

# THE WORLD ECONOMY

GLOBAL TRADE POLICY 2007

*Edited by*  
David Greenaway





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## Foreword

Each year *The World Economy* publishes an issue dedicated to developments in global trade policy. That issue always includes a number of ingredients: evaluation of a range of WTO Trade Policy Reviews; a regional feature; and a 'special feature' devoted to a current issue. Because of the interest in this particular issue of the journal, it is always published also as a stand alone book.

*Global Trade Policy 2007* includes Trade Policy Reviews of Malaysia, the United States and Trinidad and Tobago. This year's Special Focus is on the Doha Round, with contributions on not only what is at stake, but also possible outcomes. We also include an important agenda setting paper on Trade Preferences, with a focus on how they can help Africa diversify its exports.

I am grateful to the contributors to this volume for preparing an excellent set of papers and to Blackwell for expeditious publication.



# Malaysia – Trade Policy Review 2006

*Bala Ramasamy and Matthew Yeung*

## 1. INTRODUCTION

**D**ESPITE being a small economy, Malaysia is the 20th largest trading nation in the world. In fact, Malaysia's total trade is larger than that of Indonesia, New Zealand, Poland and Turkey. Openness to trade has been the prime contributor to Malaysia's economic performance since the 1960s. It is for this reason that the WTO Trade Policy Review (TPR) is an important document. It provides an impartial view of the Malaysian economy and its trading policies. While larger economies may not consider the TPR to be of much value (Prusa, 2005), for Malaysia, it serves as an effective metric to gauge an outsider perspective of its trade policies as it allows trading partners an opportunity to raise policy issues that affect bilateral trade and investment activities.

In the 2006 TPR, several issues were raised *vis-à-vis* Malaysia's trade and investment policies. These include protection given to local car manufacturers, the high proportion of unbound tariffs, intellectual property rights (IPR), liberalisation of the services sector and government procurement issues. In this paper we address some of these concerns. In Section 2 we provide an update of the Malaysian economy. We emphasise the issue of competitiveness and areas that need immediate attention. The following section considers Malaysia's engagement in regional and bilateral free trade agreements – an area that has seen major changes in trade policy since the last TPR. In the final section we briefly address the issue of Malaysia's tariff protection.

## 2. THE MALAYSIAN ECONOMY: PERFORMANCE AND PROSPECTS

During the period 2001–05, the Malaysian economy together with other countries in the region had to deal with several exogenous shocks. For an economy

that is small and open, the 9/11 terrorist attacks in 2001 and the related wars in Afghanistan and Iraq, the Bali bombings in 2003, the severe acute respiratory syndrome (SARS) in 2003, the Indian Ocean tsunami in 2004 and the crude oil price upsurge in 2004–06 created significant negative impacts. Despite these, the Malaysian economy had an average annual growth rate of 4.5 per cent during this period, marginally higher than the targeted 4.2 per cent in the 8th Malaysia Plan (8MP). In 2005 and the first half of 2006, average economic growth was at 5.35 per cent per quarter (Ministry of Finance, 2006).

The services sector was the major contributor to economic growth with an average annual growth rate of 6.1 per cent, followed by manufacturing at 4.1 per cent, agriculture, forestry, livestock and fisheries at 3.0 per cent and mining at 2.6 per cent. On the demand side, domestic demand continued as in previous years to be a driver of the economy. In 2005, domestic demand was responsible for nearly 92 per cent of the GDP. Government consumption and investment played an important role, making up nearly 30 per cent of GDP. During the 8MP, exports grew at an annual rate of 7.4 per cent compared to import growth of 6.9 per cent. During the first half of 2006, both imports and exports were growing at double-digit rates. In terms of composition of trade, there has been little change since the last TPR report. Manufactured exports still make up the lion's share, accounting for more than 80 per cent in 2005. Among manufactured goods, electrical and electronics (E&E) make up 65.8 per cent, down from a high of 72.5 per cent in 2000. This over-dependence on the E&E sector, as highlighted in the TPR, as well as commodity and mineral exports, increases the vulnerability of the Malaysian economy to foreign demand fluctuations. It is precisely for this reason that Malaysia continues to pursue both a liberal multilateral and regi-lateral trade and investment regime that promotes a stable international environment. In addition, the diversification of Malaysia's external sector to include services exports has been actively promoted. Chief among these are tourism and business process outsourcing.

