

**BILATERAL TRADE INTENSITY RELATIONSHIP BETWEEN MALAYSIA
AND CHINA TOWARDS ECONOMIC GROWTH OF MALAYSIA**

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ABSTRACT

BILATERAL TRADE INTENSITY RELATIONSHIP BETWEEN MALAYSIA AND CHINA TOWARDS ECONOMIC GROWTH OF MALAYSIA

By

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This study investigates the significance impact of bilateral trade intensity between Malaysia and China on Malaysian economic growth from the time period of 1980 to 2009. The bilateral trade intensity, foreign direct investment and exchange rate adopted by using Error-Correction Model (ECM) examined its impacts toward economic growth. The results found that there are a cointegrating vector indicates existence of the long-run relationship among the variables in the study. The empirical results of study found that there are positive nexus among the trade intensities and economic growth in the long-run and short-run bilateral trade relationship of Malaysia and China. Meanwhile, REER has a negative long run relationship. Besides, there is positive long run relationship between FDI and GDP but no short run impact on GDP.

ABSTRAK

HUBUNGAN PERDAGANGAN INTENSITI DUA-HALA ANTARA MALAYSIA AND CHINA TERHADAP MALAYSIA PERTUMBUHAN ECONOMIC

Oleh

Lee Boon Foong

Penyelidikan ini bertujuan untuk menganalisis kepentingannya kesen perdagangan intensiti dua-hala antara Malaysia dan China terhadap pertumbuhan ekonomi Malaysia dari tempoh masa 1980 hingga 2009. Terdapat tiga pembolehubah digunakan dalam model iaitu intensiti perdagangan dua-hala, pelaburan langsung asing dan kadar pertukaran asing. Kajian in menggunakan pembetulan ralat model (ECM) untuk meyelidikkan kesan pembolehubah tersebut terhadap pertumbuhan ekonomi. Hasil kajian ini menunjukkan bahawa terdapat vektor kointegrasi wujud pada jangka masa panjang antara pembolehubah-pembolehubah. Di samping itu, keputusan kajian menunjukkan perdangangan intensiti dua-hala and pertumbuhan ekonomi mempunyai hubungan positif dalam jangka masa panjang mahupun jangka masa pendek. Sementara itu, kadar pertukaran asing mempunyai hubungan negatif terhadap pertumbuhan ekonomi dalam jangka masa panjang. Sebaliknya, pelaburan langsung asing mempunyai hubungan positif terhadap pertumbuhan ekonomi tetapi tiada kesan terhadap pertumbuhan ekonomi dalam jangka pendek.

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CHAPTER ONE

INTRODUCTION

1.0 Introduction

At first, backgrounds of the study will be discussed in this section where Malaysian economy and trade policies introduced in this chapter. Besides that, China has selected as a bilateral trade partner in this study to examine the Malaysia-China trade relation, therefore trade performances of China will be discussed following. On the other hand, the economic integration between Malaysia and China also included in this study in order to explore the trade performances of Malaysia after the rise of China in the sample period. Furthermore, the problem statement, objective of study, significant of study and scope of study will be discussed.

1.1 Malaysia's Economy¹

Malaysia is an upper middle-income country that has been experienced structural transformation of the economy from agriculture sector into manufacturing and services sector since 1970s. Due to the unstable of the commodity price, lower productivity and scarcity of natural resources, Malaysia transformed the economy from producer raw materials into an emerging multi-sector economy. In Ninth Malaysia Plan, Malaysia introduced value-added production chain in order to attract

¹ This section refers to The World Factbook (2010).

investment in high technology industries, medical technology, and pharmaceuticals and support long-term growth of economy. Malaysia has gain profit from the exporting oil and gas due to the high world energy price even though Malaysia facing rose in cost of domestic gasoline and diesel fuel and strained government financial. This was induce government's subsidies of Malaysia had declined with the purpose to reduce Malaysia's debt burden. After the financial crisis had seriously hit Malaysia's economy in 1997, Malaysia's Federal Bank has play important role in reduce Malaysia economy exposure to riskier of financial crisis by healthy foreign exchange reserves and well-developed regulatory.

