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WTO Trade Policy Review: Malaysia*

Note: This text provides brief description of the conditions foreign business will encounter in trade with Malaysia. It is based on a WTO Trade Policy Review for Malaysia, end January 2010. Readers wishing for deeper analysis should turn to the original Trade Policy Review available on the WTO website. (www.wto.org/english/tratop_e/tp_r_e/tp325_e.htm)

Trade Policy Reviews are an exercise, mandated in the WTO agreements, in which member countries' trade and related policies are examined and evaluated at regular intervals.

• ECONOMIC ENVIRONMENT

Between 2005 and 2008, Malaysia's economy continued to grow steadily. Nonetheless, the pace of growth slowed in 2008, and in first quarter of 2009 the economy deteriorated markedly, reflecting the global financial crisis and associated sharp fall in exports. The Government responded promptly, with both macroeconomic and structural policies. In 2009, the Government started to relax restrictions on foreign investment in services, including health and social services, tourism, transport, business services, and computer and related services. This relaxation reflects an intensification of the Government's efforts to promote services by, inter alia, eliminating barriers to trade and investment in services, in addition to high-tech manufacturing; net FDI inflows in 2008 were about 8% lower than those in 2005, and FDI in services accounted for only about a quarter of the total FDI. Malaysia also intends to reduce reliance on exports of manufactured goods that are dependent on semi-skilled and low-cost labour. The goal is to increase services' share of GDP from around half to 60% by 2020.

Real GDP growth in Malaysia was 4.6% in 2008, down from 6.2% in 2007. With exports declining significantly in the second half of the year, there was a decrease in the contribution of external demand to economic growth. At the same time, the consumer price index increased by 5.4%, mainly reflecting the sharp rise in commodity prices in the first half of the year. Higher commodity prices partly, if not fully, explain the

rise in the shares of agriculture and mining and quarrying in GDP and the decline in the shares of manufacturing and services.

Malaysia's development of export oriented production remains highly successful, and trade plays an important role in the economy. The share in GDP of trade (exports plus imports) of goods and services was around 184% in 2008 (compared with 212% in 2005). Between 2005 and 2008, Malaysia's gross national saving rate remained among the highest in the world, averaging about 37% of GDP; its gross domestic investment averaged some 20% of GDP. The large and growing gap between gross national saving and gross domestic investment is reflected in a corresponding current account surplus, which rose to 17.5% of GDP in 2008; the increasing gap was due to an overall rise in gross national saving and a substantial decrease in gross domestic investment, both in relation to GDP.

The Malaysian economy contracted by 6.2% in the first quarter of 2009, but it contracted less (by 3.9%) in the second quarter, against the background of higher public spending and positive growth in private consumption. Healthy foreign exchange reserves, a relatively small external debt, as well as ongoing financial and corporate sector restructuring are positive factors that have enabled Malaysia to withstand the global financial crisis. Nonetheless, the economy remains vulnerable to downturns in the United States, Europe, and Japan, its top export destinations and key sources of foreign investment. The Government's forecast for real GDP growth in 2009 is about -3%; it expects the economy to grow by around 2% to 3% in 2010. Significant challenges for Malaysia include the speed at which new domestic sources of growth are found; this depends to a large extent on gains in total factor productivity (TFP) and resolving the problem of the shortage of skills. The Government aims to meet these challenges by promoting further competition through, inter alia, unilateral trade liberalization, recognizing the importance of keeping its market open to foreign competition, and relaxing FDI restrictions. It also intends to promote structural reform, for example, facilitating the diversification of the economy by encouraging services sectors by, inter alia, reducing, if not eliminating, barriers to trade in services.

Import competition is also expected to intensify as domestic barriers are dismantled through regional/bilateral FTAs and WTO negotiations. Nonetheless, several long standing barriers to trade and foreign direct investment still constitute potentially important impediments to Malaysia's recovery from the crisis. A more liberal trade and investment regime, as has recently been adopted in services, would contribute

* Extracted from WTO Secretariat Report on Trade Policy Review of Malaysia

greatly to Malaysia's long term economic growth.

