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TRADE RELATIONSHIP BETWEEN MALAYSIA AND SELECTED TRADING PARTNERS (1968-1990)

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This is to certify that Bro./~~Sis~~. AZIZ @ FIKRY B. MOHAMMAD
has written the Master of Economics research paper entitled:
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under my supervision. The relevant comments made on the Paper during its presentation have been incorporated in the present version of the paper to my full satisfaction.

I have pleasure in recommending that the graduate committee may approve the paper in partial fulfilment of the requirements for the degree of Master of Economics.

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ABSTRACT

The study analyses the performance of bilateral trade between Malaysia and its sixteen selected long-standing trading partners for the period 1968 - 1990. It compares the growth rates of export and import between Malaysia and the selected partners. Special emphasis is given to the dependency aspects of bilateral trade. The study highlights the precarious nature of Malaysia's external trade, where in recent years, Malaysia has become more dependent on the foreign sector than most of her partners, with the major portion of her export and import transactions being confined to only a few countries.

The study also tests a simultaneous equation model to analyse the impact of income on the trade interaction between Malaysia and its partners. The findings indicate the importance of the income effects in both the import and export functions in the bilateral trade between Malaysia and the selected partners.

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1. INTRODUCTION

1.1 Introductory Remarks

Malaysia had trade relations with about 140 countries in 1991, of which Singapore, U.S. and Japan remain the dominant trading partners.[1] Although this represents a multifold increase from the number of partners in 1968 when the outward oriented Investment Incentives Act was launched, the sustainability of the new relationships and their impact on the distributional pattern of the Malaysian external trade have yet to be proven. The study focuses on bilateral trade between Malaysia and each of the selected long-standing trading partners, with special emphasis being devoted to the characteristics of growth and its dependency aspects.

1.2 Scope And Objectives Of Study

The paper analyses the experiences of trade relations between Malaysia and its long-standing trading partners. To put the Malaysian trade scenario in the appropriate context, focus is given to the Malaysian policy experience, taking into consideration the country's shift from an import substitution policy (IS) to an export promoting policy (EP) starting with the introduction of the Investment Incentives Act in 1968.[2]

More specifically, the objectives of the study are:

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[1] Ministry of Finance Malaysia, Economic Report 1991/1992 (Kuala Lumpur: National Printing Department, 1991), p. 169.

[2] The shift in strategy was officially expressed in the government's Second Malaysia Plan 1971-1975 whereby "development will be directed towards increased production for exports".

(1) To examine the growth characteristics of trade between Malaysia and its sixteen trading partners during the period 1968 - 1990. The focus is on export and import dependencies.

(2) To test a simultaneous equations model of trade relationships between Malaysia and the partners. The aim is to gauge the importance of income as determinant of bilateral trade in the presence of a lagged dependent variable.

1.3 Approach Of The Paper

The study is empirical in the sense that it is very much data dependent. Bilateral dependencies between Malaysia and each of the selected partners are described in terms of growth characteristics for the period 1968 to 1990. The income effects on trade relations are analysed within a simultaneous framework.

Chapter 2 will introduce the background environment to the growth of Malaysia's external trade including her policy experience that has contributed to the current scenario. Chapter 3 will focus on the policy experiences of the major partners comprising of the U.S.A, Japan, and the Newly Industrializing Countries.

Chapter 4 will present the methods employed to derive the relevant findings from the data. Both descriptive comparisons and simultaneous regression methods are employed. The resulting empirical findings are then presented with the relevant comments.

The fifth chapter will attempt to provide the policy implications of the findings, and, in the process will highlight the new course that need to be pursued in the future. The chapter is concluded with suggestions on further works in the area.

2. MALAYSIAN TRADE STRATEGIES IN FOCUS

2.1 Background

The impetus for industrial growth in Malaysia was initiated during the First Malaya Plan period (1956 - 1960). The passing of the Pioneer Industries Ordinance in 1958 stemmed from the need to diversify an economy which was heavily dependent on a dominant agricultural sector, as well as to provide greater employment opportunities to a rapidly growing population. With rubber and tin accounting for almost 37% of GDP and 69% of exports in 1960, the diversification process was targeted towards increasing the production of other commodities such as timber, palm oil and manufactured goods as well as modernizing the rubber industry. The initial industrialization process was essentially based on an import substitution strategy. This strategy allowed for substantial import substitution of foodstuffs, tobacco, rubber and plastic products.