However, Malaysian export was affected by the subprime mortgages crisis which is demand in consumer good was declined due to the crisis. The decline in exports was significantly affected the economic growth 2009. The stimulus packages that introduced by government was minimize the impact of the global contraction on domestic economy and final quarter of 2009 was showing the signs of recovery from subprime mortgage crisis. The Tenth Malaysia Plan was introduced by previous Prime Minister Najib to outlining new reforms for Malaysia in June 2010. Some of the reforms in the services sector have been introduced to attract foreign direct investment which has stagnated in recent years (The World Factbook, 2010).

1.1.1 Malaysia Trade Policies²

In the 1950s and 1960s, Malaysia's policy thrust was to continue with the colonial open door policy stance relating to trade and industry, while attempting to

² This section refers to Athukorala (2005) and Alavi (2001).

redress ethnic and regional economic imbalances through rural development schemes and the provision of social and physical infrastructure. Therefore, import-substitution industrialization (ISI) strategy was implementing with limited state intervention to provide protection through auxiliary support facilities and tax incentives. The ISI strategy was contribute to the development process which diversify the economy, reduced excessive dependence on imported consumer goods, utilized some domestic natural resources, created opportunities for employment and contributed to economic growth. Notwithstanding this strategy contributed to economic growth, but the disadvantages of adopted ISI strategy such as reduction in unemployment and the anticipated spillover of surplus production under import substitution into export market did not take place exist. Thus, Malaysian government switched from ISI to export-orientation industrialization (EOI) strategy.

The New Economic Policy (NEP) came into effect in 1970 with two main objectives which are achieves national unity through eradication of poverty and restructuring of society t eliminate the identification of race with economic function after occurred the racial tensions in 1969. NEP has a significant emphasis on EOI aims to accelerate high economic growth, reducing unemployment and giving more opportunities for wealth ownership to indigenouse people in particular. There are two sub-sector which are electronics and textiles have a significant growth contributed to Malaysian export expansion in manufacturing output growth assist with the establishment of Free Trade Zones (FTZ). However, Malaysian government discovers that the export of manufactured goods was limited to a narrow range of products and minimum development in the manufacturing sector.

Consequently, Malaysian was moved to second round of ISI strategy that heavy emphasis on the promotion of heavy industries through direct government involvement in the first half of 1980s. The “Look East Policy” was introduced in this period due to the inspired by the alleged success of Japan and South Korea in their heavy industrialization. The Heavy Industries Corporation of Malaysia (HICOM) as a public sector holding company was formed in 1980 with the aim to venture into partnership with foreign companies in setting up industries in areas such as petrochemicals, iron and steel, cement, paper and paper products, machinery and equipment, general engineering, transport equipment, and building materials. These industries had experienced comparative disadvantages due to the existence of several problems such as high costs of production and management, high technical barriers to entry and long learning periods in these periods. In the early 1990s, Prime Minister Mahathir comes up with a blueprints policy (the Vision 2020 statement) for transforming Malaysia to a developed country status by the year 2020 (Athukorala, 2005).

1.2 China’s Economy

China’s economy was reforms from centrally planned system to market-oriented economy started in the late 1970s. Since China announced its open door policy to the world in 1979, China has become very dependent on the world economy for markets as well as for inputs, products, and technology. The ratio of total export to gross domestic products (GDP) of the Chinese economy increased from 9 percent in 1980 to more than 20 percent in the 1990s. Meanwhile, the import dependence ratio

also reveals similar trends with export which rose from 10 percent to 17 percent for the same period. The increased in trade volume has definitely stimulated China's economic growth from 459.29 billion of Yuan in 1980 to 30,067 billion of Yuan in 2008. After restructuring China's economy, the increased of the economic growth nearly 65-fold indicates that the successful and efficiency gain from the China's reforms.