Since November 2008, monetary policy has become more accommodative. Restrictions on foreign exchange transactions have been further liberalized, and the Government has employed fiscal stimulus packages, amounting to RM 67 billion (about US\$20 billion, or 9% of GDP) since November 2008, to mitigate the negative effects of the global financial crisis. An early recovery of the Malaysian economy depends not only on prudent macroeconomic policies but also on structural reforms. The Government's main objective for the structural reform is to promote competition, enhance the services sector, and move up the value chain in manufacturing.

• INSTITUTIONAL FRAMEWORK

Malaysia's overall economic policy objectives shifted during the review period towards developing services; consequently its trade objectives also changed to reflect the Government's efforts to relax barriers to trade in services and reduce reliance on manufactured exports. Other major trade objectives include: improving market access for goods and services, promoting the global competitiveness of Malaysian exports, expanding and diversifying trade with existing partners, and exploring new markets. To achieve these objectives, the Government has unilaterally liberalized Malaysia's services sector and lowered its applied MFN tariffs. Malaysia continues to consider the WTO a priority in realizing its trade objectives. Although WTO Agreements play a pivotal role in the formulation of Malaysia's trade and trade-related policies, Malaysia also considers regional arrangements to be important, notably those involving the Association of Southeast Asian Nations (ASEAN), as well as various bilateral agreements. ASEAN, of which Malaysia is a member, has RTAs with Australia, China, India, Japan, Korea, and New Zealand. Two bilateral FTAs, with Japan and Pakistan, entered into force during the period under review, and one with New Zealand was signed in October 2009 and is expected to be implemented in 2010. Malaysia is also negotiating bilateral FTAs with Australia, Chile, India, and the United States.

The Government continues to encourage FDI, and has been relaxing foreign investment restrictions in services. Since April 2009, 100% foreign equity has been allowed in 27 services subsectors and foreign investment restrictions in some financial services have been relaxed. Also, in June 2009, the Government announced the modification of the Foreign Investment Committee guidelines on the acquisition of interests, mergers, and takeovers; this included in particular the repeal of its bumiputera (ethnic Malay) participation requirement.

• TRADE POLICY INSTRUMENTS

The tariff is the main border measure affecting imports of goods. The simple average applied MFN tariff was 7.4% in 2009; about 60% of tariff lines were duty free. Around one-fifth of tariff lines were unbound, and the simple average bound MFN rate was roughly double the applied rate, leaving considerable scope for the authorities to raise tariffs within the bound levels. However, the authorities have raised tariffs in only a few cases; these involve tariff-rate quotas, which Malaysia began applying to several tariff lines since 1 April 2008. Patterns of MFN tariff dispersion and escalation have changed little since 2006. Malaysia grants preferential access to imports from Japan, China, the Republic of Korea, Pakistan, and other ASEAN countries under preferential bilateral/regional free-trade agreements.

Various non-tariff border measures are also used as instruments of Malaysia's trade and industrial policy. About a quarter of Malaysia's tariff lines (principally with regard to animal and vegetable products, wood, machinery, vehicles and transport equipment, and arms) are subject to import licensing, most of which is non-automatic. While automatic licensing is intended for data collection, the authorities maintain that non automatic licences are mainly for sanitary and phytosanitary reasons (for those concerning agriculture). However, non automatic licensing is also used to regulate the flow of imports and to promote selected "strategic" industries that have been identified to achieve certain socio-economic objectives. During the period under review, Malaysia initiated a variety of anti-dumping actions against 10 countries and economies; in the same period, 13 Members took anti dumping actions against Malaysian products. Malaysia introduced a Safeguards Act in 2006 and Safeguards Regulations in 2007.

Import duty exemptions or drawbacks are provided for intermediate goods used in the production of exports so that the import duties do not feed through to become implicit taxes on exports. The exemptions or drawbacks greatly reduce or eliminate the implicit export taxes, but they tend to increase the complexity of the border taxation. Rebates of internal sales taxes are also used to ensure that exported goods are not taxed twice (in both Malaysia and importing country).