In 2006, Malaysia launched its 9th Malaysia Plan (9MP), an economic blueprint that would take the nation to 2010. This aims to take the country closer to its aspiration of reaching developed nation status by 2020. The 9MP is organised along five major thrusts (EPU, 2006):

*Thrust 1: To move the economy up the value chain.* Supporting strategies include achieving higher value added and total factor productivity in manufacturing, services and agricultural sectors; generating new sources of wealth in technology and knowledge-intensive sectors; and expanding the international market for Malaysian goods and services.

*Thrust 2: To raise the capacity for knowledge and innovation and nurture 'first class mentality'.* Strategies here include improving access to and the quality of the education system and enhancing R&D capabilities.

TABLE 1  
Malaysia: IMD's World Competitiveness Indices

Year	2002	2003	2004	2005	2006
Overall Ranking	24	21	16	28	23
Economic Ranking	29	25	16	8	11
Government Efficiency	19	14	16	26	20
Business Efficiency	24	18	13	25	20
Infrastructure	31	31	30	34	31
Total Countries	49	59	60	60	61

Source: IMD World Competitiveness Yearbook 2006.

*Thrust 3: To address persistent socio-economic inequalities constructively and productively.* The plan aims to halve the incidence of overall poverty to 2.8 per cent and address regional and ethnic income disparities.

*Thrust 4: To improve the standard and sustainability of the quality of life.* Improvements in housing, health care, transportation systems, energy and water supply are focus areas.

*Thrust 5: To strengthen the institutional and implementation capacity.* Promotion of good governance both in the private and public sectors and the enhancement of the public service delivery system will be emphasised.

These major goals of the 9MP are timely, particularly Thrusts 1 and 2 when one considers the level of competitiveness of Malaysia *vis-à-vis* other countries. In 2005, there was uproar in political and economic circles when Malaysia slumped to 28th position in the IMD's World Competitiveness Index (see Table 1). In 2006, however, there was a slight improvement. When one considers the various categories of the Competitiveness Index, *Government* and *Business* efficiency seem to be the main culprits since Malaysia was worse in nearly all criteria in sub-categories like *Business Legislation* and *Institutional Framework*. Among the more striking indicators was the number of days to start up a new business which increased from 31 days in 2004 to 57 days in 2005. Indicators that measure corruption, red tape and transparency, all fell in 2005, although the ratings were back to the 2004 levels in the 2006 report.

However, among the four categories, *Infrastructure* is the area where Malaysia is at its weakest (ranked 31 in 2006). In particular, Malaysia is lacking in scientific infrastructure and the health and environment sub-categories. Table 2 shows the R&D expenditures and R&D personnel per capita for Malaysia and other Asian countries. It is clear that the proportion of R&D in Malaysia is at the level of a lower-middle-income country and behind more developed economies like Singapore, Taiwan and Korea. Table 2 also shows a critical cause of Malaysia's

TABLE 2  
R&D and Higher Education Achievement, Selected Countries

<i>Countries</i>	<i>Total Expenditure on R&amp;D Per Capita, 2003 or 2004 (USD)</i>	<i>Total R&amp;D Personnel Per Capita, 2003 or 2004, per 1,000 People</i>	<i>Percentage Population with Tertiary Education for Persons Aged 25–34, 2003</i>
China	18.28	0.89	
Hong Kong	161.47	2.48	37.40
India			9.51
Indonesia			5.00
Japan	1,060.33	6.91	52.00
Korea	402.61	4.04	47.00
Malaysia	29.25	0.70	18.00
New Zealand	230.43	5.34	32.00
Philippines			17.00
Singapore	566.72	6.01	49.00
Taiwan	343.99	5.70	43.20
Thailand	6.98	0.67	18.00

Source: IMD World Competitiveness Yearbook 2006.

performance in R&D, namely the education system. Thus, in its quest for developed nation status, the goal of increasing and improving access to tertiary education is critical. No doubt, the Malaysian government realises this. Over the last few years, the number of public universities has been increased such that today nearly every state in the country is home to at least one public university. Tertiary education has also been privatised to the extent that hundreds of private tertiary institutions operate side-by-side with their public counterparts. Thus, improving access to tertiary education has definitely improved. However, it is important that equal attention is given to the quality of education so that the output of the system is not mere numbers but contributes effectively to the development of the country. Failure to emphasise quality may result in similar challenges faced by India and China where the McKinsey Global Institute found only 10 per cent of its graduates are considered employable by multinationals (Farrell et al., 2005).