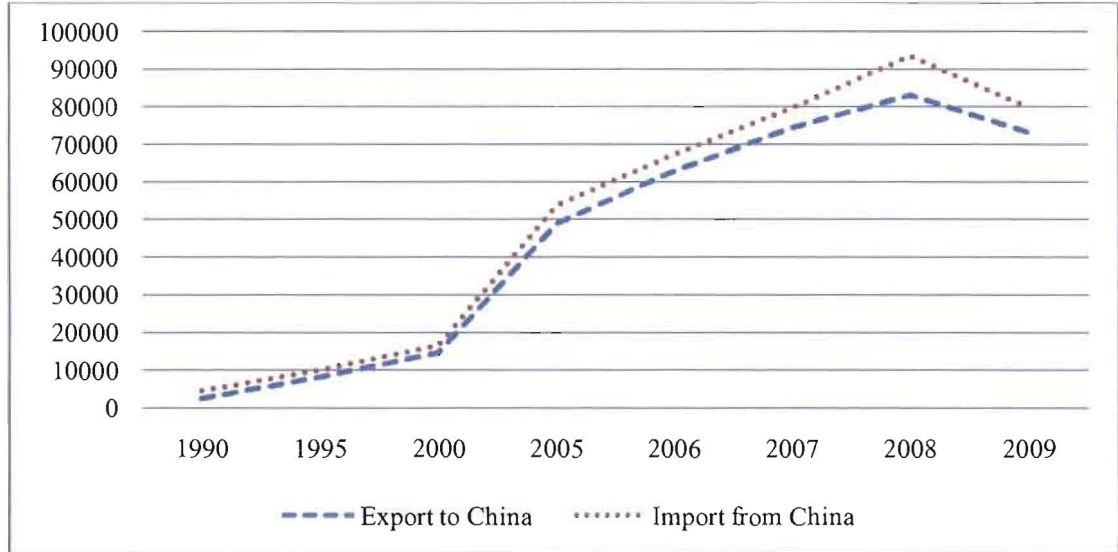
The trade structure of the China has shown the changes after the economic reforms in export and import trends. China is the country that focuses on exporting and importing agriculture products in the early 1980 rather than manufacturing products. However, the trade pattern seems has changes after the introduced of open door policy. The manufacturing products had replace the primary products in the trends exports and yet similar for the imports. Other than that, a large portion of China's exports is made up of processed products that required labor-intensive assembling and packaging with modest degree of value-add using intermediate parts and components imported from its neighbors (Tong and Lim, 2009). Thus, thriving of trade expansion was lead the China become the world's third-largest trading nation in 2004 where the total foreign trade volume surpassed \$1 trillion in November 2004 (The US-China Business Council, 2010).

There are two important factors contributed to the export-oriented industrialization in China which are rural reform and foreign directs investments. China was adopt market liberalization policies by abolish mandatory export plan and export subsidies in 1991. Moreover, the Chinese government introduced freeing more foreign exchange for no mandatory import by relaxing the import plan in 1994

(Palanca, 2000). Thus, China’s liberalization reforms and structural changes in the domestic economy had lead the foreign direct investment rapidly growth in recently. On the other hand, the potential market and the abundant supply of low cost labor are the important reasons attracting foreign direct investment. Annual inflow of foreign direct investment rose to nearly \$108 billion in 2008. Reflecting the global financial crisis, foreign direct investment fell for the first 7 months of 2009, and then started to rebound. Foreign direct investment for 2009 was down moderately but was still substantial at about \$90 billion (The World Factbook, 2010).

After China opens the market and practice in the international trade, China establishes a close relationship with ASEAN countries such as trade, information and telecommunication, agricultural and investment. Merchandise trade between the ASEAN-5 and China had a significant growth after ASEAN-5 countries discovers their enable gain trade advantages from China’s rapidly growing market as well as its industrial growth (Palanca, 2000).

Figure 1: Trends of Bilateral Trade between ASEAN-5 and China from 1990 to 2009



Notes: All figures are in US\$ million. Data obtained from Asian Development Bank (ADB), 2010.

The Figure 1 had shown the trends of the trade integration between ASEAN-5 and PRC within 20 year. At first, the share of exports to China in ASEAN-5's total exports was only around three percent but it began increase sharply after 1997, particularly after 2002 (Tong and Lim, 2009). According Tong and Lim (2009), bilateral trade between ASEAN-5 and PRC has been growing after ASEAN established official contact with China in 1991. However, China's trade with ASEAN-5 began to register significant growth after Asian financial crisis and particularly after 2002. From 1990 to 2009, import of ASEAN-5 was shown a sharply increased nearly 17-fold from US\$4,598 million to US\$79,661 million while the export increased nearly 29-fold from US\$2,583 million to US\$73,218 million. In the early 1990, the foreign direct investment began inflow into PRC was result in the changed of the trade pattern of the China. Between 1990 and 2000, the rate of increase of bilateral trade rose rather gradual. After 2000, the export and import was rose up sharply and continuously until 2009.

