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Trade Policy Review – Malaysia 2010

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1. INTRODUCTION

THE objective with this article is to give an academic analysis and assessment of the trade policy situation facing Malaysia. The starting point for the article is the recently completed WTO Trade Policy Review (WTO, 2010a).

Trade Policy Reviews are conducted on a regular basis for all WTO member countries and applicant countries. Malaysia became a member of the WTO on 1 January, 1995. The first review for Malaysia was conducted in 1993, the last in 2005 (Ramasamy and Yeung, 2007). The present review covers the subsequent five-year period 2005–10. The objective with the Trade Policy Review Mechanism launched back in 1988 is to enhance transparency in the area of trade policy by giving an objective overall assessment of the standing of each country's trade policy regime on a recurring basis *vis-à-vis* WTO objectives of achieving global free trade (WTO, 2010b).

The article is organised as follows. We start with an introductory note to the Malaysian context of economic policy. Then, in Section 3, we give a general analysis and overview of Malaysia's trading regime. A main theme of this section is the ambiguity of Malaysia's development situation. It is argued that several of the dual economy features may be reinforced by present trade-related policies. Despite this Malaysia has diversified her export base since independence. This is a major strength and adds an important element of flexibility in terms of future avenues for specialisation. In the remainder of the paper, we explore three of the areas that are treated as potential strengths or weaknesses of Malaysia's present trade and development policies by the WTO in the most recent Trade Policy Review document to demonstrate this point.

The World Economy: Global Trade Policy 2011, First Edition. Edited by David Greenaway.

In Section 4, foreign direct investment policies are reviewed. We discuss whether the present policies and recent changes in the investment regime have been able to recast the structure of costs and benefits of hosting FDI in Malaysia. Section 5 takes a focus on a particular priority sector for Malaysia, which is tourism. We discuss whether policies to promote tourism are wholehearted. What has Malaysia done to bridge dual structures in this sector? We discuss how the Malaysian government has been quite successful in approaching tourism combining a well-designed public policy framework with the dynamic mindset of private entrepreneurs. Section 6 focuses on Malaysia's external and regional trade partners and the combined challenges of competing in the Asian region under rapidly changing conditions. A short conclusion follows in Section 7.

2. AN INTRODUCTION TO MALAYSIAN ECONOMY AND POLITICS

To understand Malaysia's economy, a few points about the country have to be borne in mind. Malaysia is a very young nation having only recently embarked on the process of nation building. Prior to the establishment of the union of the Malaysian states (which includes the 11 states of Johor, Kedah, Kelantan, Malacca, Negeri Sembilan, Pahang, Perak, Perlis, Penang, Selangor and Terengganu on the Malaysian peninsula or what is called West Malaysia, the states of Sabah and Sarawak on the island of Borneo or what is called East Malaysia and the three federal territories of Kuala Lumpur, Labuan and Putrajaya), the area that today constitutes Malaysia has been under influence of several outside invading and/or trading nations. In terms of institutions, probably the British left the largest imprint because of the adoption of the Common Law system. However, this system of laws is not being adopted without challenge from other competing systems and influences. Historically, Malaysia has been under the influence of the Muslim world for the longest period in classical and modern times. This has left a colossal imprint on Malaysian culture and traditions. Minor influences are also seen from short periods of European settlements and from a short period of communist rule.

All these influences have left an economic system that can best be described as a mélange of what is today mainly a free market economy combined with a mix of oligarchic style and state ownership. Furthermore, the ethnic makeup of Malaysia also *de facto* means a large influence from major settlers groups from Asia – especially China and India – which are estimated to make up 30 and 10 per cent respectively of the population. Malaysia also continues to be a popular destination for settlers and international workers from around the Muslim world since it is one of the economically freest Muslim countries in the world (Miller and Holmes, 2011). Indigenous Malay people are estimated alone to constitute around half of the total population. The protection of the rightful interests of the

Malay people in the midst of all these outside pressures from what we could think of as ongoing globalisation has been an important factor towards informing economic policies in Malaysia since the 1970s and until today.

Major changes for the economy now and in the future will be more because of the influence that mainland China has directly and indirectly on the Malaysian economy. Whilst linking up to the new economic powerhouse of Asia, Malaysia is also under tremendous pressure of low skilled immigrants from very poor and/or politically unstable neighbouring countries. Few places in the world do we find a scenario of such drastically opposing development circumstances. Within a radius of less than 1,000 km, we can move from countries that count amongst the poorest (Laos, Cambodia and Myanmar) to countries that count amongst the richest (Brunei and Singapore) in the world. Malaysia is exactly the bridge of these very diverse levels of economic development (Hill and Menon, 2010). This situation places unprecedented demands and constraints on economic policies.

