through an FTA is a key factor that can boost Malaysia's palm oil exports.

For Malaysian labor-intensive industries that are facing rising labor costs such as textiles, footwear and furniture, reduction of tariff is essential in helping these industries maintain their competitiveness vis-à-vis exports from countries with lower labor costs. For example, in New Zealand, these products are subjected to relatively high tariffs – tariff rate for textile, clothing and footwear is 19% and for furniture 17.5% – and as such lowering import duties would help these products to compete.

However, for agriculture products, an FTA is unlikely to improve significantly market access in the partner market unless health standards and food safety measures are addressed meaningfully. For example, even though tariffs for Malaysian agriculture and food exports to Japan are low, these products face stringent Japanese health and food safety measures, which are beyond the international norms. These standards and measures can be a major market entry barrier. The FTA negotiation was not successful in getting Japan to recognize the Malaysian health and food standard and inspection measures. Some progress were made where the FTA establishes a framework that will increase cooperation between regulatory agencies of the two countries in order to reduce or remove health and food safety measures that were regarded as trade barriers. Besides the work on health standards and food safety measures, the FTA is also employed to reduce other non-tariff barriers for agriculture and food products such as the requirement that specific ports of entry are used for the importation of selected goods.

(ii) Domestic industries

The widely held view is that the competitiveness of domestic industries can be increased through liberalization. But, in developing countries the liberalization process should be done gradually because many domestic industries are still at the fledging stage of development. In an FTA involving smaller number of countries, the opening up of domestic industries can be more targeted and limited and thus can serve as a preparation for multilateral liberalization commitments. The opening up of protected domestic industries is of keen interest to other trading partners because these industries offer the most lucrative markets for imports of goods or business provided by foreign providers. Therefore, it is not surprising that FTA negotiations have spent a large amount of time on this matter.

Services sector

The services sector is under heavy pressure to be liberalized. The argument is that liberalization will increase competition, productivity and ultimately improve the overall national economic competitiveness since services is basic or intermediate inputs for many industries and activities. Nonetheless, Malaysia is cautious in opening up its services sector because its domestic services providers are not developed enough to compete with the more established foreign services providers. In particular, financial services, transportation, whole and retail trade, government procurement and public funded and assisted education are excluded from liberalization. However, manufacturing related services, which are considered sensitive because the domestic providers are operating in uneconomic scale, use low level technology and have low productivity, are included in the list of services industries for opening up.

Malaysia also used the FTA to promote its specific services industries of interest such as tourism, education and health services and professional services. As an outcome of the FTA, work has began on recognition of qualification and mutual recognition arrangements, which are essential in exports of services, especially professional services. Whether Malaysia can significantly increase its services exports as a result of FTA is yet to be seen because global competition is very keen.

Malaysia has requested for emergency safeguards measures for the services sector to be included in its FTAs. These are intended as a safety net against a surge in imports from the partner country that would lead to injury to domestic industries due to concessions made in the FTA agreement. Currently, safeguards are quite well-developed in the goods sector. However, for the services sector, the concept of emergency safeguard is still not widely accepted because of the difficulty of measuring injury and identifying the countervailing measures that can be imposed. In the services sectors, the utilization of domestic regulations is critical, not as safeguard measures, but to ensure an orderly development of the sector.

The liberalization impact on the services sector is limited because Malaysia has managed to push for the sector to be opened up progressive liberalization, using a positive listing method. This means that Malaysia only offers services industries which are ready for opening up and the commitment can be improved progressively. Nevertheless, in preparing for the negotiation and more liberalization in the future, Malaysia needs to have full information about the services sector including policies and regulatory systems. In this way, the services sector can be governed better and more efficiently.

Manufacturing industry

Automotive, chemicals, iron and steel, wood-based, selected food and agro-based products are among the most sensitive Malaysian industrial goods. These industries were protected by high tariffs. The liberalization of these industries, in particular automotive, would have a far reaching impact and there will be a significant restructuring. Even at this initial stage, the market share of the national car (Proton) has declined. Competition from imports will certainly increase and these protected domestic industries would have to improve their competitiveness especially through productivity enhancement, marketing strategy and business operation restructuring. Domestic industries will have to comply with international standards and this may lead to industries improving their operation. . It is important that the liberalization of the sensitive industries (automotive and steel) be carried out gradually to minimize unemployment and loss of business for suppliers, vendors and sub-contractors. The domestic restructuring may put Malaysia in a better position in the regional and global production network. The initial adjustments in terms of loss of employment may be short-term and can be compensated when the industries enjoy rapid growth because of increased competitiveness.

In the case of wood-based products and wood exports, FTA can be a channel to minimize measures that are put in place by importing countries based on environmental reasons. This would reduce uncertainty and unclear reasoning for restricting imports.