The declining competitiveness of Malaysia in 2005 should not have come as a surprise since a report by the World Bank in the same year highlighted similar findings. World Bank (2005) was based on the Malaysia Productivity and Investment Climate Survey of 1,151 firms conducted in 2002–03. The objective of the study was to identify the key obstacles to competitiveness from firms' perspectives. The report identified two crucial weaknesses that hinder the level of competitiveness and the investment climate, namely the regulatory burden and skills and innovation capability shortage. Despite having an investment climate that was better than most dynamic regions in China, Malaysian firms still had difficulties when hiring

both local and foreign workers due to skill shortages and bureaucratic procedures. In fact, the report states that in the services sector, regulatory restrictions in Malaysia were greater than the average for Asia, Latin America and OECD countries, thus increasing the cost of doing business. As for skill shortages, firms identified insufficient supply of university graduates as a key factor. Acknowledging that the Malaysian government was already addressing these issues, the report calls for:

- a. A further strengthening of the investment climate by reducing the high cost of the regulatory burden.
- b. An increase in tertiary education enrolment and access to the international labour supply pool.
- c. Raising the quality of secondary and tertiary education, in particular English language and IT proficiency.
- d. Encouraging greater training activities by firms.
- e. Strengthening the National Innovation System by promoting greater firm-institution collaboration and accelerating patent-granting procedures.

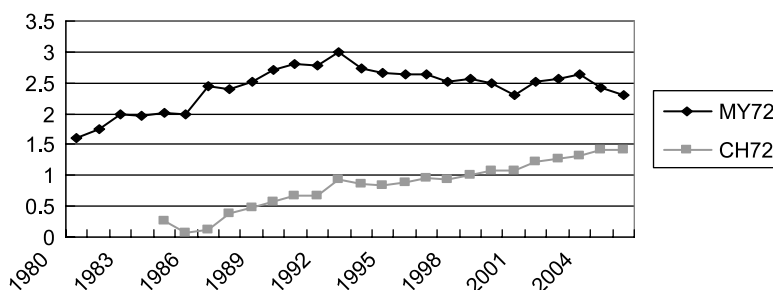
International competition will get stiffer as globalisation and trade liberalisation gather momentum (Ariff, 2005). Being competitive is relative. Although Malaysia was once considered among the most competitive countries in Asia, there has to be a realisation that other countries like China, India, Vietnam and even neighbours like Indonesia and Thailand are putting their houses in order. These countries have larger markets and better access to resources.

Take, for instance, SITC72 (Electrical Machinery), Malaysia's single largest manufactured export item. Figure 1 shows the revealed comparative advantage (RCA) for Malaysia and China. In Panel A, we note that Malaysia's RCA has not improved since 1992. On the other hand, China's has been on an upward trend since it became a player in the international economy. Panel B shows the RCA of the two countries in the US market. The declining position of Malaysia is obvious. Since the mid-1980s, Malaysia's comparative advantage has consistently dropped in the US market. In 2002, it lost its market position to China.

Figure 2 shows the results of a correspondence analysis of Malaysia's five largest export markets – the United States, Japan, Singapore, China and the Netherlands (shown in circles). The diamonds are Malaysia's competitors in these markets. Consider the US and Singapore markets. Malaysia's main competitors in these markets are China and Japan as the two countries are the closest to the two markets in the correspondence map. Similarly, Malaysia's main competitors in Japan and China are Korea, Taiwan and Thailand as these three countries are the closest to the two markets in the correspondence map. The result of the correspondence analysis underscores the challenge faced by Malaysia. On the one hand, it has to compete against China – the world's low-cost producer – and on the other it has to challenge Taiwan, Korea and Japan – countries known for their innovation and productivity. Malaysia cannot afford to bask in its former

FIGURE 1  
Malaysia and China: Revealed Comparative Advantage for Electrical Machinery (SITC72)

Panel A: RCA World

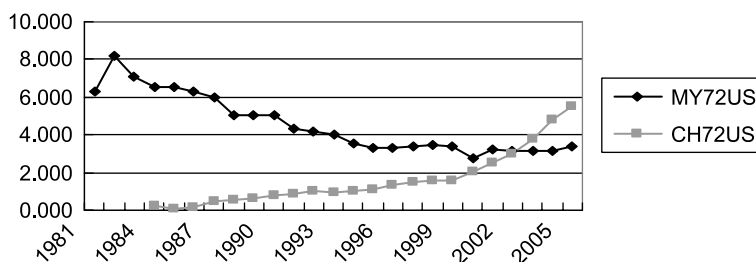


Notes:

MY72 = (Malaysia's exports of SITC72 to the World/Malaysia's exports of all goods to the World)/(World's exports of SITC72/World's exports of all goods).