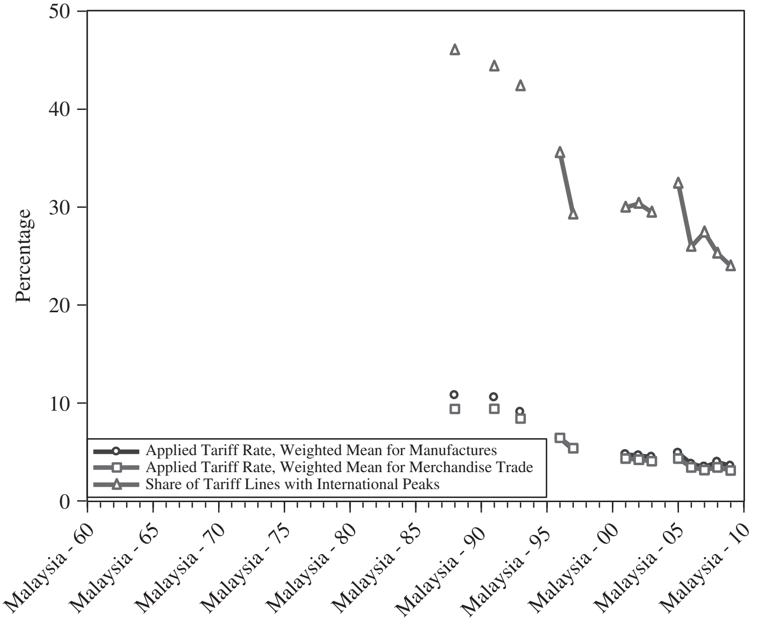
3. MALAYSIAN TRADE AND POLICY

The *de facto* trade regime in Malaysia may on the surface be characterised as highly liberal, because most instruments used are tariffs and the average incidence of tariffs is relatively low (WTO, 2010a). This is also corroborated by historical data from the WTO but administered by the World Bank as shown with Figure 1.

However, the indirect trade regime reigning in Malaysia must at the same time be classified as modestly to fairly discriminatory – if we focus on other policies that indirectly affect trade and drive a wedge between domestic and international prices (Menon, 2000; Woo, 2009). A number of such policies are in place today, the most obvious being those that affect different segments of the market for housing and cars (Malpezzi and Mayo, 1997, WTO, 2010a; Wad and Govindaraju, 2011). Indirectly a number of other markets are under similar influence such as the capital market because of the rebates or give-away shares offered to ethnic Malaysians (Woo, 2009). Another example is foreign-based banks that despite the recent reductions in requirements on ownership control operate under different rules compared with their domestic counterparts (WTO, 2010a, p. 58).

These markets function under government administered price discrimination schemes where sorting is sometimes by preferences (cars), sometimes by nationality (housing, banking) and sometimes by ethnicity (housing, investment). The practical implication of these policies is very similar to that of interventionist trade and/or investment policies. Their aim is to do away with dual economy features of the Malaysian economy, whereas in reality, they may be sustaining them. The most pronounced of these are the large differences between rural and urban, followed by differences between the foreign and domestic sectors. Both dimensions of the dual economy also have an ethnic component. These are policies that are

FIGURE 1
Average Import Tariff Rates and the Share of Tariff Lines with Peaks



Source: The World Bank, *World Development Indicators*, downloadable at http://www.data.worldbank.org.

considered in the Trade Policy Review to be of particular concern in the context of trade in Malaysia today (WTO, 2010a).

Furthermore, the various types of instruments used combined with a lack of data availability from national statistical sources on important aspects, for example export processing zones or regional economic development data, make the trading regime nontransparent. This was also noted in the recent Trade Policy Review (WTO, 2010a). Similarly, Yusuf and Nabeshima's (2009) comparative work on Malaysia shows the great lack of knowledge about industries; either industry or firm level data or both are lacking to assess the real situation of competition in the country.

Despite the above, the trading regime of Malaysia is rated as amongst the freest in the world also by international rating houses such as the Heritage Foundation (see third column in Table 1). This is because the incidence of discriminatory policies is not *de jure* but only *de facto* related with Malaysia's external border.

One of the major strengths of the Malaysian economy obtained through its continued commitment to a strong export and outward orientation in its trading environment is the diversity of the export base. Malaysia shows very few traits of a natural resource-dependent developing country today. In 1960, more than 80 per

TABLE 1
Economic Freedoms in Malaysia

Year	*Overall Score*	*Business Freedom*	*Trade Freedom*	*Government Spending*	*Investment Freedom*	*Property Rights*	*Freedom From Corruption*
2011	66.3	69.7	78.7	79.2	45	50	45
2010	64.8	69.9	78.7	81.3	30	55	51
2009	64.6	70.8	78.2	81.4	40	50	51
2008	63.9	69.3	76.2	80.8	40	50	50
2007	63.8	67.6	76.8	78.9	40	50	51
2006	61.6	68.6	76.6	75.1	30	50	50
2005	61.9	70	75.8	75.3	30	50	52
2004	59.9	70	73.4	74.2	30	50	49
2003	61.1	70	73	82.9	30	50	50
2002	60.1	70	66.6	84.1	30	50	48
2001	60.2	70	66	85.5	30	50	51
2000	66	85	68.8	81.3	30	70	53
1999	68.9	85	72.2	84.7	50	70	50
1998	68.2	85	65	85.3	50	70	53
1997	66.8	85	55	83.6	50	70	53
1996	69.9	85	67	82.7	50	70	70
1995	71.9	85	67	78.3	70	70	70

Source: The Heritage Foundation, downloadable at http://www.heritage.org.