For a relatively small country like Malaysia, the possibilities for sustaining growth through a prolonged import substitution were limited. In 1968, the government of Malaysia introduced the Investment Incentives Act, which was to mark a gradual shift in emphasis in Malaysia's industrial policy from import sustitution to export expansion. Export expansion in Malaysia developed along two distinct lines, namely the stimulation of domestic manufacturers to export part of their products and the establishment of Export Processing Free Zones (EPFZs) or Free Trade Zones (FTZs).

The establishment of the International Trade and Industry

Division within the Ministry of Trade and Industry in 1972 provided Malaysian exporters with export advisory services, information on overseas markets, and overseas business contacts as well as facilitated their participation in international trade fairs and the promotion of Malaysian products abroad. The government's role also included negotiating bilateral and multilateral trade agreements and introducing the Export Credit Refinancing Scheme to give Malaysian exporters greater access to credit. The establishment of FTZs encouraged the growth of labour intensive export oriented industries like electronics, textiles and wood products.

Further incentives for promoting export growth were provided in the 1980's in the form of tax deductions through export allowance based on value of export sales, accelerated depreciation allowance and deduction for promotional expenses incurred abroad. The early 1980's also marked the government's new emphasis on the development of heavy industries to stengthen the industrial base of the country and to meet the input requirements of export oriented industries. Projects under consideration were cement, sponge iron, cold rolling, ammonia-urea, methanol, automobile and petro-chemical plants. The government founded the Heavy Industries Corporation Malaysia Berhad (HICOM) in 1980 to initiate, implement and manage capital intensive industries.[3] The Fifth Malaysia Plan (1986 - 1990) and current government policies are mainly guided by an export-oriented growth strategy.

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3 <u>Fourth Malaysia Plan 1981-1985.</u>

The success of the Malaysian policy of diversification of its economy to reduce its reliance on rubber and tin as its main export earners is reflected in the following table. Although after 1980 other resource-based commodities such as palm oil, timber, and crude petroleum & LPG experienced a decline in their share of Malaysia's total export, the manufacturing sector has continued to increase its share of Malaysia's export.

Table 1

Composition of Malaysian Exports 1970, 1980 and 1990

Merchandise	1970 (%)	1980 (%)	1990 (%)
Agriculture	55.9	40.2	18.8
Rubber	33.4	17.1	3.8
Timber	16.3	12.9	8.9
Palm Oil	5.1	9.1	5.5
Other Agriculture	1.1	1.1	0.6
Mining	22.8	34.1	17.3
Crude Petroleum and LPG	3.2	25.3	16.2
Tin	19.6	8.8	1.1
Manufactures	11.1	20.6	60.4
Miscellaneous	10.2	5.1	3.5
TOTAL EXPORTS	100.0	100.0	100.0

Source : Chin, Keat Yue, Trade And Growth In Malaysia. Unpublished M.A. thesis, Vanderbilt University, 1993, p. 7.

2.2 External Trade and Industrial Growth

As a consequence of the gradual shift to export promotions, Malaysia's industrial sector has undergone tremendous changes both in growth and structure. The increasing dominance of the manufacturing sector involves a change in distribution of emphasis within the sector.

Based on the data for the period 1968 - 1986, Lee(1990) observed that a Leontief-type test on the manufacturing sector confirmed that Malaysia has a comparative advantage in labor-intensive lines of production, thus supporting the Hecksher-Ohlin theory(H-O).[4]

Lee's empirical results showed that an extension of the H-O theory ('a la Keesing') by incorporating skill content offers a good explanation of Malaysia's trade pattern in manufacturing goods . Malaysia's manufactured imports are more skill intensive than her manufactured exports. This is also a reflection of Malaysia's comparative disadvantage in skill intensive industries.