The liberalization in the automotive sector is to be complemented by industrial collaboration between Japan and Malaysia. Cooperation projects include a Technical Experts Assistance Programme; capacity building for Malaysian auto parts suppliers; the setting up of an Automotive Skill Training Centre and a Components and Parts Testing Centre in Malaysia; and business development programme to strengthen ties and to increase sales of auto parts from Malaysian companies. These projects are aimed to increase the medium and long term competitiveness of the Malaysian automotive industry.

Agriculture

The impact on the agriculture sector is likely to be minimal because the primary commodity industries do not receive any protection. Protection is only for selected agricultural activities such as rice and poultry due to reasons of food security. The agriculture export products such as palm oil and rubber received no protection, incentives or subsidy

(iii) Growth

FTAs can result in higher economic growth fro Malaysia if it can create a vibrant investment climate, improve productivity of domestic producers and open up new markets for exports. Investment policy in the manufacturing sector is liberal with no equity requirement. In other words, foreigners are allowed to hold 100% equity in manufacturing companies. The request by FTA partners to eliminate pre- and post-establishment requirements such as transfer of technology and employment of local staff was not agreed. Although some quarters view the existence of such requirements is a disadvantage for attracting foreign investment, other factors such as the availability of skilled workers are more important to companies when making decisions on investment.

The FTAs did not make progress on liberalization of investment in the Malaysian services sector. Equity condition for investment in the services is subject to national development policy, which requires 30% equity holding by Bumiputera while foreigners can hold up to 70%, depending on the sensitivity of the industries. This condition is unlikely to bring about a large inflow of foreign investment to Malaysia.

The formation of Fats with emerging trading partners can be a booster for Malaysia's economic growth. As the traditional export markets nearing the saturation point, Malaysia needs to expand markets for its usual exports of electrical and electronic goods, palm oil and resource-based products. The new markets may also be the destination for Malaysia's new exports such as halal foods and services.

5. Conclusion

Bilateral FTA is an important way for a country to respond to the proliferation of preferential regional and global trading arrangements. If Malaysia did not join the band wagon and undertake its own bilateral FTAs, it could be left behind and lose competitiveness especially in terms of market access for manufactured goods. Generally the impact of FTAs on the Malaysian economy is expected to be positive because it is a very open economy, with only few sensitive sectors and has benefited from its participation in the global economy. The manufacturing sector has a low tariff regime and has liberalized fully the equity condition where foreigners are allowed full ownership in the manufacturing sector. Although the remaining few protected industries, namely automotive and steel, will reduce their tariff rates progressively under the AFTA scheme, the bilateral FTAs namely the MJEPA has accelerated this process.

The lliberalisation commitments in new areas such as services, investment and government procurement are not deep and extensive as that of the manufacturing sector. The smaller capacity for domestic services providers, different stage of development and attainment of socio-economic objectives are among the main factors for this stance. The wider coverage and demand for higher commitments such as the opening up government procurement and removal of subsidies for domestic industries also raise concerns over the intrusion into domestic policy space, which can limit the government’s ability to help small domestic companies.

Malaysia is looking for a balanced outcome from any FTA that it enters, which weighs the costs and benefits of the commitments. The core parts of FTAs are goods, services and investment. The goods sector usually involves tariff reduction and elimination of non-tariff barriers. But as liberalization in the good sector is already well advanced under the multilateral trade agreements, the FTAs are now focused on the opening up of the services sector, a key and untapped part of the economy with a huge growth potential but sometimes heavily protected. Malaysia’s FTAs commitments for services so far is very cautious and not requiring deep opening up or restructuring of the services industries. Therefore the FTA impact on the services sector is not as considerable as in the manufacturing sector.

By increasing competition for the domestic producers through reduction of tariff or the liberalization of services sector, the questions that the Government has to bear in mind is what are gains that it can get from FTAs?. One way to achieve a balanced outcome is to put equal importance to cooperation as those for liberalization and facilitation. Malaysia's objective in embarking in an FTA is not only to enhance economic efficiency through liberalization and improvement in market access but also to achieve a more comprehensive and closer socio-economic relationships and to strive for a balanced outcome. Ensuring that cooperation forms a critical element of the agreement is essential for human resources development because the main element in cooperation is capacity building, involving training, skills improvement and educational exchanges. This is reflected in Malaysia’s FTAs which put a substantial focus on co-operation.

In conclusion, the overall effect of FTAs on Malaysia's competitiveness is not significant at this beginning phase of the FTAs because the liberalization commitments are not very deep. Perhaps as the opening up and restructuring deepens through the mandated subsequent liberalization, the impact on Malaysia's competitiveness is more evident and pronounced. It is important that in targeting for a higher level of competitiveness, Malaysia must be prepared to take the cost and pain of adjustments and the potential fall-out in sensitive socio-economic sectors.

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[i] The concern about a "back-door" entry was that non-members of ASEAN can enter the regional market by having a preferential trade agreement with one of its members. This caution is not applicable in the Singapore case because Singapore has already zero tariff rates for almost all its trade. Furthermore there is the safeguard-enabling clause that can invoke if there are evidence that there exists an unusual import surge due to liberalisation undertaken by its member.