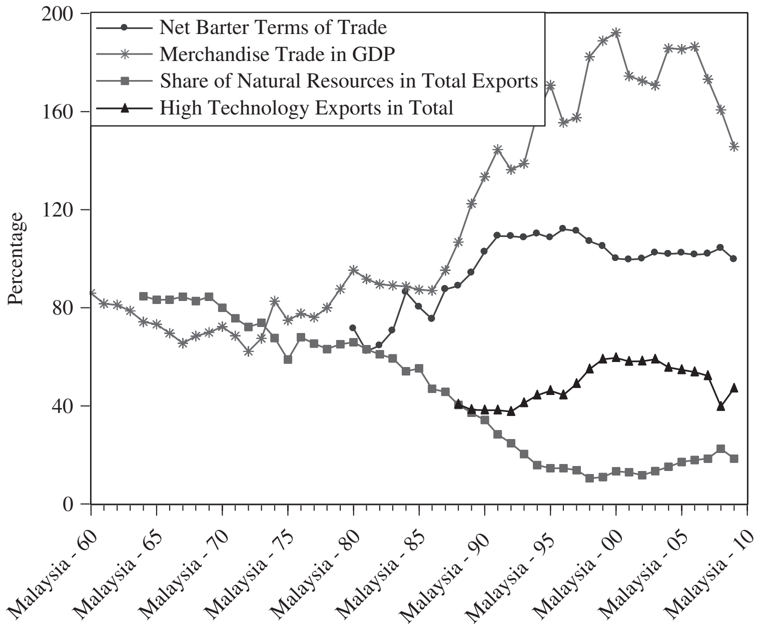
cent of Malaysia's export revenue is estimated to have accrued from natural resources as shown in Figure 2 using trade data compiled by the World Bank. Today that share has fallen to less than 20 per cent.

This shows that during the last thirty years, Malaysia has proven capable of spreading its export base towards a large variety of activities. In more recent times, there has been a rapid growth of trade in services, which today constitute around 30 per cent of total trade – well above the average for developing Europe. Whilst lacking separate series for education and health services, the available data on trade in services from the World Bank (Figure 3) show the composition of services trade on different sectors.

Financial and ICT-related service exports are minor but growing in importance, whereas travel and transport are amongst the dominant exports, which show the significance of the tourism sector to the present strength in services. Also health and education are not unimportant – estimated to be similar in significance to financial services. However, it is clear that at the moment Malaysia has a stronger revealed comparative advantage in basic services or the least knowledge-intensive types such as tourism and travel. According to the 10th Malaysia Plan (EPU, Chapter 2, p. 61, 2nd paragraph):

> The services sector is expected to remain the primary source of growth, driven mainly by the expansion in finance and business services, wholesale and retail trade, accommodation and restaurants as well as the transport and communications subsectors.

FIGURE 2
Trade in GDP, Terms of Trade and Structural Change in Trade



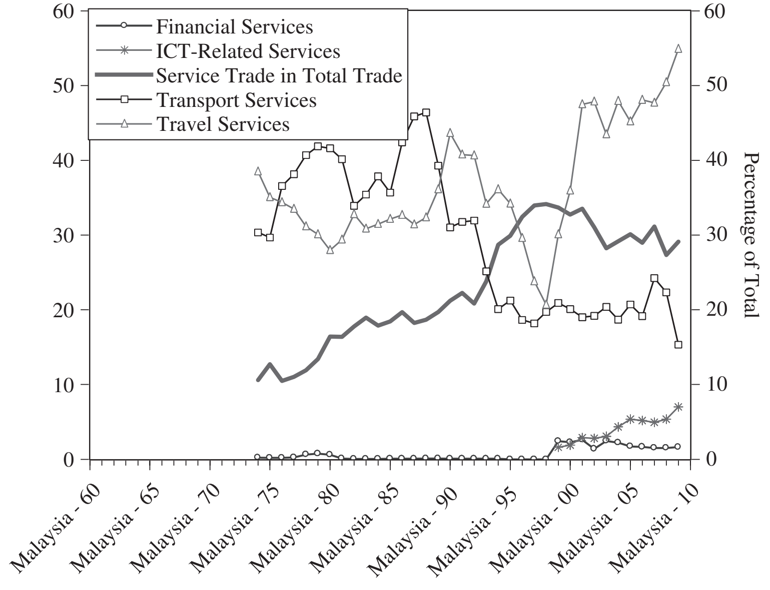
Source: The World Bank, *World Development Indicators*, downloadable at http://www.data.worldbank.org.