Malaysia's export drive has resulted in major structural changes in the industrial sector, especially the emergence and rapid growth of the non-traditional industries such as textiles and wearing apparels, and, electrical machinery and precision equipment.

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[4] Lee Keng Fatt, Export Expansion and Industrial Growth: The Malaysian Experience (1968-1986) , Unpublished M.Econs Dissertation, Univ. of Malaya, 1990, p. 64-85.

Table 2

Growth And Structural Change Of Manufacturing By Major Industry Groups : 1968 - 1986

Industry Group	Value Added			Export		
	Sectoral Share 1968	Sectoral Share 1986	Annual Growth	Sectoral Share 1968	Sectoral Share 1986	Annual Growth
Food	17.10	14.0	15.05	15.74	21.12	16.86
Beverages	4.15	2.04	11.20	0.29	0.16	11.32
Tobacco	6.53	4.19	13.09	0.33	0.02	-1.73
Textiles	2.24	3.72	18.84	0.78	2.79	23.37
Made-up Textile Goods, Apparel & Footwear	0.88	2.80	32.01	1.04	5.57	26.18
Leather Products	0.11	0.05	25.52	0.02	0.05	20.12
Wood & Cork Products	10.81	5.55	10.71	11.90	9.00	13.21
Furniture & Fixtures	1.18	1.00	21.63	0.10	0.22	19.91
Paper & Paper Products	0.71	1.40	32.28	0.21	0.33	17.84
Printing & Publishing	6.01	3.24	11.86	0.34	0.11	8.22
Industrial & Other Chemical Products	9.09	14.43	18.76	2.26	3.76	18.27
Petroleum & Petroleum Products	4.65	3.62	11.84	10.55	3.10	7.41
Rubber Products	13.61	6.22	11.69	0.71	0.76	15.33
Plastic Products	0.96	2.16	28.94	0.03	0.40	32.78
Non-Metallic Mineral Products	7.07	6.45	15.28	0.61	0.75	16.29
Basic Metal	2.43	3.16	17.12	49.87	4.77	0.92
Fabricated Metal Product	4.46	2.61	13.18	0.39	0.62	17.95
Non-electrical Machinery	2.88	2.08	15.95	1.92	3.60	19.05
Electrical Machinery & Appliances	2.38	16.42	30.67	0.55	37.92	45.41
Transport Equipment	2.14	2.96	17.06	1.95	2.53	16.65
Miscellaneous	0.61	1.88	23.78	0.41	2.40	26.88
Total Manfacturing	100.00	100.00	15.79	100.00	100.00	14.97

Source :

Lee Keng Fatt, Export Expansion and Industrial Growth: The Malaysian Experience (1968-1986) , Unpublished M.Econs Dissertation, Univ. of Malaya, 1990, p. 19,20,23,24.

During the import substitution - export promotion phase (1968 - 1986) value added growth for the manufacturing sector accelerated at an annual rate of 15.79 per cent. As shown in the above table, "Paper and paper products", "Made-up textile goods, wearing apparel and footwear", "Electrical machinery and appliances", "Plastic products", and "Miscellaneous" were the main growth subsectors.

During the same period the annual overall growth rate in manufactured exports was recorded at 14.97. The leading growth subsectors are "Food","Textile","Made-up textile goods, wearing apparel and footwear", "Furniture and fixtures", "Plastic products","Fabricated metal products", Non-electrical machinery", "Electrical machinery and appliances" and "Miscellaneous".

The growth subsectors are dominated by multinational corporations and are mostly concentrated in EPZs because of certain locational factors such as attractive incentives, infra-structural facilities and the ready availability of cheap labour. However, in recent years, scarcity of labour and the corresponding rise in wages have made Malaysia less attractive for labour intensive industries.

2.3 Policy Review

Malaysia's approach to industrial development in relaxing her import substitution policy to include an outward looking strategy was both timely and warranted. Such a move has brought about a sustained rate of rapid growth in the economy over the last two decades.

However, a note of caution is in order. Industrialization through the EPZs has resulted in the proliferation of footloose industries in the country. Their main attraction being the above mentioned locational factors.