CH72 = (China's exports of SITC72 to the World/China's exports of all goods to the World)/(World's exports of SITC72/World's exports of all goods).

Panel B: RCA in the US Market



Notes:

MY72US = (Malaysia's exports of SITC72 to the US/Malaysia's exports of all goods to the US)/(US's imports of SITC72 from the World/US's imports of all goods from the World).

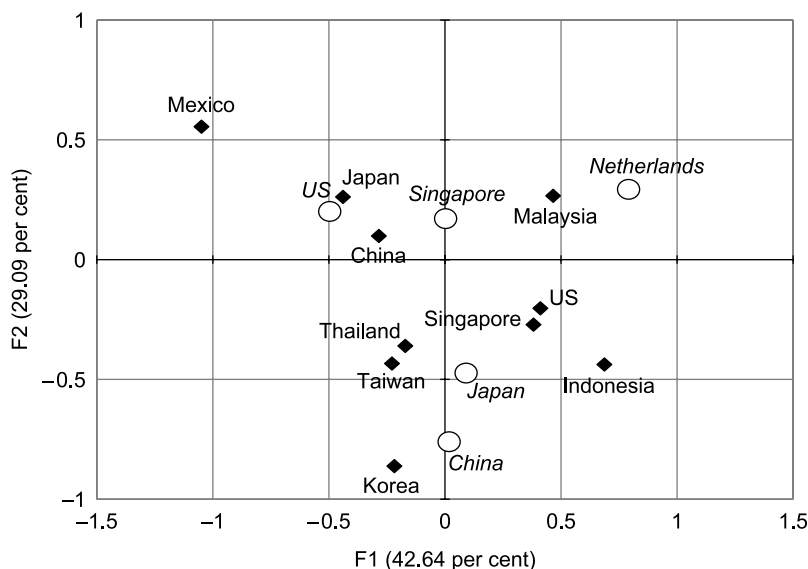
CH72US = (China's exports of SITC72 to the US/China's exports of all goods to the US)/(US's imports of SITC72 from the World/US's imports of all goods from the World).

glory. To face these challenges, Malaysia will need to re-focus its efforts into reducing the cost of doing business by increasing productivity and creating a better investment climate. These two strategies would have to be the mantra of economic policies if Malaysia is to regain its position in the world market.

### 3. REGIONAL AND BILATERAL TRADING ARRANGEMENTS

If there is one area of trade policy that has seen a major change between the last TPR in 2001 and the current one, it has to be the extent to which Malaysia

FIGURE 2  
Malaysia's Competitors in International Markets



Notes:

Malaysia's top 200 export product categories, the top 200 importers by categories, and the top three competitors in each category were obtained from the trade map developed by the International Trade Centre UNCTAD/WTO. This information showed that the USA, China, Singapore, Japan and the Netherlands ranked among the top five importers of Malaysian goods. From the list of competitors, the top nine competitors were identified. They are the USA, Indonesia, Singapore, China, Taiwan, Japan, Korea, Thailand and the Free Trade Zones. We set up a contingency table with the top five importers as the row and the top nine competitors together with Malaysia as columns. The cells are filled with the frequency counts of the corresponding competitors who ranked top three in the corresponding markets. One simple way to visualise this contingency table is to plot the information onto a bi-plot using correspondence analysis. Correspondence analysis is a method for representing data in an Euclidean space so that the patterns and structures can be visually analysed.

has been involved in bilateral and regional trading arrangements via its membership in the Association of South East Asian Nations (ASEAN). The noodle bowl (Baldwin, 2006) that Malaysia is involved in comprises 18 countries – ASEAN-9, China, Japan, Korea, India, Australia, New Zealand, Pakistan, Chile and the United States. The ASEAN Free Trade Area (AFTA) and the ASEAN China FTA (ACFTA) are perhaps the most advanced among these while other agreements are still at various negotiation stages. See Table 3 for an updated status report. Although these 18 countries account for 71.5 per cent of Malaysia's total trade in 2005, clearly some FTAs are more important than others, namely agreements involving ASEAN, the United States, Japan, China and Korea.