4. FOREIGN DIRECT INVESTMENT POLICIES

During the colonial period up until independence, Britain is believed to have been one of the largest investors alongside Japan and the United States. However, no data exist to verify this. Upon independence, foreign direct investment received less priority by the first Malaysian governments under Prime Ministers Tun Razak and Tun Hussein Onn. However, this changed and with the Investment Incentives Act of 1968 (Ramasamy, 2003), foreign direct investment along with trade started to receive greater priority. During this era, it was customary in the developing and socialist parts of the world (and this tradition continues to date in the Middle East and parts of Asia) to only invite in foreign investors under certain conditions. The first investment incentive act started an enduring tradition of discrimination between foreign and domestic held capital in Malaysia. Despite this differential and restrictive treatment of foreign investors, Malaysia has been able and especially successful during Prime Minister Mahathir's reign (1981–2003) to attract substantial FDI inflows (see Figure 4).

Foreign direct investors in Malaysia participate in production through three different types of entry modes that lead to various ownership constellations:

FIGURE 3
The Rise of Services

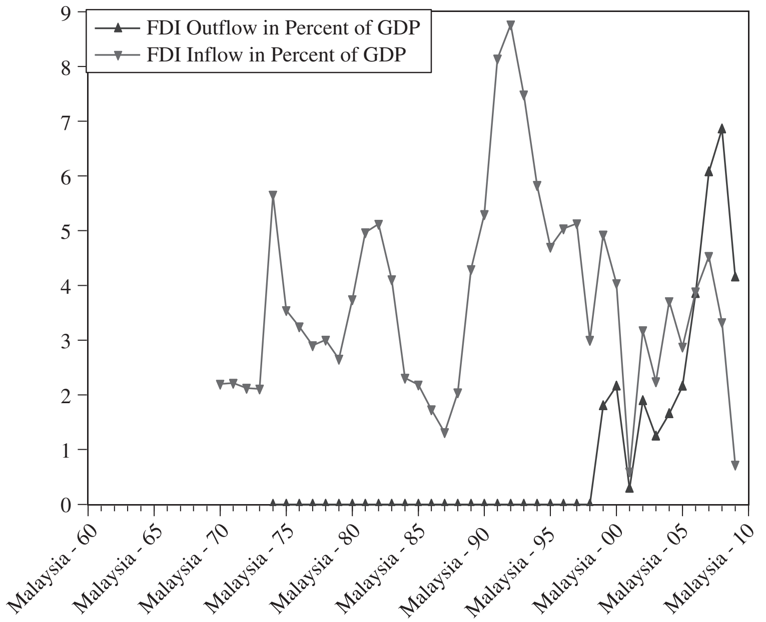


Source: The World Bank, *World Development Indicators*, downloadable at http://www.data.worldbank.org.

1. Greenfield investment or newly established fully foreign-owned subsidiaries which until recently was only the norm amongst small- and medium-sized enterprises and especially in trades or the least prioritised areas of the manufacturing sector.
2. Mergers and acquisitions in the free market which historically has made up only a minor share of FDI because of the restrictions investment policies place on this type of entry including the oligarchic nature of many of Malaysia's most important industries.
3. Joint ventures with local industrialists and/or the government (also called government-linked companies GLC). Until recently, the main share of FDI in Malaysia has been received in this form and especially in prioritised industries or in industries dominated by large market shares of local industrialists and/or the government.

However, the end of the Mahathir period and the Asian Financial Crisis also coincided with a new economic era in the world and especially in the perspective of developing Asian and European countries. Two factors have changed upon the entry into the twenty first century. One is the rise of China as an economic power that has a strong impact on both the European and Asian regions.

FIGURE 4
Foreign Direct Investment Trends



Source: The World Bank, *World Development Indicators*, downloadable at http://www.data.worldbank.org.

Potentially, this rise has both a trade and investment diverting and creating effect on Malaysia. How much diversion and creation that takes place *de facto* now depends a lot more than in the past on the conduct of policies in Malaysia. Second, with economic transition and new economic policies becoming the fashion, Malaysia is facing a lot more competition from neighbours that also try to attract FDI. The niche that Malaysia occupied in the past as unusually outward oriented, more developed, more skilled and English speaking compared with her neighbours whilst still very cost competitive is no longer as unique as it was 20 years ago.

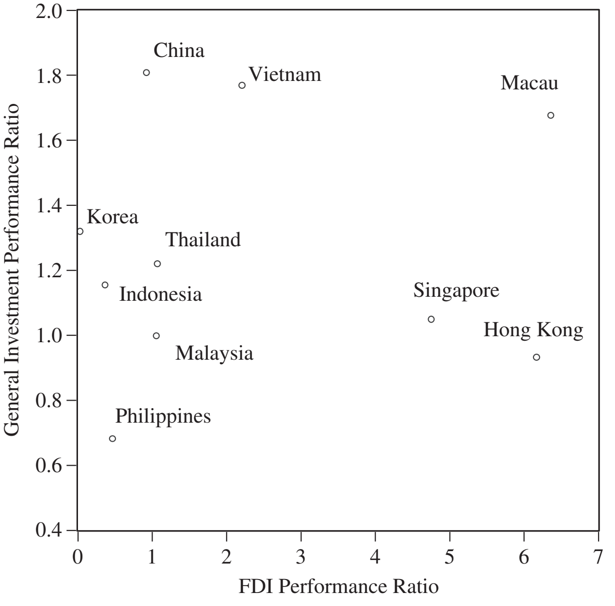
These new circumstances have led to a new direction of policies in particular to foreign direct investment which we could call revisionist. There is awareness that the previous discriminatory policies may no longer be viable and that more liberalisation is necessary to maintain interest amongst foreign investors. Not least because of the vision of Malaysia graduating to become a high income economy by 2020 (EPU, 2010), that is based on resources such as skills and knowledge rather than natural resources or capital intensive industries. This has led to significant revisions of the joint venture laws, opening up of more sectors for Greenfield investment and fully foreign-owned subsidiaries (Rasiah and Govindaraju, 2011). The intention behind these changes is at least two-fold – to gear up again the inflow of FDI and to attract FDI into more skill and knowledge-intensive sectors. The 2020 vision of Malaysia is unlikely to be achieved without transfer of technologies from abroad that are not readily available from the 'shelf' to be purchased such as imports, royalties or licences. Furthermore, the red figures on Malaysia's technology balance of payments indicate that upgrading will be too expensive and perhaps also quite ineffective without participation of foreign capital.