While both ASEAN's exports to and imports from the PRC have increased in tandem, the latter has consistently exceeded the former, ensuring that the PRC has enjoyed a persistent trade surplus with ASEAN (Srivastava and Rajan, 2004). The figure showed that the import from China is relatively high than export to China from 1990 to 2009. This was indicates that the China's enjoyed a persistent trade surplus with ASEAN-5. However, not all the ASEAN-5 practices the trade deficit within 20 years. Singapore, Malaysia and Thailand are the nation practices export-oriented which heavily dependence on export especially trade with China after 2002. Moreover, Singapore is the nation as a larger trade partner among ASEAN-5 countries even ASEAN countries that occupy the larger share on the import from and export to China.

The Singapore's export and import consists 31 percent and 46 percent of the total share of the total export and import ASEAN-5 in 1990 respectively. In 2009, the share of the total export and import ASEAN-5 same with 1990 which Singapore's export and import occupy the larger share with 36 percent and 33 percent respectively. The changes trade pattern among ASEAN-5 countries and China was reveals in the increased of bilateral trade where focused in basic manufactures and machines and equipment.

Nowadays, china as a second-largest economy in the world after the United States, although in term of per capita China is still lower middle- income nations. In 2009, the economic downturn reduced foreign demand for Chinese exports for the first time in many years after restructuring. The government intended to continue reforming China economy by emphasized on domestic consumption in order to make China less reliable on foreign exports to boost up GDP in the future (The World Factbook, 2010).

1.3 Economic Relation between Malaysia and China

Nowadays, Malaysia has 35 years of trade relationship with China after established diplomatic relations in 1974. Malaysia enjoys excellent relations with China and relationships between two nations have progressed substantially over 35 years. Moreover, China as one of the important Malaysia trading partner for now and even for the foreseeable future. Recently, trade relations between Malaysia and China had dramatically strengthened after implement ACFTA. From 1974 to 2008,

Malaysia-China bilateral trade grew significantly at an average annual rate of 16.8 percent from less than US\$100 million to around US\$40 billion (Lim, 2009).

The bilateral trade between Malaysia and China was significantly growth after the Asian financial crisis 1997 which China's willingness to provide assistance to the ailing ASEAN economies during the crisis despite its developing status impressed most ASEAN leaders. Consequently, ASEAN countries change their perception of the "China threat theory"³ and facilitated ASEAN's countries greater economic integration with China. The changes of the bilateral trade trends among ASEAN's countries and China was shown the significant growth and proven through average annually grew rate from 1991 to 1996 with about 16 percent to 25 percent in the periods 2002 to 2006 (Tong and Lim, 2009). Moreover, Malaysia was picking up speed after China's accession to the World Trade Organisation (WTO) in 2002 and the conclusion of the ASEAN-China Free Trade Agreement (ACFTA) in 2003 (Lim, 2009). Therefore, China becomes fourth largest trading partner of Malaysia by the end of 2008.