Almost all capital and intermediate inputs are imported; the EPZs have few linkages with the country's economy in general. The labour-intensive nature of the industries, involving standardized production processes, limits the contribution of EPZs to technological development and skill creation.

A country which is highly dependent on EPZs will find that economic well-being will be largely determined by external factors, such as external markets and investment policies of other countries, which are beyond the control of her national planners and policy makers.

Malaysia may possibly lose her comparative advantage in labour-intensive industries as a result of rising labour costs. To the extent that labour cost is a major determinant of foreign investment in the country, there is a likelihood of the potential foreign investors as well as some footloose industries already in the country heading for other developing countries.

In respond to this, Malaysia has rightly shifted the emphasis for future industrial growth to her resource-based and skill-intensive industries where her long-run comparative advantage seems to lie. The development of downstream activities of these industries will unavoidably involve a higher level of skill input. To satisfy this need, the government and the private sector should jointly ensure an adequate supply of skilled labour for sustained industrial growth. Thus, beside export incentives to ensure a greater participation of domestic producers, incentives should also be provided to industries which can contribute substantially to the development of skills and the transfer of modern technology as well as to those with strong linkage effects.[5]

[5] Malaysia, The Second Outline Perspective Plan 1991-2000 (Kuala Lumpur: National Printing Department, 1991), p. 79-81.

3. MALAYSIA AND MAJOR TRADING PARTNERS

3.1. Policy Arguments

Economists are divided as to the appropriate trade policy choice for developing countries; Whether outward-looking or inward-looking.

The group in favour of export-promoting (EP) over import substitution (e.g. Anne O.Krueger(1986)[6]) claims that Import Substitution (IS) leads to :

(a) Incentive stifling.

(b) An over valued home currency which discourages export.

(c) A rising balance of payments deficit.

In a study of ten developing countries, Krueger(1986) finds that a one percent increase in exports led to a 0.1 percent increase in the rate of growth of gross domestic product.

Streeten(1986)[7] on the other hand argues that what matters for the success of an industrial policy is a host of factors such as the quality of management, scale, technology, types of training and education; deficiencies of which may occur along side with export-promoting as well as import-substituting policies.

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[6] Krueger, Anne O.,"The Effects of Trade Strategies on Growth" International Trade and Finance ed.,R.E.Baldwin and J.D.Richardson(Boston: Little, Brown and Co.,1986),p. 216-227.

[7] Streeten, Paul,"A Cool Look at 'Outward-looking' Strategies for Development" International Trade and Finance ed., R.E. Baldwin and J.D.Richardson(Boston:Little, Brown and Co.,1986),p. 222-281.

The arguments in favour of EP based on comparative advantage, economies of scale, and increased competition, as forwarded by advocates of trade liberation, according to Streeten, are mutually inconsistent. He disputed the contribution of EP strategies in Taiwan's and South Korea's success stories. He attributed Taiwan's growth to such factors as massive foreign aid, access to Japanese market, presence of both indigenous and immigrant entreprenours, favourable trade treatment from the boom after the Vietnam war, and an effective land reform. Similarly, he attributed South Korea's success to IS-related strategies.

Meier(1989)[8] favours export substitution (ES) rather than IS. Considering that this implies the export of nontraditional products rather than primary products, ES means moving towards more labor intensive value added products to address a wider market. The gain from export is then used to import agricultural products at cheaper prices. The increase in export revenue helps debt servicing by reducing the ratio of debt servising to export revenue.

3.2 Partners' Picture

In this section we shall briefly look at the factors that help shape the economic profiles of Malaysia's main trading partners.

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[8] Meier, Gerald M., <u>Leading Issues In Economic Development</u>, 5th Ed.,(London:Oxford University Press,1989),p. 304-307.

3.2.1. Japan

Japan was the first NIC. Like the NICs export growth played an important role in its industrial take-off. However, fast export growth is not the only important factor. Other equally important contributions come from the high levels of domestic savings and investment, high rate of technological innovation, an abundant supply of labour, and a high degree of adaptability of its industrialization strategy.