This new direction for FDI policies may not lead to the desired results for at least three reasons (Figure 4). First, the changing laws are in a period of disarray – institutions may be changing, but the implementation and enforcement of new laws may take at least a decade to trickle down through the government system (O'Shannassy, 2011), that is, if the act in itself of implementing change does not receive greater priority by the government administration. The lack of freedom in terms of property rights and lack of freedom from corruption as reported with the Heritage Foundation's sub-indices (see Table 1) are in particular alarming from an investor perspective. These factors are more important for investors in the high value-added end of most industries and hence the type of investors that Malaysia now needs to attract. Second, the changes compared with other reforming economies of the last two decades are still modest and may not be as persuasive to potential foreign investors as they could be. Finally, the reforms may not be as effective as one could hope especially because of the lock-in created by established market shares, the oligarchic nature of many industries including quite restrictive investment laws when it comes to floating and thereby opening up for trading of existing Malaysian companies quoted on the stock exchange.

This new policy context can perhaps be better understood with data on annual foreign direct investment flows to (inflows) and from (outflows) Malaysia as shown in Figure 4. The recent downturn in FDI inflows, which notably has been accompanied by a significant rise in outflows, may have a number of different explanations that would confirm or affirm the hypothesis that the revisionist period so far has not been able to recast the cost and benefits of FDI in the way the government hopes – even though this may also be too early to evaluate.

The most popular explanation is that the decline in FDI has its roots in the financial crisis of the last decade and the more recent 2008 crisis. No doubt this has been an accompanying factor. However, it refutes the fact of the reverse and quite strong trend in outflows, which is a recent phenomenon. A somewhat competing explanation is that Malaysia's situation mirrors a capital flight scenario that has its roots in the general deterioration of the investment climate over the past two decades (Table 1 and Woo, 2009). However, this explanation is also

FIGURE 5
Malaysian Investment Performance Compared, 2007



Source: The World Bank, *World Development Indicators*, downloadable at http://www.data.worldbank.org.

problematic in view to the fact that outward FDI is mainly in natural resource intensive industries and often undertaken by GLCs from Malaysia such as Petronas' investments in Africa (Rasiah and Govindaraju, 2011).

The most likely explanation is the rise of a number of competing destinations for FDI in the region (such as Vietnam). This is currently reducing inflows and also attracting some outflows from Malaysia even though they do not concern major government sponsored projects. For example, some Chinese–Malay investors are shifting their labour-intensive projects to Vietnam. Figure 5 shows a plot of the so-called FDI performance ratio as proposed by the UNCTAD team behind the *World Investment Report* UNCTAD, 2009). The data shown are for 2007, as the 2008 and 2009 data were deselected because of the impact of the financial crisis on the series. This index shows the extent to which an economy in successful in attracting FDI against the world average and weighted by the size of the economy. The same index was calculated for general investment performance, which turns out simply to be the investment rate divided with the global average investment rate. Countries that score low on both indices and hence lie close to the origin are global underperformers in generating overall investment and also therefore have difficulty attracting FDI – for example, more because of their general business climate than because of particular laws favouring or disfavouring foreign investors. Countries that lie along the y-axis are the independent investors that rely less on FDI flows. Most likely these countries apply strict controls on FDI but have a good investment climate otherwise. Countries that lie along the x-axis are the maturing economies that experience a levelling out of their capital build up but who rely extensively on FDI inflows and conduct open-door policies. Countries furthest out in the diagram are the best performers in terms of combining a good general investment climate with open-door policies.