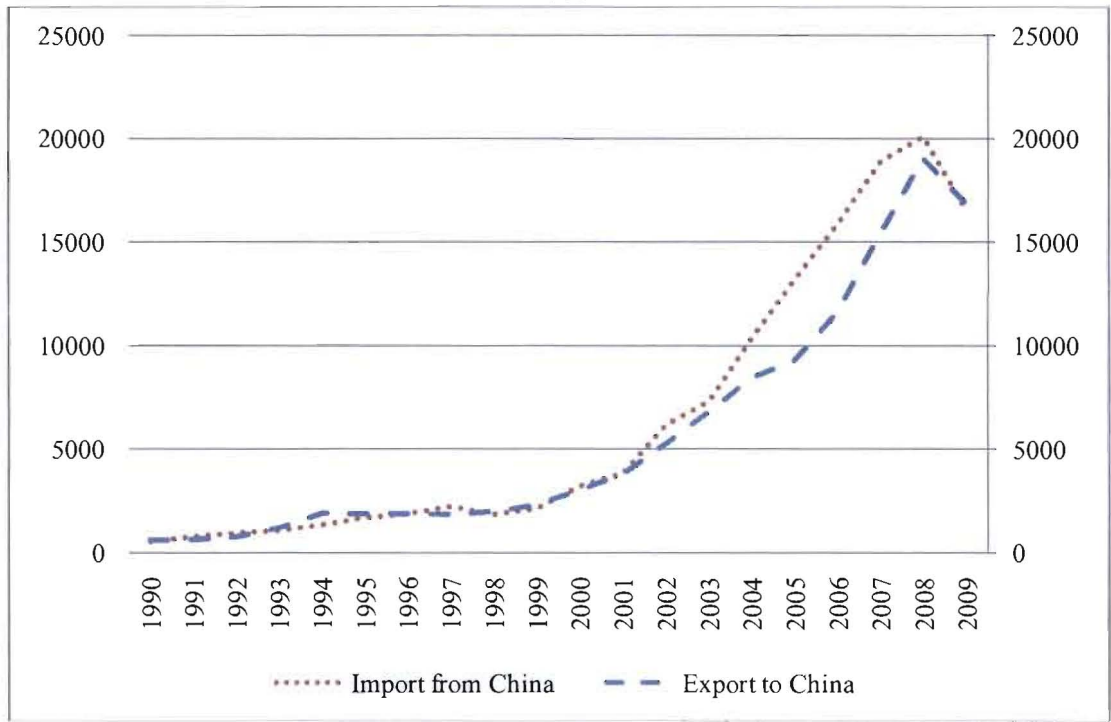
Notwithstanding rise of China's economy will bring challenges to the Malaysia economy in manufacturing sectors and foreign direct investment, Malaysia's previous Prime Minister Najib still aims to take advantage of China's "go global" economic strategy by encouraging Chinese companies to invest in Malaysia. However, the growth of Chinese investment in Malaysia is quite sluggish. On the other hand, the establishment of a bilateral currency swaps agreement between Malaysia and China was concluded in February 2009 in order to promote bilateral trade and investment for

³ The "China threat" theory was used to explain the animosity harboured by ASEAN countries towards China's rise as not only a security threat, but an emerging competitor for foreign capital.

economic development between Malaysia and China by provide about RM40 billion or 80 billion Yuan for a period of three year.

Furthermore, the establishment of ACFTA also accelerates the growth and deepening of Malaysia-China economic integration due to the significant reduced in import tariffs. In fact, under the early harvest scheme, china has reduced import tariffs on more than 7,000 products from ASEAN which the tariffs on more than 60 percent of all the products had been eliminated. The bulk of duties on goods entering China from ASEAN countries will be reduce to zero by the end of 2010. In the Malaysia context, the tariff reduction indicates that more than 9,000 products imported from China to Malaysia would also be duty free. The trend of bilateral trade between Malaysia and China before and after the establishment of ACFTA was show as below.

Figure 2: Trends of Bilateral Trade between Malaysia and China from 1990 to 2009



Notes: All figures are in US\$ million. Data obtained from Asian Development Bank (ADB), 2010.

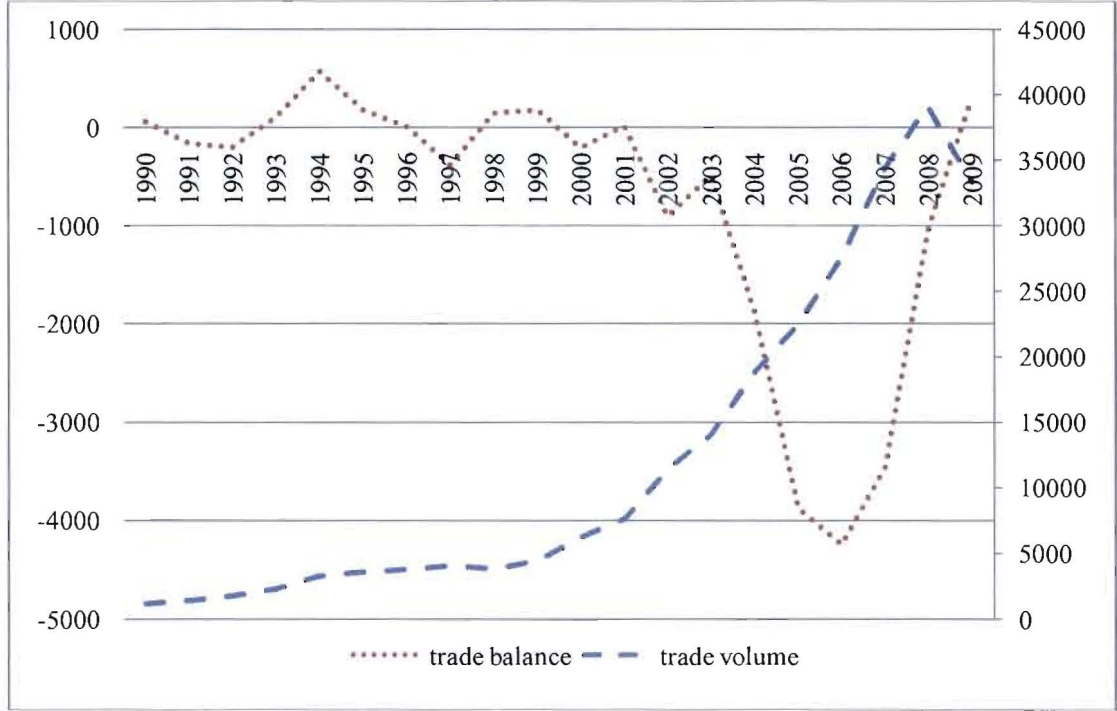
The Figure 2 reveals trends in bilateral trade between Malaysia and China between 1990 and 2009. The trade relationship between Malaysia and China had strengthened within 20 years. The merchandise trade was exposed trends continue rose starts from 1990 to 2009. The export of Malaysia was shown a sharply increased from US\$619 million to US\$16,840 million which nearly 27-fold within 20 years. Other than that, the import Malaysia also has similar trends with export which is rose sharply nearly 29-fold from US\$561 million to US\$16,533 million.