Explicit export taxes and export promotion measures also continue to play an important role in Malaysia's industrial policy. Export taxes and/or export licence requirements, which are applied to certain goods (such as timber), have the effect of discouraging the export of those products and reducing their domestic prices, thereby assisting downstream processing of the products concerned. Export promotion measures include export processing zones, concessionary

credits, insurance, and guarantees, as well as government-sponsored promotion and marketing assistance.

Tax incentives have long been an important instrument of Malaysia's industrial policy. Direct and indirect tax incentives apply, *inter alia*, to investments in the manufacturing, agriculture, tourism and approved services sectors, R&D, training, and environmental protection activities. No estimates have been available of total tax revenue forgone as a result of these incentives. Experience in other countries suggests that tax incentives are rarely cost-effective. The publication of estimates of tax revenues forgone as well as studies evaluating the cost effectiveness of incentives would improve fiscal transparency in Malaysia and contribute to a more effective tax policy.

Standards and standardization activities are among Malaysia's priorities for achieving developed-nation status by 2020. Malaysia aims to align Malaysian standards with international standards; in 2008, some 58% were aligned, up from 51% in 2005. This reflects the authorities' stance that, when developing or revising standards adoption of international standards is the primary option. The new alignment covers diverse sectors, e.g. Food & Agriculture, Chemicals, Mechanical engineering, Information technology, Plastics, Packaging, Rubber, Textiles, Environment management.

Preferential government procurement procedures continue to be used as a major instrument of industrial policy to favour locally owned businesses; international tenders are invited only if goods and services are not available locally. Malaysia is not a party to the WTO Agreement on Government Procurement.

Government-linked companies (GLCs) also continue to play an important role in the Malaysian economy through their involvement in the provision of essential services, such as transport, energy, telecommunications, and financial services. The Government aims to improve GLC productivity notably through the GLC Transformation Program, which aims to make them as productive as their non-GLC competitors. As in the case of government procurement, GLCs are encouraged to purchase from locally owned businesses.

Recent initiatives in regard to corporate governance include a revision to the Malaysian Code on Corporate Governance, which entered into force on 1 October 2007. Malaysia does not have a comprehensive competition law; however, it is in the process of drafting such a law.

Since 2006, the Government has further strengthened its intellectual property regime. It has also made further efforts

to improve enforcement, such as the establishment of IP courts, although problems of piracy and counterfeiting seem to remain.

• **SECTORAL POLICIES**

Malaysia has a generally liberal trade regime for agricultural products, with an average applied MFN tariff of 2.8% (WTO definition) in 2009, although some non ad valorem tariffs tend to conceal relatively high rates. Some of 6.1% of all agriculture tariff lines are subject to non-ad valorem tariffs. The average duty for agricultural products including AVEs is 18.1%. In addition, import licensing applies to some agricultural products, and rice may only be imported by BERNAS.

As a monopsony buyer of rice, BERNAS has the market power to negotiate lower prices with its suppliers. Malaysia began to apply tariff-rate quotas on agricultural products in 2008. Import tariffs are zero for mineral resources and oil and gas, which are not subject to any import licensing requirements. Export taxes, however, apply to some mineral products, and to crude oil and condensate.

Malaysia's manufacturing sector is relatively open to trade and foreign investment; the average tariff for manufacturing products was 8.7% in 2009, and 100% foreign equity participation is generally allowed. However, a notable exception is the automotive sector, which has long been sheltered from foreign competition by both tariff and non-tariff measures. Although the sector has been successful in taking a large share of the domestic market, its exports are modest, indicating a lack of external competitiveness. In October 2009, following a review of Malaysia's National Automotive Policy, the MITI announced liberalization measures; the Government intends to encourage investment, promote exports, and enhance the competitiveness of Malaysia's cars in the global market. Nonetheless, the sector continues to be protected; in particular, in response to an economic downturn after the global crisis, cash rebates are given for buyers replacing vehicles over ten years old with national brands.

The services sector has been the largest contributor to GDP. Compared with manufacturing (with the notable exception of automobiles), the sector has been relatively closed to international competition, with FDI restrictions comprising the major obstacles. However, the Government has recently been relaxing or removing foreign investment restrictions in services, although more measures are needed to promote competition.