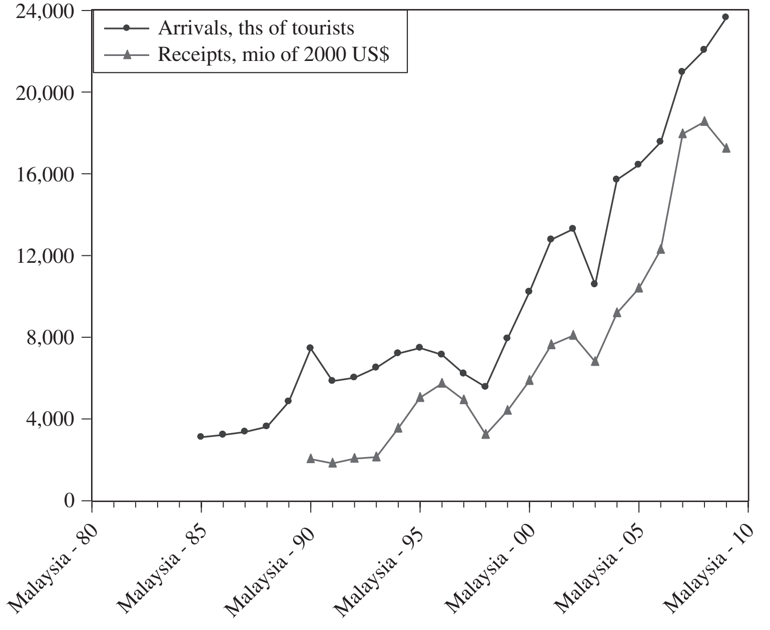
A likely complementary explanation of the downturn is the shift towards an emphasis on services that are much less capital intensive in terms of investment per job or income generated. Another and also likely complementary explanation is that whereas the market in Malaysia for FDI perhaps is much less driven by free or open-market operations in terms of buying up existing companies, still the joint venture-based deals have their natural limitations as there is a limited amount of partners especially in oligopolistic industries. Finally, (and difficult to evaluate without additional information) is the role that the Economic Processing Zones played in the past towards generating FDI and today towards retaining FDI. At least the role of these zones seems *passé* or outplayed in terms of generating FDI into new sectors and activities such as service and knowledge-intensive value-added activities. It remains to be seen whether the revisionist policies to date are sufficient to realise the visions they entail.

5. TOURISM AS TRADE IN SERVICES

Tourism in Malaysia is one of youngest and fastest growing industries contributing positively to the trade balance. Mass arrivals have only taken place since the late 1990s (see Figure 6). In the very early days of independence, the tourism sector was not recognised as important to economic development. It was not until the mid-1960s that it became recognised as a vital sector. Malaysian governments during the 1970s decided to invest more by improving infrastructure networks for instance highways, airports, the condition of tourist attractions in each state, funding various tourism projects, creating peace and security and launching the first marketing and promotional activities.

To solidify the sector, the government also established several organs to make it perform to its fullest potential. These are the Tourism Development Corporation (TDC) and Ministry of Culture and Tourism (MCT). The success of the sector started to be recognised when the government developed the first National Tourism Policy (NTP) in 1992. Apart from NTP, other tourism-related policies were developed, amongst them the National Eco-tourism Plan of 1996, the Rural Tourism Master Plan of 2001 and currently the government has adopted the 2nd NTP that was established for the years 2003–10 (Hamzah, 2004).

FIGURE 6
Tourism Arrivals and Receipts



Source: The United Nation's World Tourism Organisation, *Tourism Factbook*, partially downloadable at http://www.unwto.org.

The tourism sector is subject to three forms of government and hence fairly decentralised in terms of decision-making powers. The Federal Government has the duty of overseeing all planning activities carried out by the Ministry of Culture Arts and Tourism (MOCAT) and collecting tourism revenues generated from these activities and subsequently channelling them back through an equitable scheme of tourism development towards all the states in Malaysia (Hamzah, 2004). Another major task of the Federal Government is to oversee and carry out marketing campaigns at the national level. The main responsibility of State Governments is to deal with formulating tourism development policies. The local authority or municipality is the lowest form of the government that has the task of actual planning, carrying out programmes and undertaking local marketing of the tourism sector.

The task of marketing and promoting Malaysia as a destination is left with the Malaysia Tourism Promotion Board (MTPB), a government organ that was established under the jurisdiction of Malaysia Tourism Promotion Board Act (1992). Malaysia has been using different promotional strategies to attract both domestic and international tourists.[1] The emphasis on the domestic segment of the market is relatively unusual for a country such as Malaysia and has received increasing priority over time with the realisation that the domestic market serves as an important stabiliser of the sector.

Today tourism is the second sector for generating foreign currency after the manufacturing industry. It is estimated that the contribution of tourism revenue to GDP in 2009 was 8.2 per cent (Tourism Malaysia, 2009). Because of the abundant tourist attractions, the World Tourism Organization ranked Malaysia as the third most popular tourist destination in the Asia Pacific in terms of generating more foreign visitors.

The increase in the number of visitor arrivals has gone hand in hand with a major increase in foreign exchange earnings from tourism. The global financial crisis merely led to a levelling out in receipts. By comparison, many other leading tourist destinations have experienced large drops in both arrivals and receipts in 2008 and 2009. Tourist arrivals from Asian countries in 2009 were reported to have increased the most by 31.5 per cent in Malaysia, whereas the non-Asian markets exhibited a negative growth of 1.5 per cent in the period 2008–09. In terms of employment generation, the sector is estimated by the World Travel and Tourism Council (WTTC, 2011) to contribute a total of RM 56.9 billion to the Malaysian economy equivalent to 7.2 per cent of total GDP in 2011. The sector is estimated to generate 768,000 direct jobs in 2011.