However, bilateral trade pattern of Malaysia has changed recently which the import of Malaysia is greater than the export of Malaysia. The figure was clearly shown the volume of export and volume of import from 1990 until 2001 are almost same. At first 12 year, Malaysia practices the export activities rather than import activities in the bilateral trade relationship between China. The export reveals slightly higher trends compare to the import Malaysia along the 12 years. Conversely, the trade pattern had been changes which the Malaysia more reliance on the import from China rather than export. After the ACFTA employed, import from China dramatically increased due to the reduction trade barrier between Malaysia and China. The figure was proven that import Malaysia rose 334.62 percent from US\$3,804 million in 2001 to US\$16,533 million in 2009. This indicates that the products import from China was cheaper than domestic products relatively. Currently, electrical and electronic products, and commodities, primarily palm oil occupy close to 70 percent of Malaysia export to China. Meanwhile, Malaysia imports from China consisted electrical and electronic products, machinery, appliances and parts (Lim, 2009).

1.4 Problem Statement

Despite that Malaysia’s previous Prime Minister, Abdullah Badawi view the rise of China as an opportunities of Malaysia rather than treat to gain advantages in bilateral cooperation and thus growth together with the China, there are still substance same problem with the trade relationship between Malaysia and China. Malaysia has a large and growing trade deficit with China even though the trade volumes dramatically increase after China introduces the ‘open door policy’ in 1980s. Moreover, the gap of the trade deficit reveals growing phenomena after established of ACFTA. The issue that Malaysian domestic market had experienced difficulties and challenges to compete with Chinese manufactured goods in terms of price and quality. The Figure 3 shows the trade volume and trade balance of the bilateral trade among Malaysia and China.

Figure 3: Trade Volume and Trade Balance of the Bilateral Trade among Malaysia and China.



Notes: All figures are in US\$ million. Data obtained from Asian Development Bank (ADB), 2010.

The figure reveals that the negative relationship between trade volume and trade deficit of bilateral trade among two countries. The figure clearly reveals gaps between the trade volume and trade deficit was growing significantly since the establishment of ACFTA. Malaysia and China had a significant trade integration after established ACFTA where Malaysia is highly interdependence on the immediately products import from China especially manufacturing goods that relatively cheaper than domestic market. Due to this comparative disadvantage, the import of Malaysia is relatively higher than export of Malaysia and this could be explained trade deficit in Malaysia was largely contributed by the electronic products which accounted more than 60 percent of the Malaysia import and export (Tong and Li, 2010). The immediately products imported from China will be added value in Malaysia as final products and exported to China. The reliance of the China in the immediately product is one of the reasons Malaysia stagnated at middle income country and unable achieve the high value added economy.

