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TRADE POLICY REVIEW

MALAYSIA

Report by the Secretariat

This report, prepared for the fourth Trade Policy Review of Malaysia, has been drawn up by the WTO Secretariat on its own responsibility. The Secretariat has, as required by the Agreement establishing the Trade Policy Review Mechanism (Annex 3 of the Marrakesh Agreement Establishing the World Trade Organization), sought clarification from the Government of Malaysia on its trade policies and practices.

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Document WT/TPR/G/156 contains the policy statement submitted by the Government of Malaysia.

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(1) ECONOMIC ENVIRONMENT

1. Trade and trade-related policies remain integral parts of Malaysia's broad economic development strategy, whose key objectives are economic growth sufficient for the attainment of developed country status by 2020 and an equitable distribution of the resulting wealth. Hence, during the period under review (2001-05), Malaysia has continued to liberalize its policies on international trade and foreign investment. Indeed, imports and exports of goods, respectively, were on average equivalent to 86% and 110% of GDP during that period. Inflows of foreign direct investment (FDI), although down from the high level of 7% of GDP between 1990-97, were still around 3% of GDP during the period 1999-04, a level more in line with the world average.

2. As a consequence of its openness to trade together with prudent macroeconomic and structural reforms in key areas, it looks as if the Malaysians economy has now fully recovered from the Asian financial crises in 1997-98. Growth in real GDP, after slowing to 0.3% in 2001, owing to a contraction in exports, rebounded to 4.4% in 2002, 5.4% in 2003, and 7.1% in 2004. At the same time, both unemployment and inflation have remained low during the period under review, with unemployment at around 3.5% and inflation within the 1-2% range. Real GDP growth for 2005 is expected to consolidate at 5%, due to slower world growth and trade activities, the downward trend in the global semiconductor cycle, higher imported inflation arising from relatively higher world oil prices, and lower prices of commodities, particularly palm oil, Malaysia's main agricultural export.

3. Malaysia's current account surplus widened from 8.3% of GDP in 2001 to 12.6% of GDP in 2004. The current account position is due to merchandise trade; Malaysia has a persistent deficit on invisibles trade.

4. With the exchange rate pegged to the U.S. dollar (until July 2005), thereby limiting the scope for independent monetary policy, compensatory fiscal policy sustained Malaysia's growth momentum between 2001 and 2003 in the face of softening global demand and uncertainties created by the 11 September attacks, the war in Iraq, and SARS. In the process, federal government debt rose appreciably, albeit from relatively low levels. Post-crisis reforms to restructure the financial sector and clean up balance sheets have been almost completed and the financial and corporate sectors have been strengthened. Restrictions on foreign exchange transactions were lifted gradually and the liberalization of the trade and investment regime has continued. In July 2005, Malaysia abandoned its currency peg against the U.S. dollar and replaced it with a "managed float" system based on a basket of currencies. This marked the end of almost all of the capital controls that had been established in September 1998 in the wake of the Asian financial crisis.

5. Malaysia's economic slowdown earlier in the period under review highlighted the problems associated with over-reliance on an export-led growth strategy, particularly in electrical and electronic products and the consequent vulnerability to industrial countries' business cycle. To address this issue, measures have been taken to develop new sources of growth, whereby agriculture, resource-based industries, high-technology manufacturing and services have been given higher prominence in order to improve the economy's competitiveness and resilience to shocks.

(2) TRADE POLICY REGIME: FRAMEWORK AND OBJECTIVES

6. There has been little change in Malaysia's trade-related institutional framework since its last Review. Malaysia has continued efforts to liberalize its relatively open trade and investment regime. In the WTO, Malaysia has implemented its Uruguay Round commitments, has unilaterally lowered tariffs in its annual budget exercises, and is *participating actively in the Doha Development Round.*

7. One notable feature of the review period is that Malaysia has joined the trend in the south-east Asian region of seeking closer economic relations at both the regional and bilateral levels. Thus, in addition to moving with its ASEAN partners towards achieving a single market by 2020 and full participation in the APEC forum under its 2004 Individual Action Plan, Malaysia, since the WTO's Fifth Ministerial talks in 2003, has been actively seeking bilateral free-trade agreements, with an important investment component, with Australia, India, Japan, Korea, New Zealand, and Pakistan. Through ASEAN, it is participating in regional free-trade and investment negotiations with Australia/New Zealand, China, India, Japan, and Korea. It has also signed a trade and investment framework agreement with the United States. The Malaysian authorities maintain that existing as well as planned bilateral and regional free-trade agreements are consistent with, and complement, the multilateral framework for trade negotiations. Although, negotiation of a number of ASEAN-wide as well as bilateral agreements could increase competition in Malaysia, such agreements also raise issues of uniformity and consistency as well as trade diversion. These FTAs could erode the competitive position of suppliers with MFN access to the Malaysian market.