Two events could have precipitated the shift towards FTAs. An obvious one has to be the stalemate of the Doha Round. It must be noted that in the mid-1990s,

TABLE 3  
Bilateral and Regional Trading Agreements Involving Malaysia

<i>Partner Country(ies)</i>	<i>Agreements</i>	<i>Status</i>	<i>Proportion of Trade in 2005 (Per cent)</i>
ASEAN	a. ASEAN Framework Agreement on Services b. ASEAN Free Trade Area (AFTA)	a. Negotiations are ongoing. Mutual Recognition Arrangements (MRAs) is the most recent development which enables the qualifications of professional services suppliers to be mutually recognised by member countries, thus facilitating easier flow of professional services providers in the ASEAN region. Areas currently being negotiated and considered for possible conclusion of MRAs include Engineering, Architecture, Accountancy, Surveying and Tourism. b. Reduction of tariff was completed with exceptions by the ASEAN-6 including Malaysia in 2003.	25.24
China	ASEAN–China Free Trade Area (ACFTA)	Signed in 2002 and began to take full effect from 1 July 2005 with a complete establishment of the FTA in 2010 for older ASEAN members including Malaysia. Negotiations for FTA in services and investment are ongoing.	8.79
India	a. Malaysia India Comprehensive Economic Partnership Agreement b. ASEAN–India Framework Agreement on Comprehensive Economic Cooperation	a. Feasibility study for a comprehensive Economic Cooperation Agreement is now complete. b. Framework agreement signed in 2003, with a target realisation date of 2011 for the older ASEAN members. Though an agreement for FTA in goods was expected for January 2006, it has been delayed to January 2007 due to difficulties in defining the rules of origin clause.	1.98
Pakistan	Malaysia–Pakistan Free Trade Agreement	Negotiations ongoing.	0.003



Australia	<ul style="list-style-type: none"> <li>a. ASEAN–ANZCERTA Free Trade Agreement</li> <li>b. Australia–Malaysia Free Trade Agreement</li> </ul>	<ul style="list-style-type: none"> <li>a. Negotiations started in early 2005 with a view of completion in 2007. Agreement in non-tariff barriers, services and investment also being negotiated.</li> <li>b. Negotiations supposed to conclude in mid-2006 but difficulties remain in the areas of Government Procurement, Competition Policy and Intellectual Property.</li> </ul>	2.71
New Zealand	<ul style="list-style-type: none"> <li>a. Malaysia–New Zealand Free Trade Agreement</li> <li>b. ASEAN–ANZCERTA Free Trade Agreement</li> </ul>	<ul style="list-style-type: none"> <li>a. Negotiations have been suspended due to difficulties in the areas of services, Government Procurement, Labour and Environment.</li> <li>b. as <i>a</i> above</li> </ul>	0.34
Korea	<ul style="list-style-type: none"> <li>a. Malaysia–Korea Free Trade Agreement</li> <li>b. ASEAN–Korea Free Trade Agreement</li> </ul>	<ul style="list-style-type: none"> <li>a. FTA in goods completed in 2005. The Agreement in Services and Investment still being negotiated.</li> <li>b. FTA for trade in goods ongoing. First tranche of tariff reduction/elimination started in July 2006. Negotiations on Trade in Services to be concluded by 31 December, 2006.</li> </ul>	4.09
United States	<ul style="list-style-type: none"> <li>a. Malaysia–United States Trade and Investment Framework</li> <li>b. Malaysia–United States Free Trade Area Agreement</li> </ul>	<ul style="list-style-type: none"> <li>a. Agreement signed in 2004. Cooperation ongoing.</li> <li>b. Negotiations launched in March 2006 and expected to be completed in early 2007.</li> </ul>	16.63
Japan	<ul style="list-style-type: none"> <li>a. Japan–Malaysia Economic Partnership Agreement</li> <li>b. ASEAN–Japan Comprehensive Economic Partnership</li> </ul>	<ul style="list-style-type: none"> <li>a. Formal negotiation started in 2003 and Agreement signed in 2005. Cooperation ongoing.</li> <li>b. Agreement involves both an FTA in goods and services. Negotiations are ongoing with a targeted FTA in 2012.</li> </ul>	11.67
Chile	<ul style="list-style-type: none"> <li>Malaysia–Chile Free Trade Agreement</li> </ul>	<ul style="list-style-type: none"> <li>Negotiations ongoing.</li> </ul>	0.09

Source: <http://www.aseansec.org>