Other than that, the rising of FDI inflow to China could be an economic threat to Malaysia's trade with the world and had competition relations in term of FDI. Malaysia had been loss the attractiveness of FDI after the Asian Financial Crisis since the FDI dropped from 6.4 percent of its GDP from 1990 to 1996 to 1.2 percent in 2002 (Poon, 2004). According to the World Investment Report 2010, FDI fallen 81 percent from US\$7.32 billion in 2008 to just US\$1.38 billion last year and the performances of FDI in 2009 is less than half of the annual average FDI inflow between 1995 to 2005. On the other hand, lack of ability in research, design and development of new products were leads Malaysia lose the attractiveness of FDI. Similarly, Malaysian industries do not keep pace with advanced technologies and development compare to other countries.

For instances, Malaysia industries do not engage in the production of complete sets of machinery or other manufactured products. In contrast, China is relatively more advanced in heavy industries which proven by the regularly practice in exporting heavy mechanical equipment to other countries (Tong and Li, 2010).

Consequently, the implementing of ACFTA such as reduce the tariffs of the Malaysia until zero on 90 percent of import goods will critically distort the domestic market due to the comparative disadvantages. The reductions of tariffs in bilateral trade between Malaysia and China will lead the Malaysia lost the competitiveness to compete with the China's industries that enjoys the technologies advantages in certain industries. The competitiveness of the Malaysia's domestic firms is one of the main concern that determined whether the ACFTA bring the mutually benefit to the both of the countries. Therefore, the long-run relationship between the trade growth and the economic growth as main attentions to justify whether the trade integration with China will gains a positive or negative relationship toward Malaysia economic growth.

1.5 Objectives of Study

1.5.1 General Objective

The general objective of the study is intended to investigate the bilateral trade intensity between Malaysia-China toward Malaysia economic growth from 1980 to 2009. The purposed of the study is exploring the change of the bilateral trade intensity and its impact on the Malaysia growth.

1.5.2 Specific Objectives

The specific objectives of the study are:

- i. To study the impact of changes in trade patterns among Malaysia-China toward Malaysia economic growth.
- ii. To investigate the trade relationship of the Malaysia and China after China imposed the open door policy in 1980s.
- iii. To identify the long-run relationship of the Malaysia economic growth and its determinants.

Other control variables in the specification are foreign direct investment (FDI) and real effective exchange rate (REER). These variables are included in this research because past studies and economic theories have pointed out the importance of these variables as a stimulant for economic growth and to get a more accurate result. It is also to avoid the mistake of missing variables or big errors (Baharom *et al.*, 2008).

1.6 Significance of Study

This study analyzes the bilateral trade intensity of Malaysia and China to examine the impact of the close economic integration among Malaysia and China toward trade pattern among Malaysia. By investigating the bilateral trade of Malaysia against China, the economic growth of Malaysia emphasized in this study to identify whether the trade integration Malaysia-China will bring the benefits on Malaysia growth. If the empirical results show the positive significant relationship among the

bilateral trade intensity and growth, it implied that the closer bilateral trade between Malaysia-China might motivate Malaysia growth.

This research will be the sources to the government of Malaysia to further comprehend the causal relation between the changed of the trade pattern and economic growth. Moreover, the result of the empirical result provide evidence that enable government to understand the potential relationship of trade between Malaysia and China whether closer trade integration Malaysia-China will bring mutual benefits toward both country or harm each other. Indirectly, the result will contribute to some government policy in conducting the trade with China such as grant up the protection on the comparative disadvantages domestic producers and strengthen the trade relationship Malaysia-China in the Malaysian industry that enjoy the comparative advantages in the particular relationship.

Meanwhile, the empirical outcomes of the study might provide reader some insight on the crucial trade relationship between Malaysia and China towards Malaysia's economic growth. Besides, the trade-led growth model that adopted in this study will help them understand further how the trade driven growth.

1.7 Scope of Study

This present study is organized in the following manner. In the chapter two, the summary of the previous researches and studies that are relevant to the bilateral trade and trade intensity. In chapter three, a theoretical model is presented which

forms the basis empirical model for testing the trade intensity of the ASEAN-5 countries after implementing ACFTA. Moreover, the empirical estimation procedures and data description will be discussed in this chapter. The chapter four, the empirical results and findings will be presented and followed by the analysis of the results. The empirical results will be discussed in chapter five and lastly the conclusion and recommendations are drawn in the closing chapter.