8. In terms of investment liberalization, equity holdings in all new manufacturing projects have been fully liberalized; foreign investors can now hold 100% equity in all investments in new projects as well as expansion/diversification projects. Malaysia has also relaxed its guidelines to provide greater flexibility for foreign equity participation in local firms; for acquisitions by Malaysian and foreign interests, the only equity condition is to maintain at least 30% bumiputera equity. Sectors deemed strategic, such as broadcasting, water and energy supply, banks, and health, however, are still limited to 30% foreign equity participation.

(3) TRADE POLICIES AND PRACTICES BY MEASURE

9. During the period under review (2001-05), Malaysia's economy has remained relatively open to trade and foreign investment. The tariff continues to be the main border measure affecting imported goods and accounted for 5.4% of overall tax revenue in 2004. Over one third of tariff lines remain unbound and the considerable gap between bound and applied tariffs creates a degree of unpredictability for traders in the sense that there is significant scope for the authorities to raise tariffs. However, applied tariffs have come down in successive annual budget exercises to an MFN average applied rate of 8.1% in 2005, compared to 9.2% in 2001. Patterns of MFN tariff dispersion and escalation have changed little since 2001.

10. Imports are generally treated in the same way as domestically-produced goods as regards excise duty; an exception concerns the rebate of excise duty for national car manufacturers. Approximately 27% of Malaysia's tariff lines are subject to import licensing, a substantial part of which appears to be non-automatic. This would seem to provide the authorities with scope for administrative discretion to encourage or discourage certain types of activity. In particular, the Ministry of International Trade and Industry (MITI) oversees a system of approved permits that allows the holder to import foreign-built or assembled cars and distribute them locally; this can act as a quota, restricting the total number of cars that can be imported. Malaysia has become quite an active user of contingency measures, initiating 17 anti-dumping actions during the review period, and has been the target of 26 investigations. Malaysia is also planning to develop safeguard legislation.

11. Malaysia has phased out all remaining trade-related investment measures as well as local-content requirements in the automotive industry. The Government continues to be an important purchaser of goods and services, with the government-

procurement market equivalent to 20% of GDP in 2004. Preferential government procurement procedures continue to favour locally owned businesses, especially for smaller amounts. International tenders are invited only if goods and services are not available locally. The Government also affects procurement and supply of goods and services through its extensive ownership of enterprises. Malaysia is not a party to the WTO Plurilateral Agreement on Government Procurement.

12. Export duties and export licensing measures play a role in Malaysia's industrial policy. Export taxes and extensive licensing arrangements are applied to certain exports such as timber, which has the effect of discouraging the export of those goods and reducing their domestic prices. The aim of such measures, according to the authorities, is to foster the development of downstream industries, which provide value-added content. In 2001, 36% of Malaysian tariff lines were subject to export licensing requirements and in 2005 the situation appears to be similar. At the same time, export assistance is provided through various measures, including: import duty exemptions/drawbacks, tax relief, concessionary credits, insurance, and guarantees, as well as government-sponsored promotion and marketing assistance.

13. Standards activities have been recognized as one of Malaysia's priorities to achieve developed nation status by 2020. Malaysia aims to align Malaysian standards with international standards and, as of May 2005, some 51% of Malaysian standards were so aligned, up from 35% in 2001. Malaysian standard setting committees choose international standards as the primary option in revising standards and creating new ones; about 80% of around 350 standards adopted annually are aligned. Malaysia's role in the development of halal certification, earned the citation of the UN Codex Alimentarius Commission of Malaysia as the best global example for halal food production. This reflects the objective of the Government to develop the country as a hub for halal food products.

14. Tax incentives have long been an important instrument of Malaysia's economic development strategy. They apply to investments in manufacturing, agriculture, tourism and approved services as well as R&D, training, and environmental protection activities. No estimates are available concerning total tax revenue forgone as a result of the tax incentive schemes. The Malaysian system of tax incentives may not necessarily be leading to improved investment performance. The publication of estimates of tax revenues forgone would improve fiscal transparency in Malaysia and contribute to a more effective tax policy.

15. The Malaysian Government has strengthened its intellectual property regime. It has sought to improve the enforcement of intellectual property rights, in particular to curb infringement of copyrights and trade marks. The Malaysian authorities maintain that they have had considerable success in eradicating optical disc product piracy, although piracy would seem to remain a problem along with counterfeiting.

16. Malaysia does not have a comprehensive competition law, but set itself the target of a drafting a broad competition law by the end of 2005.

17. The authorities have focused on the improvement of corporate governance, essential for an efficient capital market capable of mobilizing and channelling savings into the most productive investments. Requirements for companies to be listed on the stock exchange have been revised, the Capital Markets Master Plan was established in 2001 to set out the strategy for reform, and government-linked companies (GLCs) are being restructured.