Apart from the international travel market, the domestic travel market has also started to perform very well. This market emerged after the Gulf war, bird flu and the Asian financial and economic crisis in the 1990s. After intensive promotional activities, Malays started travelling more frequently within their own country. Because of the limitations of observing domestic tourism activities without the frequent usage of surveys, the performance of the domestic market is perhaps best reflected by data on hotel occupancy rates. This is shown in Table 2. Occupancy rates reveal the relative size, importance and increase in the domestic market segment for the Malaysian tourism sector.

[1] Among these marketing strategies are the 'stay home', 'Malaysia truly Asia', 'Malaysia My second Home', 'Visit Malaysia 2007', 'Fabulous Food 1 Malaysia', 'Cuti-Cuti 1 Malaysia', 'Malaysia Mega Sales' and 'MyCEB'. Other promotional events used to market tourism are the Formula One Petronas Malaysia Grand Prix Championship and Le Tour De Langkawi (Tourism Malaysia, 2008). Apart from the above strategies other promotional campaigns used to market the sector are the use of sales mission and visits, the development of an overall affordable tourist package, participating into various local and international trade fairs for example Arab Travel Mart in Dubai, New Delhi, Berlin, Milan, Moscow, Australia and so forth, seminar and workshop participation, use of media (Newspaper, Television), online resources (e-newsletter, e-brochures, ministry's website information), etc. As a result of the intensive promotional marketing campaigns Malaysia's tourism sector has grown at an estimated annual rate of 5–7 per cent over the last 10–15 years.

TABLE 2
Hotel occupancy rates by main market and state, 2007–09

State	*Domestic (Share)*	*Foreign (Share)*	*State (Share)*	*Change 2007–09*	*Total 2009*
Perlis	84.7	15.3	0	−1.7	102,547
Kedah	49.5	50.5	6	−7.5	3,846,529
Penang	50.0	49.9	9	7.5	5,960,329
Perak	78.2	21.7	6	1.8	2,523,029
Selangor	33.0	66.9	3	−12.7	2,839,229
Kuala Lumpur	42.1	57.8	20	−2.6	15,737,306
Putrajaya	44.6	55.3	0	3.2	181,104
Negeri Sembilan	66.3	33.7	3	−0.7	1,602,804
Melaka	46.9	53.1	5	8.1	3,759,515
Johor	54.7	45.3	6	−3.3	3,525,991
Pahang	61.4	38.5	18	15.5	9,652,909
Terengganu	85.3	14.6	3	2.2	1,219,127
Kelantan	89.9	10.0	2	−0.2	847,343
Sarawak	72.2	27.7	9	−4	3,908,815
Sabah	52.8	47.2	9	−6.5	5,362,270
Labuan	59.3	40.7	1	−6.6	294,549

Source: Tourism Malaysia (2009).

Over the last decade, the Malaysian government has successfully rebalanced the growth of the tourism sector towards a more sustainable pattern in the midst of international instability. That proved vital for the continued performance and survival of many establishments during the recent crisis. Even though the sector is performing well, it is also over capacitated in terms of number of hotel rooms and in particular in the federal territory of Kuala Lumpur. The data on occupancy rates help reveal this dimension. The dispersion of tourism activity is quite high, and the sector does not only have a significant impact on the more metropolitan and foreign dominated parts of the economy. Hence, we would rate it as one of the most successful sectors in Malaysia in terms of generating economic sustainability overall – that is securing simultaneously goals of growth, stability and equity.

6. TRADE PARTNERS YESTERDAY, TODAY, TOMORROW

For a country such as Malaysia, there is an ongoing discussion as to who are and should be the natural trading partners. As in many other developing and transition economies, the present day trade partners are not only dictated by ‘natural’ economic forces but also by history and established traditions and linkages. This being said, Malaysia today would appear to be rapidly converging onto a rather

TABLE 3
Trade Partners in Merchandise Trade and Tourism Services, 2009 (1999)

Partner Region/Country	*Merchandise Trade*		*Tourism Services*	
	Imports, %	*Exports, %*	*Imports, %*	*Exports, %*
ASEAN	25 (25)	26 (24)	61	80
Singapore	11 (14)	14 (17)	11	54
Thailand	6 (4)	5 (3)	26	6
Indonesia	5 ()	3 (1)	18	10
Vietnam	2 (0)	1 (0)	2	–
Philippines	1 (3)	1 (2)	1	2
Brunei	0 (0)	0 (0)	1	4
Asia	68 (63)	69 (56)	91	90
China (greater)	20 (11)	20 (12)	25	4
Japan	12 (21)	10 (12)	1	2
India	2 (1)	3 (2)	2	2
Australasia	2 (2)	4 (13)	3	2
European Union	12 (12)	11 (16)	7	5
Germany	4 (3)	3 (2)	–	–
France	2 (2)	1 (1)	–	–
United Kingdom	1 (2)	1 (4)	2	2
NAFTA	12 (18)	12 (23)	1	2
United States	11 (18)	11 (22)	1	–

Source: United Nations Conference on Trade and Development, UNCTADstat, downloadable at http://www.unctadstats.unctad.org and UNWTO World Tourism Factbook.

natural set of trading partners. In terms of merchandise trade, 70 per cent is within its own region – which is very similar to the within region trading frequency of other regions such as Europe (Hill and Menon, 2010).