Unlike today's NICs which adopted an open-door approach to foreign capital, Japan discouraged foreign investment for most of the post-war period. She preferred to gain access to western technology through reliance on licensing agreements. The rapid expansion of manufacturing exports from both Japan and the NICs have created tension with the advanced industrialized nations, giving rise to the new protectionism.

Of particular concern to the industrialized nations are the growing Japanese trade surplus. By 1991, Japan had a trade surplus of $38.6 billion with the U.S. and $27.6 billion with the EEC. With private sector savings that more than offset the public sector deficit, the under valuation of the Yen, the tight control over interest rates, as well as strict regulations discouraging competition among domestic financial institutions, the exchange rates will continue to fail in achieving the necessary balance-of-payments adjustment.

In future, the Japanese trade is expected to adhere to a slower pace. The anticipated slower export growth is attributed to rising value of the Yen, as well as difficulties in gaining access to the western market. The higher exchange rate is likely to cause Japanese exporters to resort to intra-industry specialization and move up-market into higher quality, higher value-added lines in which price competition is less important.

The rise in the ratio of aged people to working age population will contribute to a reduction in Japan's saving ratio. Liberalization of financial markets and boost in value of the Yen will provide easier access of foreign financial institutions to Tokyo market.

3.2.2. The Newly Industrializing Countries

Against the above background, we will now look at the NICs[9] of today, namely, Singapore, South Korea, Hong Kong and Taiwan. The growth of the NICs is attributed to a number of factors. The rise in labour costs in advanced countries and the workings of the product life-cycle in many branches of manufacturing places a premium on locating productions where cost is lowest. Due to technological change, vertical disintegration of production led multinationals to relocate the more labour intensive stage of production at sites in developing countries. As mentioned earlier in the case of Malaysia, EPZs, with attractive range, of facilities and incentives are a common feature of all NICs.

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9 Due to incompleteness of data, especially for the earlier periods, South Korea and Taiwan are excluded from our empirical work.

Similarly, Offshore Assembly Provisions (OAP) promotes an increased division of labour between developed and developing countries.The trade policies in the western industrialized countries, particularly the Generalized System of Preferences (GSP), helped the achievements of their outward-looking strategy.

As in the case of Japan, future NIC success will be less dramatic. Growth is taking place at a higher base where new export industries will require considerably more resources and finances. Market access for NIC manufactures looks likely to become more restricted in the future.

Intra-industry trade between industrialized and developing countries could increase through the vertical specialization in multi-process industries as well as through specialization according to differentiated products with the advanced nations concentrating on upmarket products.

3.2.3. The U.S.A.

The impending slow-downs anticipated for Japan and the NICs seems to have started earlier in the case of the U.S., but for different reasons. This is mainly due to the decline in competitiveness in world markets. Her trade balance turned negative in 1971 and, starting in 1981, the negative gap kept on widening. The U.S. share in world export for the top five exporting countries was 15.1% in 1975, but fell to 11.0% in 1986. Productivity growth in the U.S. over the period 1960 - 1985 has lagged behind Japan and West Germany.[10]

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10 Franklin R Root, International Trade And Investment(Ohio: South Western, 1990), p. 213-251.

The U.S. economy has a traditionally low level of private savings relative to private investment, while in recent years the public sector has recorded extremely large deficits. To circumvent the problem, she took the easy way out of borrowing from the rest of the world to finance a substantial portion of her investment (foreign countries finance one-fifth of gross private investment in the U.S. in the 1985 - 1987 period).

U.S. expenditure on research and development was more than Japan and West Germany for the period 1970 - 1987 period. However, while Japan and West Germany allocate their expenditure in strengthening their economic competitiveness, a relatively larger fraction of U.S. expenditure on R & D is allocated for defence.

Thus, although U.S. might have a lead in product technology, its competitiveness suffered due to the strong exchange rate, high labour cost and , as compared with Japan, low priority on commercialization of research products. The U.S. is said to have used their research efforts less efficiently than the Japanese.

3.2.4. Lessons From Partners

From the foregoing discussions on trade policy considerations we have presented some observations and reservations concerning factors that are said to influence the economic success of the countries practicing them. Focus is centred on the experiences of Malaysia, Japan, and the U.S. as well as the NICs in general.