18. The State continues to have a strong presence in most sectors of the economy, mainly through over 40 listed and non-listed GLCs, with combined assets equivalent to *more than half of Malaysia's GDP. Some of the biggest GLCs are Petronas (oil and gas), Tenega (power), Malaysian Airlines, Proton (the car company), and Telekom Malaysia. Recent steps to reform these companies are part of a broader effort to improve the transparency and performance of GLCs through the introduction, inter alia, of key performance indicators and performance-linked compensation for their managers. The objectives are to create a more arms-length relationship between the State and GLCs, make them more independent and commercially oriented and encourage greater private investment in the GLCs.*

(4) TRADE POLICIES BY SECTOR

19. During the review period, competition has intensified for Malaysian industries as domestic barriers are dismantled through bilateral and regional FTAs and through WTO negotiations, and as low-wage countries, especially China, erode Malaysia's competitive advantage in unskilled, labour-intensive manufacturing. Competitive pressures are moving the Malaysian economy to the upper end of the value-chain, producing knowledge- and technology-intensive goods as well as supplying services. In 2001, the Third Outline Perspective Plan and the Eighth Malaysia Plan emphasized the Government's commitment to moving from an input-driven to a knowledge- and productivity-driven economy in order to generate sustainable economic growth and maintain competitiveness. A significant challenge in this regard is the speed at which new domestic sources of growth can be found, which depends considerably on the gains in total factor productivity (TFP). In 2001, this was projected to grow at an annual rate of 2.8%, but was substantially lower, at 0.8% for the period 2001-03. It was expected to return during 2004-05 to around 1.7%, more in line with Malaysia's historical experience.

20. The Government is promoting domestic and foreign investments in selected subsectors, notably high-technology manufacturing, ICT, biotechnology, education, and tourism, with the aim of developing products in new areas of growth.

21. The most important agricultural activities are production of food commodities and of plantation crops for international markets, led by palm oil, rubber, and timber. To promote the development of agriculture, which accounted for 7.5% of gross exports in 2004, the Government is focusing on increasing productivity and competitiveness through higher value-added activities and utilization of modern technology. In particular, current development expenditure is focused on agriculture and R&D in halal products is being actively promoted.

22. The manufacturing sector has long been the catalyst of growth. Malaysia, one of largest exporters of semiconductors in the world, is now climbing the value chain to move its electronics industry from commodity chip-making to testing and design in order to stay ahead of competitors. Generally, however, Malaysia's export orientation may be more difficult to sustain as an increasing number of countries pursue export-led economic growth. Despite heavy protection over the years, Malaysia's domestic car makers, and notably Proton, have seen their market share decline as the Malaysian car market becomes increasingly open. With the 2008 deadline for liberalization of the automotive sector drawing nearer, some segments of the industry may have to restructure to achieve international competitiveness.

23. Services accounted for some 60% of GDP in 2004. In general, the services sector is not yet as open to trade as agriculture and manufacturing, due perhaps to restrictions on foreign direct investment. The Government has identified services as one of the key drivers of economic growth, with the focus on selected industries, including tourism, health, education, Islamic finance and information and communications technology (ICT)-related and manufacturing-related services. Tourism has become Malaysia's most successful service sector and has increased in importance as a *source of economic growth. Negotiations at regional and global level to liberalize trade in services offer both challenges and opportunities for Malaysia's relatively protected sector in terms of the need to increase competitiveness. In financial services, for example, Malaysia has sought to boost the competitiveness of locally owned financial institutions, through measures to enhance consolidation and mergers, in anticipation of increased competition from foreign-owned financial services providers.*

(5) OUTLOOK

24. Healthy foreign exchange reserves, a relatively small external debt, as well as financial and corporate sector restructuring have strengthened the economy and its resistance to external shocks. Nonetheless, the economy remains vulnerable to downturns in key markets. The near-term outlook is favourable with real GDP growth projected to moderate to 5% in 2005 and 5.5% in 2006 in line with global trends. The main concern is lower than anticipated growth in the external demand for Malaysia's exports stemming from sustained, substantially higher than anticipated world oil prices.

25. In the medium term, Malaysia is likely to remain vulnerable to industrial countries' business cycle, although continued implementation of sound macroeconomic policies and sustained structural reform efforts could diversify the industrial and export structure more rapidly than expected and strengthen Malaysia's resilience to shocks. Policies will continue to focus on improving the business and investment climate primarily by reforming government-linked companies, which play a major role in the Malaysian economy.

26. On the trade and investment front, import competition may be expected to intensify as domestic barriers are dismantled. Malaysia expects exports to ASEAN to grow due to further liberalization of intra-ASEAN trade. In the face of increased competition from China in goods markets, Malaysia is focusing on higher value-added exports and encouraging services exports. Malaysia recognizes that it has a role as a gateway to the ASEAN market and is offering incentives to foreign companies as it competes for FDI against regional neighbours and the much bigger economies of China and India. A flexible exchange rate regime, backed by sound economic fundamentals, may enhance investors' perception of the country and encourage inflows of capital. Domestic and foreign investment is likely to remain a key factor in bringing about Malaysia's transformation to a knowledge-based economy.