China (including Hong Kong, Taiwan and Macau) and Singapore are the largest trading partners – where processing and distributive trades within and between the Chinese territories must be expected to continue to be the driving engine of Malaysian trade in the foreseeable future. Within Asia, the ASEAN neighbours constitute as a group, the second largest trading partner. Besides China and ASEAN, other important partners include Japan, Korea and Australasia. Outside Asia, the European Union and the US (NAFTA) contribute equally with around 11–12 per cent each. The rest of the world, including Latin America and Africa, are only minor trading partners. These figures are summarised in Table 3. When comparing 2009 data with that a decade ago (not available for services), we observe a quite rapid shift away from the Western Hemisphere towards Asia because of the rising importance of China and the Asian region as a whole. For Malaysian industries, this shift has not been unimportant and is perhaps one of the underlying factors behind the faltering levels of investment in particular in manufacturing (Woo, 2009).

In terms of service trade partners – where we rely on tourist arrivals from different countries as a proxy here – it is clear that proximity plays a much greater role for the development of this type of trade. According to these figures, Asia accounts for up to 90 per cent of all service exports, and the neighbouring ASEAN countries are dominant partners with 80 per cent of total exports. Necessarily, there is a bias in these figures because of the role of Singapore–Malaysia border trade. However, this bias may not be less important for merchandise trade because the Malaysian trade data are so heavily inflated by processing trade that does not involve a major value added component (see Maurer and Degain, 2010). Hence in a comparative perspective of the two types of trade, proximity does play a much greater role in services trade. This is of course not surprising because of the special characteristics of services and the fact that many are difficult to deliver over a great distance (e.g. they have to be consumed at the point of production and cannot be stored for later consumption). Similarly, whereas traditional trade with western countries is of the inter-industry type (EC, 2008), manufacturing trade with neighbouring countries is much more likely to have a great potential in intra-industry type of exchanges.

Hence, with the rise of China and the Asian region, there is a constant pressure on Malaysia to reorient and upgrade its trading patterns. With increasing competition follows a change in activities and with a change in activities follows also a change in who are the most important partner countries. With the shift of manufacturing industry towards China, there has been a great shift in processing and distributive kinds of trade. With the shift towards services in Malaysia and rising affluence, there has been an equal shift in particular towards making ASEAN countries much more attractive trading partners. This also shows how much a reorientation towards the domestic market makes sense for developing products, because domestic consumers are more representative of what the future main markets want and can afford. These trends must be expected to continue, and Malaysia should therefore try to make the most of trade agreements with these two important spheres of influence.

7. CONCLUDING REMARKS

Since independence, the Malaysian economy has developed rapidly towards a modern, free-trading nation that relies on a very varied composition of both manufactured exports and services trades involving a multiplicity of partners. Notable over the last decade is the rising importance of services where we have focused on a relatively labour-intensive service activity such as tourism as an example of one of the most successful industry cases over the last two decades. Another trend that may be of importance is the gravitation towards a much greater reliance on her own region for future trade developments. Overall, Malaysia has navigated very successfully under the guidance of the WTO to achieve a prominent status as one of the freest trading nations in the world today.

But whilst emphasising a liberalised trading regime, the government has paid less attention to the accompanying importance of liberalising the investment climate. The Trade Policy Review shows that the government since the beginning of the new millennium has taken significant steps in the area of foreign direct investment towards opening up for free, less regulated flows subject to a lesser degree of discriminatory measures in terms of distinguishing groups of investors such as those of domestic and foreign origin. However, we also discussed how these steps may be less successful in part because they do not go all the way towards abolishing all discriminatory measures and also there is a lack of targeting of general barriers and impediments to investment. Trade without investment makes little sense since investment paves the way for production and the value adding activities on the basis of which all gains from trade derive (Bhagwati, 2011).

At the same time, Malaysia should be praised for being a cautious reformer in times of great crisis, uncertainty and volatility. Despite the wellknown disadvantages of taking gradual steps according to the theory of second best, gradualism allows for constant learning and adjustment on the reform path. For gradualism and informed feedback to work, there is a greater need than ever for better data gathering and intelligence in Malaysia about the economy to inform policy makers. A great danger of gradualism that must also be avoided is that too little progress will be achieved – perhaps the essence of the problem of the middle income growth trap that many of the developing or emerging nations find themselves in today (Woo, 2009). Hence development and in particular investment policies may now be slowing too much behind the harsh realities of competing in the world economy. A good example is the free trade zones that might have worked well in the past but are not suitable instruments of development policy in a service and knowledge-based economy. The accompanying free-trade policies are in place, but to really work to full potential, they need to work in tandem with investment policy.

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